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Proposed Statement of Position: Identifying and Accounting for Real Estate Loans that Qualify as Investments in Real Estate, 6/7/93; Exposure Draft (American Institute of Certified Accountants), 1991, June 7

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

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June 7, 1993

Mr. J.T. Ball
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

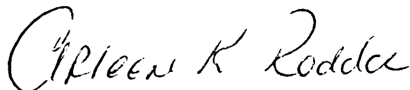
File 3455

Dear Mr. Ball:

Enclosed for review by the FASB is a draft exposure draft of the proposed statement of position, *Identifying and Accounting for Real Estate Loans That Qualify as Investments in Real Estate*, which was approved (13 yes, 1 abstain, 1 absent) for exposure at the March 1993 AcSEC meeting, subject to negative clearance of suggested changes.

Please inform Clifford Schwartz, the senior technical manager on the project, of the Board's action on the proposed exposure draft. Representatives of the accounting standards division are available to meet with you or your staff to discuss the document at your convenience.

Sincerely,



Arleen K. Rodda
Director
Accounting Standards

AR:chs

cc: Accounting Standards Executive Committee (1120)
Task Force on ADC Arrangements (3455)
Real Estate Committee (4210)

DRAFT
6/7/93

DRAFT EXPOSURE DRAFT

PROPOSED STATEMENT OF POSITION

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

DATE, 199X

Prepared by the Task Force on ADC Arrangements,
Accounting Standards Division,
American Institute of Certified Public Accountants

Comments should be received by Date, 199X, and addressed to
Clifford H. Schwartz, Senior Technical Manager,
Accounting Standards Division, File 4210.SY.
AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775

SUMMARY

This proposed statement of position (SOP) applies to all entities that make or acquire real estate loans. It provides guidance on identifying and accounting for real estate loans that qualify as investments in real estate for financial reporting purposes. Such loans may include real estate acquisition, development, and construction (ADC) loans, loans on operating real estate, convertible mortgages, and shared appreciation (participating) mortgages. It requires real estate loans that do not meet certain criteria to be classified and accounted for as investments in real estate. For purposes of applying this proposed SOP, a loan that is classified and accounted for as an investment in real estate is considered to be the equivalent of an investment by the lender in a hypothetical partnership, the assets of which include the subject real estate.

This proposed SOP does not apply to (1) troubled debt restructurings, foreclosures, or in-substance foreclosures relating to real estate loans that have been accounted for as loans using the criteria set forth in this proposed SOP, (2) debtors, (3) real estate loans that result from the sale of real estate by the lender, (4) permanent mortgage real estate loans on one-to-four family residential properties, or (5) small real estate loans that are evaluated for impairment by the lender in the aggregate.

The proposed SOP supersedes the guidance in the February 10, 1986, *AICPA Notice to Practitioners on ADC Arrangements* (the third Notice), which was carried forward in the AICPA's Accounting Standards Executive Committee's (AcSEC) Practice Bulletin No. 1,

Purpose and Scope of AcSEC Practice Bulletins and Procedures for Their Issuance.

This proposed SOP should be applied to real estate loans entered into after December 31, 1994. Earlier application is encouraged.

DRAFT
6/7/93

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

INTRODUCTION

1. This proposed statement of position (SOP) provides guidance on identifying and accounting for real estate loans that qualify as investments in real estate for financial reporting purposes. Such loans may include real estate acquisition, development, and construction (ADC) loans, loans on operating real estate, convertible mortgages, and shared appreciation (participating) mortgages. The proposed SOP would supersede the guidance in the February 10, 1986, *AICPA Notice to Practitioners on ADC Arrangements* (the third Notice), which was carried forward in Practice Bulletin No. 1 of the AICPA's Accounting Standards Executive Committee (AcSEC), *Purpose and Scope of AcSEC Practice Bulletins and Procedures for Their Issuance*, and would incorporate the consensus of the FASB Emerging Issues Task Force Issue (EITF) No. 86-21, *Application of the AICPA Notice to Practitioners Regarding Acquisition, Development and Construction Arrangements to Acquisition of an Operating Property*[1].

BACKGROUND

2. During 1986, AcSEC approved the third Notice, which stated that financial institutions should account for ADC arrangements that meet certain criteria as investments in real estate rather than as loans. The third Notice superseded two previous Notices to Practitioners

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[1] 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.

on the same subject--the first Notice, which was published in the November 1983 *Journal of Accountancy*, and the second Notice (a supplement to the first), which was published in the November 26, 1984, *CPA Letter*.

3. In EITF Issue No. 84-4, *Acquisition, Development, and Construction Loans*, the FASB's Emerging Issues Task Force initially reached a consensus that the guidance in the first Notice was adequate. Several members of the EITF subsequently indicated, however, that there was considerable diversity in the application of the first and second Notices. That diversity led to the publication of the third Notice, which resolved the issue to the satisfaction of the EITF at that time.

4. As issued, the third Notice applied only to financial institutions and included only those ADC arrangements providing for participation by the lender in expected residual profit. In EITF Issue No. 86-21, *Application of the AICPA Notice to Practitioners regarding Acquisition, Development, and Construction Arrangements to Acquisition of an Operating Property*, a consensus was reached that, although the third Notice was issued to address ADC arrangements of financial institutions, preparers and auditors should consider the guidance contained in the third Notice in accounting for shared appreciation mortgages, loans on operating real estate, and ADC arrangements entered into by enterprises other than financial institutions.

5. Although many entities purported to follow the guidance in the third Notice, AcSEC's recommendations for identifying and accounting

for loans that qualify as investments in real estate were not being applied consistently in practice. It became apparent that additional clarification and guidance were needed to achieve consistent practice and to reinforce the broad principles set forth in the third Notice.

SCOPE

6. This proposed SOP applies to all entities that make or acquire real estate loans. This proposed SOP does not apply to troubled debt restructurings, foreclosures, or in-substance foreclosures relating to real estate loans that have been accounted for as loans using the criteria set forth in this proposed SOP. The relationship of those events to this proposed SOP is discussed in paragraph 20 of this proposed SOP. This proposed SOP also does not apply to (1) debtor accounting for real estate borrowings, (2) real estate loans that result from the sale of real estate by the lender (which are covered by FASB Statement No. 66, *Accounting for Sales of Real Estate*), (3) permanent mortgage real estate loans on one-to-four family residential properties, or (4) individual small real estate loans that are evaluated for impairment by the lender on an aggregate basis.

7. In addition, the proposed SOP does not apply to entities, such as investment funds and pension plans, that report on a current value basis. Those entities should refer to the relevant literature on accounting for the current value of loans or real estate.

8. Real estate loans that are classified and accounted for as investments in real estate in accordance with this proposed SOP

should not be considered loans for purposes of applying FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, and FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*. Paragraphs 18 to 22 of this proposed SOP discuss changes in the classification of real estate loans subsequent to inception.

9. For purposes of applying this proposed SOP, a loan that is classified and accounted for as an investment in real estate is considered to be the equivalent of an investment by the lender in a hypothetical partnership, and the real estate subject to the loan is considered to be the real estate project of the hypothetical partnership. The guidance in this proposed SOP does not apply to the separate financial statements of the project that otherwise might be prepared.

DEFINITIONS

10. This proposed SOP uses the following terms with the definitions indicated:

a. *Inception of a Real Estate Loan*. The date of the real estate loan or loan commitment date, if earlier. For purposes of this definition, a commitment should be in writing, signed by the parties in interest to the transaction, and should specifically set forth the principal provisions of the transaction. If any of the principal provisions are yet to be negotiated, such a preliminary agreement or commitment does not qualify for purposes of this definition.

b. *Sweat Equity*. A contribution of services performed subsequent to the inception of the real estate loan in lieu of an initial investment of cash or property.

CONCLUSIONS

11. The following conclusions should be read in conjunction with the "Discussion of Conclusions," beginning with paragraph 43 of this proposed SOP, which explains considerations that were deemed significant by members of AcSEC in reaching the conclusions.

CLASSIFYING REAL ESTATE LOANS

12. A real estate loan should be accounted for as a loan if it has one or more of the following characteristics at inception:

a. The borrower has an equity investment that is substantial to the project and that is not funded by the lender. For purposes of this proposed SOP, an equity investment of the borrower should not be considered substantial unless the amount or percentage meets the minimum initial investment criteria set forth in paragraphs 53 and 54 of FASB Statement No. 66. (Paragraph 51 of this proposed SOP provides additional guidance for determining whether a borrower's initial investment is substantial.) That investment may be in the form of cash payments by the borrower or a contribution to the project by the borrower of land (without considering value expected to be added by future development or construction), developed real estate, or other assets. The value attributed to

contributions of land, developed real estate, or other assets should be the fair values of the respective assets net of any encumbrances, such as superior liens. A contribution of recently acquired real estate by the borrower should not be valued at an amount greater than the borrower's acquisition cost.

b. The lender has recourse to substantial tangible, salable assets of the borrower, other than the real estate subject to the real estate loan and has the ability to control the disposition of the assets by the borrower. (In evaluating the assets to which the lender has recourse, "substantial" has the same meaning as that used in subparagraph (a).) Those assets have a determinable sales value and are not pledged as collateral under other loans or financing arrangements. To the extent that those assets previously have been pledged as collateral under other loans or borrowing arrangements, only the value in excess of the amounts pledged under those other loans or borrowing arrangements should be considered in applying this subparagraph.

c. The borrower has provided the lender with a letter of credit or qualifying surety bond for a substantial portion of the loan from a creditworthy, independent third party, and the letter of credit or surety bond is irrevocable by the third party during the entire term of the loan. (In evaluating the letter of credit or qualifying surety bond,

"substantial" has the same meaning as that used in subparagraph (a).)

d. A takeout commitment for the full amount due the lender has been obtained from a creditworthy, independent third party. Conditional takeout commitments should not be considered characteristics of a loan for purposes of applying this proposed SOP, unless it is probable that the conditions will be met.

e. Noncancelable sales contracts, leases, or lease commitments from creditworthy, independent third parties exist that will provide sufficient net cash flows on completion of the real estate project to service normal loan amortization of principal and a market rate of interest for a reasonable amount of time. A conditional sales contract or conditional lease commitment should not be considered characteristics of a loan for purposes of applying this proposed SOP, unless it is probable that the conditions will be met.

f. A qualifying guarantee is in place, as described in paragraph 14 of this proposed SOP.

Otherwise, the entire loan arrangement should be classified and accounted for as an investment in real estate. If the borrower has the right to obtain a release from any one of the loan characteristics described in (a) to (f) above within the existing terms of the real estate loan, that characteristic should not be considered a

loan characteristic in determining the initial classification of the real estate loan as either a loan or an investment in real estate.

Sweat Equity

13. Sweat equity should not be considered in assessing whether a borrower's equity in a real estate loan is substantial.

Guarantees

14. Subpart (f) of paragraph 12 of this proposed SOP identifies a qualifying guarantee as one of the characteristics of a loan. As described in paragraph 53 of this proposed SOP, some real estate loans include guarantees of the borrower, a third party, or both. The existence of a guarantee by itself rarely provides sufficient evidence for concluding that a real estate loan should be accounted for as a loan. Such a conclusion could, however, be reached if all of the following conditions are met:

a. The guarantee covers a substantial portion of the real estate loan. (In evaluating whether the guarantee covers a substantial portion of the real estate loan, "substantial" has the same meaning as that used in paragraph 12(a) of this proposed SOP.)

b. The guarantor is expected to be able to perform under the guarantee and such ability can be reliably measured.

c. The guarantee is enforceable in the applicable jurisdiction.

d. An intent to enforce the guarantee can be reasonably demonstrated.

Multiple Funding Arrangements

15. A lender that makes a real estate loan may make or commit to make another real estate loan to the same borrower on the same real estate at or near the same time as the initial loan. The classification of such real estate loans should be determined in the aggregate for purposes of applying this proposed SOP.

16. In addition, a lender that makes a real estate loan may, at or near the same time, acquire a direct ownership interest in the same real estate or an interest in a partnership or other entity that owns an interest in the real estate. All ownership interests in real estate should be accounted for as ownership interests in conformity with SOP 78-9, *Accounting for Investments in Real Estate Ventures*. The classification of the real estate loan portion of the transactions should, however, be determined as described in paragraph 12 of this proposed SOP and in the preceding paragraph.

CHANGES IN CLASSIFICATION

17. After a loan is initially classified as either a loan or as an investment in real estate, its classification generally would not change unless the conditions discussed in paragraphs 18 to 22 of this proposed SOP are met. In particular, paragraph 22 of this proposed SOP prohibits loans that initially are classified as loans from being reclassified as investments in real estate unless the underlying loans are renegotiated. Further, guidance is provided

in paragraph 20 of this proposed SOP on loans that initially are classified as loans and that subsequently are restructured under troubled circumstances.

18. A real estate loan that initially is classified as an investment in real estate should be reclassified as a loan if, as a result of the periodic reassessment, the arrangement is found to meet one or more of the characteristics of a loan described in subparts (a) to (f) of paragraph 12 of this proposed SOP. An example would be a loan in which a takeout commitment for the full amount due the lender has been obtained from a creditworthy, independent third party lender subsequent to the inception of the real estate loan. The arrangement would thus meet at least one of the characteristics of a loan described in paragraph 12 of this proposed SOP.

19. In assessing whether the characteristic in subpart (a) of paragraph 12 is met subsequent to the initial classification, no value should be attributed to unrealized appreciation in the value of the real estate. Such appreciation should be considered solely in the context of noncancelable sales contracts or leases or lease commitments (i.e., by reference to subpart (e) of paragraph 12 of this proposed SOP). A change in classification from an investment in real estate to a loan should be accounted for prospectively. AICPA Practice Bulletin 6, *Amortization of Discounts on Certain Acquired Loans*, provides guidance on accounting for the difference between the carrying amount of a loan and its face amount.

20. Deteriorating economic prospects for a real estate project subject to a real estate loan may cause the lender to restructure

the loan under troubled circumstances or to foreclose on the underlying real estate. Such deterioration also may indicate that an in-substance foreclosure has occurred. If one of those events occurs for a real estate loan that is classified as a loan, the lender should account for the arrangement in accordance with FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, SOP 92-3, *Accounting for Foreclosed Assets*, or AICPA Practice Bulletin No. 7, *Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed*, as amended by AICPA Practice Bulletin No. 10, whichever is applicable.

21. If, however, one of the events discussed in paragraph 20 of this proposed SOP occurs for a real estate loan that is classified and accounted for as an investment in real estate, a modification of the terms of the loan should be considered and reported on as an amendment to the hypothetical partnership agreement, as described in paragraph 23 of this proposed SOP, and a foreclosure should be accounted for as the surrender by the owner-partner of its interest in the hypothetical partnership.

22. An arrangement that is initially classified as a loan subsequently should be reclassified as an investment in real estate if none of the characteristics in subparts (a) through (f) of paragraph 12 are met solely due to a renegotiation of the terms of the loan other than in connection with a troubled debt restructuring. For example, a lender might renegotiate the terms of a loan and release collateral supporting a guarantee, thereby assuming additional risk.

ACCOUNTING FOR REAL ESTATE LOANS CLASSIFIED AS INVESTMENTS IN REAL ESTATE

23. A real estate loan that is classified as an investment in real estate is, in effect, a loan for legal purposes and an ownership interest for financial reporting purposes. For financial reporting purposes, the loan document and any other agreements between the lender and the borrower entered into at or near the same time as the loan are analogous to a hypothetical partnership agreement. The hypothetical partnership consists of a lender-partner (the contractual lender) and an owner-partner (the contractual borrower). For financial reporting purposes, the hypothetical partnership is deemed to be the owner of the real estate.

24. For financial reporting purposes, the fair value of the 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. Similarly, the proceeds of the loan are analogous to an initial capital contribution by the lender-partner. Because the hypothetical partnership agreement generally provides for preferential returns to the lender in the form of interest and principal, the lender-partner's contribution may be considered to be analogous to a preference capital contribution. Preferential returns to the lender are analogous to a return on the capital contribution (the coupon interest) and a return of the capital contribution (the principal or face amount of the loan.) Generally, the hypothetical partnership agreement also explicitly or implicitly specifies the

allocation of real estate sales proceeds and operating cash flows in excess of the contractually stipulated preference returns.

Consolidation, Equity Method, or Cost Method

25. A real estate loan that is classified as an investment in real estate generally should be accounted for by the lender-partner using the equity method. The underlying real estate project should be consolidated if the lender-partner has a controlling interest. However, in most situations, the lender-partner does not have a controlling interest because the owner-partner has legal title to the real estate and control over operating decisions. The lender-partner's hypothetical partnership interest generally would not be accounted for using the cost method, as described in paragraph 8 of SOP 78-9, because, although the hypothetical partnership agreement generally does not provide the lender-partner with a controlling interest, it typically provides the lender-partner with significant influence over major operating and financing decisions and specifies the timing of cash distributions.

Accounting for Payments Described as Interest in the Loan Agreement and Related Other Agreements

26. For a real estate loan that is classified and accounted for as an investment in real estate, a payment to the lender-partner that is described as interest in the loan agreement and related other agreements should be accounted for as a distribution from capital. Such payments should not be classified or accounted for as interest expense of the hypothetical partnership or as interest income in the financial statements of the lender-partner, because the lender-

partner's initial contribution is, in substance, a preference capital contribution to the hypothetical partnership rather than a loan.

Applying the Equity Method

27. The following discussion focuses on the application of the equity method, which generally should be used in accounting for real estate loans that are classified as investments in real estate in accordance with this proposed SOP. For purposes of applying this proposed SOP, the real estate subject to the loan is considered to be the real estate project of the hypothetical partnership. As noted in paragraph 9 of this proposed SOP, the guidance in this proposed SOP does not apply to the separate financial statements of the project that otherwise might be prepared.

Capitalization of Interest by the Lender-Partner

28. Lender-partners that have the kinds of interest costs described in paragraph 1 of FASB Statement No. 34, *Capitalization of Interest Cost*, as amended by FASB Statement No. 58, *Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method*, should consider whether any of those interest costs should be capitalized. Paragraph 5 of FASB Statement No. 58 requires eligible interest of the lender-partner to be capitalized on an investment accounted for by the equity method "while the investee has activities in progress necessary to commence its planned principal operations provided that the investee's activities include the use of funds to acquire qualifying

assets for its operations." The investment ceases to qualify for interest capitalization when those operations begin.

Initial Capital Accounts

29. At the inception of the hypothetical partnership, hypothetical initial capital accounts should be established for both the owner-partner (i.e., the borrower) and the lender-partner. The amount of the lender-partner's initial capital account should be equal to the amount of its contribution in the form of the loan (and other equity investments, if any, that are reported in accordance with SOP 78-9); the amount of the owner-partner's initial capital account should be equal to the fair value of its equity in the real estate at the inception of the real estate loan and any other assets, net of encumbrances, to which the lender-partner has recourse.

Results of Operations Including Depreciation

30. 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. In a typical real estate loan, the amount described as coupon interest and the amount described as loan principal are payable to the lender-partner as preference returns. Any operating results in excess of the preference returns are allocated between the lender-partner and the owner-partner in a manner specified in the hypothetical partnership agreement.

31. In a typical real estate loan that is classified as an investment in real estate in accordance with this proposed SOP, the hypothetical partnership agreement specifies the manner in which the owner-partner and the lender-partner share the proceeds from either selling the real estate to third parties or from refinancing with another lender. If the net proceeds are less than the depreciated carrying amount of the real estate property (from the perspective of the hypothetical partnership), the deficiency is first attributed to the owner-partner to the extent of the owner-partner's hypothetical capital account. Unless the real estate loan provides recourse to the borrower, any additional deficiency should be attributed to the lender-partner.

32. GAAP requires the recognition of depreciation on real estate other than land regardless of whether the real estate appreciates in value. As stated in ARB 43, *Restatement and Revision of Accounting Research Bulletins*, the recognition of depreciation "is a process of allocation, not of valuation."

33. For a real estate loan classified as an investment in real estate, depreciation should be allocated entirely to the owner-partner until its hypothetical capital account, determined on a GAAP basis, is reduced to zero. Once the owner-partner's hypothetical capital account has been reduced to zero, all further depreciation should be charged to the lender-partner.

34. Real estate loans typically are without recourse, and the owner-partner's hypothetical capital account should not be reduced below zero. However, in determining the amount of depreciation to

be allocated to the owner-partner, its hypothetical capital account should include any other assets to which the lender-partner has recourse, measured at their fair value at the inception of the arrangement and subsequently adjusted as required by GAAP for such assets.

35. Similarly, 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. As described in the preceding paragraph, the owner-partner's hypothetical capital account determined in conformity with GAAP should not be reduced below zero.

36. Some real estate loans classified as investments in real estate allow the lender-partner's preference payment (coupon interest) to be deferred temporarily if income before depreciation for a period is inadequate. The deficiency becomes due if the real estate subsequently achieves profitability, if it is sold, or if the real estate loan is refinanced. Although the owner-partner may have a positive hypothetical capital account as determined in conformity with GAAP, the lender-partner should not recognize income on a transfer of capital from the owner-partner to make up for the deficiency in the preference payment. Sufficient income determined in accordance with GAAP is required.

37. A cash payment by an owner-partner directly to a lender-partner to prevent a default on the preference obligations to the lender-partner should be accounted for by the hypothetical partnership as a capital contribution from the owner-partner with a corresponding

distribution to the lender-partner. The balance in the owner-partner's capital account should thus increase, and the balance in the lender-partner's capital account should decrease. The lender-partner should account for the cash received as a return of investment.

38. Appendix A includes an example of the application of the equity method of accounting, as described in paragraphs 27 to 37 of this proposed SOP.

ACQUIRING REAL ESTATE LOANS

39. Loans or participations in loans frequently are bought and sold. The determination of whether an acquired real estate loan should be classified as a loan or as an investment in real estate should be based on the characteristics of the transaction at the time of purchase, as described in paragraphs 12 to 14 of this proposed SOP.

FINANCIAL STATEMENT PRESENTATION

40. Balance sheet and income statement amounts relating to real estate loans accounted for as investments in real estate should not be combined with amounts related to real estate loans accounted for as loans. The carrying amount of real estate loans accounted for as investments in real estate should be disclosed either on the face of the balance sheet or in the accompanying notes.

EFFECTIVE DATE AND TRANSITION

41. Except as provided for in the following paragraph, this proposed SOP should be applied to real estate loans entered into after December 31, 1994. However, earlier application is encouraged for loans entered into during periods for which financial statements have not previously been issued.

42. Paragraphs 18 to 22 of this proposed SOP that relate to changes in classification should be applied to financial statements for fiscal years beginning after December 15, 1994. Earlier application is encouraged.

DISCUSSION OF CONCLUSIONS

43. This section discusses issues that were deemed significant by members of AcSEC in reaching the conclusions in this proposed SOP. It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

44. The primary objective of this proposed SOP, which is to define the criteria that distinguish a real estate loan from an investment in real estate, is consistent with that of the third Notice. AcSEC considered expanding the scope to include loan arrangements involving assets other than real estate, but it was decided that separate guidance was required to accommodate the unique characteristics of real estate. That decision is supported by paragraph 43 of FASB Statement No. 98, which states in part that "[r]eal estate

sales transactions may be accounted for differently than sales of other assets."

45. A borrower in a financing arrangement that meets one or more of the criteria set forth in paragraph 12 of this proposed SOP retains the risks and rewards attributable to the ownership of real estate and, therefore, the lender should classify and account for the arrangement as a real estate loan. An arrangement that does not meet at least one of those criteria should be accounted for as an investment in real estate, because (1) the arrangement does not possess characteristics generally present in a lending relationship and (2) the lender assumes substantial risks and, possibly, rewards normally associated with ownership. Such accounting is representationally faithful and thus contributes to the reliability and decision usefulness of the reported information, as discussed in paragraphs 59 and 63 of FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*.

CLASSIFYING REAL ESTATE LOANS

Expected Residual Profits

46. During the development of this proposed SOP, AcSEC considered the adequacy of the definition of expected residual profit in paragraph 3 of the third Notice, as follows:

> Expected residual profit is the amount of profit, whether called interest or another name, such as equity kicker, above a reasonable amount of interest and fees expected to be earned by the lender.

It was observed that the benchmark for the definitions's reasonableness test had not been clearly defined. In practice, an assessment of reasonableness might be based on the corresponding terms of a mortgage loan with no participation feature. In contrast, it could be concluded that expected residual profit never exists because, by definition, all interest and fees agreed to by the parties to a loan in an arm's-length transaction are reasonable for the types of risks associated with the loan.

47. AcSEC considered whether the presence of expected residual profit should be a deciding factor in classifying and accounting for real estate loans. Though it generally was agreed that a lender would be unlikely to assume the risks of ownership without receiving some of the rewards, it was concluded that the classification decision should focus on the assumption of risk and that the presence of expected residual profit is a secondary consideration that should not affect the classification decision.

48. AcSEC concluded that the absence of all of the characteristics described in paragraph 12 would indicate that the lender had assumed a substantial portion of the ownership risks associated with the real estate project. Examples of arrangements in which the lender assumes such risks include those in which:

a. The lender agrees to provide all or substantially all necessary funds to acquire, develop, construct, or operate the real estate. The borrower has title to the underlying real estate but has little or no equity in it.

b. The lender funds all or substantially all interest and fees, including commitment and origination fees, during the term of the loan by adding them to the loan balance.

c. The lender's only collateral is the real estate subject to the real estate loan. The lender has no recourse to other assets of the borrower, and the borrower does not provide a qualifying guarantee of the debt.

d. The arrangement is structured so that foreclosure during the project's development as a result of delinquency is unlikely because the borrower is not contractually required to make any payments of principal or interest until the project is complete and, therefore, the loan normally cannot become delinquent.

49. In considering whether to eliminate expected residual profit as a determining factor in the classification of real estate loans, particular attention was given to the so-called "50 percent requirement" in paragraph 16(a) of the third Notice, which states the following:

> If the lender is expected to receive over 50 percent of the expected residual profit . . . from the project, the lender should account for income or loss from the arrangement as a real estate investment as specified by Statement of Financial Accounting Standards (SFAS) no. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, and SFAS no. 66, *Accounting for Sales of Real Estate*.

Because it would be highly unusual for a real estate loan meeting any of the characteristics for loan accounting described in paragraph 12 of this proposed SOP to also provide for lender

participation in more than 50 percent of the expected residual profit, it was determined that the so-called "50 percent rule" should be eliminated.

Sweat Equity

50. The exclusion of sweat equity as a qualifying equity investment is consistent with paragraph 9 of FASB Statement No. 66, which discusses the kinds of down payment and subsequent payments that may be considered in determining whether a sale of real estate has been consummated, as follows:

> The buyer's initial investment shall include only: (a) cash paid as a down payment, (b) the buyer's notes supported by irrevocable letters of credit from an independent established lending institution,[3] (c) payments by the buyer to third parties to reduce existing indebtedness on the property, and (d) other amounts paid by the buyer that are part of the sales value. Other consideration received by the seller, including other notes of the buyer, shall be included as part of the buyer's initial investment only when that consideration is sold or otherwise converted to cash without recourse to the seller.
>
> ---
>
> [3] An "independent established lending institution" is an unrelated institution such as a commercial bank unaffiliated with the seller.

Borrower's Equity Investment

51. Paragraph 12(a) of this proposed SOP discusses the adequacy of the borrower's equity investment in the real estate in determining whether the real estate loan should be classified as a loan or as an investment in real estate. As indicated in that paragraph, AcSEC concluded that in assessing whether a borrower has an equity investment that is substantial to the project (paragraph 12(a) of

this proposed SOP), the minimum down payment requirements set forth in FASB Statement No. 66 should be used. That conclusion is consistent with EITF Issue No. 87-9, *Profit Recognition on Sales of Real Estate with Insured Mortgages or Surety Bonds*, in which the Emerging Issues Task Force addressed specific issues pertaining to the borrower's equity investment and reached a consensus, in part, that "the minimum initial investment criteria set forth in Statement 66 should be followed."

Surety Bonds

52. As noted in paragraph 12(c) of this proposed SOP, surety bonds may be accepted by sellers of real estate to support the buyer's notes in lieu of an irrevocable letter of credit. In EITF Issue No. 87-9, a consensus was reached that

> an irrevocable financial instrument, such as a surety bond, from an established independent insuring institution that . . . [has] characteristics (such that the instrument has *all* the rights and obligations of an irrevocable letter of credit) may be considered by the seller to be equivalent to an irrevocable letter of credit and included as part of the buyer's initial and continuing investment in determining whether it is appropriate to recognize profit under the full accrual method [described in FASB Statement No. 66]. The Task Force noted that the requirement in Statement 66 to demonstrate the buyer's commitment to pay is an important criterion that must be met before profit is recognized by the full accrual method.

Guarantees

53. Some real estate loans include guarantees of the borrower, a third party, or both. The existence of a guarantee alone rarely provides sufficient evidence for concluding that a real estate loan should be accounted for as a real estate loan. Provided that all

the conditions set forth in paragraph 14 are met, examples of guarantees that generally would be sufficient to demonstrate that a real estate loan is a loan would include those supported by:

- Liquid assets placed in escrow.
- Pledged marketable securities.
- Irrevocable letters of credit from creditworthy, independent third parties.

The amount of the guarantees should be sufficient to provide the necessary equity investment that is substantial to the real estate, as described in FASB Statement No. 66.

54. In the absence of such support for the guarantee, other reliable information about the guarantor, such as that available in current audited or reviewed financial statements, may be considered in determining the guarantor's ability to perform. However, due consideration should be given to the potential risks associated with guarantees, as follows:

- Liquidity and net worth of the guarantor. There should be evidence of sufficient liquidity to perform under the guarantee. A guarantee may have little substance if the guarantor's net worth consists primarily of assets pledged to secure other indebtedness.
- Guarantees provided by the guarantor to other projects. There is generally a risk that a guarantor's ability to perform may be compromised by guarantees made to other

projects. Further, there is a risk that some guarantees may not be immediately evident or fully disclosed in the guarantor's financial statements, particularly if those financial statements are unaudited.

- Intent and ability to enforce the guarantee. The enforceability of the guarantee in the applicable jurisdiction should be determined. Further, normal business practice, unique business considerations, or the length of time required to pursue an action in court may preclude the lender from taking action on a legally binding guarantee. The likelihood that a guarantee will be enforced also may be affected by contractual or legal restrictions, such as limitations on the election of remedies that preclude the lender from simultaneously pursuing both the guarantee and the project's assets.

CHANGES IN CLASSIFICATION

55. In evaluating the criteria for reclassifying a real estate loan from an investment in real estate to a loan, as discussed in paragraphs 18 and 19 of this proposed SOP, the reverse scenario of reclassifying a loan to an investment in real estate was considered. It was determined, however, that such accounting potentially would conflict with the scope paragraphs (paragraphs 4 to 7) of FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, which state, in part, that the Statement applies

> to all creditors . . . [and] to all loans that are identified for evaluation, uncollateralized as well as

> collateralized, except [for those arrangements specifically excluded by the Statement] . . . .

AcSEC concluded that subsequent to the initial classification at inception and in the absence of a renegotiation of the loan, reclassification from loan to investment should be prohibited, as described in paragraph 20 of this proposed SOP. It was noted that a loan that ceases to meet the criteria for loan accounting in paragraph 12 of this proposed SOP would likely be categorized as a loan "identified for evaluation" and would thus be subject to the FASB Statement. Conversely, it was noted that a lender may voluntarily renegotiate the terms of a loan that originally met the criteria for loan accounting in paragraph 12 of this proposed SOP, such that the loan no longer does so. AcSEC concluded in paragraph 22 of this proposed SOP that such a transaction should be evaluated in the same manner as a new loan arrangement.

ACCOUNTING FOR REAL ESTATE LOANS CLASSIFIED AS INVESTMENTS IN REAL ESTATE

56. As noted in paragraph 33 of this proposed SOP, appreciation in the value of the owner-partner's share of the hypothetical partnership's assets should not be considered in determining the allocation of depreciation between the owner-partner and the lender-partner. That conclusion is supported by paragraph 25 of SOP 78-9, which states, in part, that the allocation of venture income and losses should be based on an analysis of

> how an increase or decrease in net assets of the venture (*determined in conformity with generally accepted accounting principles*) will affect cash payments to the investor over the life of the venture and on its liquidation. . . . *[Emphasis added.]*

57. Several individuals, however, proposed that appreciation of the owner-partner's share should be considered in the allocation of depreciation. They focused on the amelioration of losses to the lender-partner based on the possibility that real property appreciation attributable to the owner-partner ultimately would be realized either in a sale or in a refinancing. They indicated that the underlying economics of the transaction would thus require an allocation of depreciation up to the fair value of the owner-partner's equity interest. In support of their position, they referred to paragraph 19 of SOP 78-9, which states, in part, that

> the accounting by an investor for losses otherwise allocable to other investors should be governed by the provisions of FASB Statement No. 5 relating to loss contingencies. Accordingly, the investor should record a proportionate share of the losses otherwise allocable to other investors if it is probable that they will not bear their share. In this connection, the division believes that each investor should look primarily to the *fair value* of the other investors' interests in the venture and the extent to which the venture's debt is nonrecourse in evaluating their ability and willingness to bear their allocable share of losses . . . . *Emphasis added.]*

58. Opponents of that position note that paragraph 19 of SOP 78-9 addresses situations in which a venturer might need to recognize losses otherwise allocable to its co-venturers. However, the issue being considered is one of allocation of depreciation in the first place, and paragraph 25 of SOP 78-9 provides the relevant guidance on how to allocate depreciation to the venture partners. Given the nonrecourse nature of the loan, the reduction in the net carrying amount of the real estate resulting from depreciation must be allocated. The allocation of such amounts to an owner-partner that has a capital account with a zero balance would ignore the

nonrecourse nature of the underlying financing. Some opponents also believe that reducing the capital account of an owner-partner for depreciation based on expectations of market appreciation is inconsistent with the principles underlying the historical accounting model. The position described in the preceding paragraph was therefore rejected.

APPENDIX A

Illustration of the Application of Paragraphs 27 to 37:

Facts: On January 1, 19X1, ABC Financial Institution (ABC) loaned $10,000,000 to XYZ Real Estate Acquisition, Inc. (XYZ) for the permanent financing of a commercial office building. XYZ's initial equity investment totaled $500,000. (For purposes of this Example, $500,000 is not considered substantial, using the minimum down payment requirements of FASB Statement No. 66, as discussed in paragraph 12(a) of this proposed SOP.) The real estate loan has none of the characteristics described in paragraph 12 of this proposed SOP and, accordingly, is accounted for as an investment in real estate. The real estate loan has a stated interest rate of 10 percent, and the loan agreement provides for ABC to share in 50 percent of the positive cash flows from the property (operating cash flows as well as cash flows upon sale of the property). Operating cash flows, by definition in the loan agreement, are determined after deducting mortgage interest on the ADC arrangement and are paid in cash distributions each year.

Operating results of the ABC project are as follows:

	19X1	19X2	19X3
Operating income before depreciation and interest expense	$1,000,000	$1,600,000	$1,700,000
Interest expense	(1,000,000)	(1,000,000)	(1,000,000)
Operating income after interest expense but before depreciation	0	600,000	700,000
Depreciation	(300,000)	(300,000)	(300,000)
GAAP basis net income (loss)	(300,000)	300,000	400,000
Add back interest expense	1,000,000	1,000,000	1,000,000
Adjusted GAAP basis net income	$ 700,000	$1,300,000	$1,400,000

Cash flows from the ADC project are distributed as follows:

	19X1		19X2		19X3	
	ABC Lender	XYZ Owner	ABC Lender	XYZ Owner	ABC Lender	XYZ Owner
Preference return to ABC (coupon interest on ADC loan)	$1,000,000	$ -	$1,000,000	$ -	$1,000,000	$ -
Operating income (loss) after preference, shared 50/50:						
Year 1 - -0-						
Year 2 - $600,000			300,000	300,000		
Year 3 - $700,000					350,000	350,000
Total distribution of cash flows	$1,000,000	$ -	$1,300,000	$300,000	$1,350,000	$350,000

Allocation of adjusted net income (loss):[1]

	ABC (Lender)	XYZ (Owner)	Total
19X1			
Preference return (coupon interest)	$1,000,000	$ -	$1,000,000
Operating income (loss) after preference	-	-	-
Income (loss) before depreciation	1,000,000	-	1,000,000
Depreciation	-	(300,000)	(300,000)
Adjusted net income	$1,000,000	$(300,000)	$ 700,000
19X2			
Preference return (coupon interest)	$1,000,000	$ -	$1,000,000
Operating income after preference	300,000	300,000	600,000
Income before depreciation	1,300,000	300,000	1,600,000
Depreciation	(100,000)	(200,000)	(300,000)
Adjusted net income	$1,200,000	$ 100,000	$1,300,000
19X3			
Preference return (coupon interest)	$1,000,000	$ -	$1,000,000
Operating income after preference	350,000	350,000	700,000
Income before depreciation	1,350,000	350,000	1,700,000
Depreciation	(300,000)	-	(300,000)
Adjusted net income	$1,050,000	$ 350,000	$1,400,000

[1] As noted in paragraphs 32 and 33 of this proposed SOP, depreciation should be allocated on a GAAP basis, and appreciation in the value of the owner-partner's share of the hypothetical partnership's assets should not be considered in determining the allocation of depreciation between the owner-partner and the lender-partner. As noted in paragraph 34 of this proposed SOP, for the purpose of determining whether the owner-partner's GAAP basis capital has been reduced to zero, other assets to which the lender-partner has recourse may be considered.

Determination of Hypothetical Capital Account Balances:

	ABC (Lender) Capital Account	XYZ (Owner) Capital Account
Balance, January 1,19X1	$ 10,000,000	$ 500,000
Distributions, 19X1 (From schedule of cash flow distributions)	(1,000,000)	--
Allocation of income before depreciation, 19X1	1,000,000	--
Allocation of depreciation, 19X1	--	(300,000)
Capital account balance, January 1, 19X2	10,000,000	200,000
Distributions, 19X2 (From schedule of cash flow distributions)	(1,300,000)	(300,000)
Allocation of income before depreciation, 19X2	1,300,000	300,000
Allocation of depreciation, 19X2	(100,000)	(200,000)
Capital account balance, January 1, 19X3	9,900,000	--
Distributions, 19X3 (From schedule of cash flow distributions)	(1,350,000)	(350,000)
Allocation of income before depreciation, 19X3	1,350,000	350,000
Allocation of depreciation, 19X3	(300,000)	--
Capital account balance, January 1, 19X4	$ 9,600,000	$ --