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Valuation of certain real estate and loans and receivables collateralized by real estate; Exposure draft (American Institute of Certified Public Accountants), 1976, May 25

American Institute of Certified Public Accountants. Accounting Standards Committee on Real Estate Accounting

VALUATION OF CERTAIN REAL ESTATE AND LOANS AND RECEIVABLES COLLATERALIZED BY REAL ESTATE

A Proposed Recommendation to the
Financial Accounting Standards Board

EXPOSURE DRAFT

As indicated in the accompanying letter, this exposure draft has been prepared for public comment by the Accounting Standards Committee on Real Estate Accounting. The conclusions herein have not been approved by the Accounting Standards Division.

This exposure draft has been distributed to Members of Council of the AICPA; Members of Technical Executive Committees of the AICPA; State Society Presidents and Executive Directors; Chairmen of State Society Committees on Accounting Practices; and certain organizations outside the accounting profession. Copies are available to interested persons and organizations upon request.

Comments should be sent, in time to arrive not later than August 31, 1976, to—

Director, Accounting Standards
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File Reference 4210

AICPA

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May 25, 1976

To Persons and Organizations Interested in
Valuation of Real Estate and Loans and
Receivables Collateralized by Real Estate

Statement of Position No. 75-2, issued on June 27, 1975, presents recommendations of the Accounting Standards Division on Accounting Practices of Real Estate Investment Trusts. The Committee on Real Estate Accounting has considered whether the conclusions in that Statement with respect to the valuation of real estate should be recommended to the Financial Accounting Standards Board (FASB) as applicable to companies that are not REITs; the accompanying exposure draft presents the Committee's views on that and related issues.

This exposure draft has been issued to obtain the views of interested persons and organizations and is subject to change after such views are studied. It is also subject to change upon completion of the current FASB agenda project entitled "Accounting by Debtors and Creditors When Debt is Restructured," for which a Discussion Memorandum dated May 11, 1976, has been issued. It is likely that this FASB agenda project will establish accounting standards that will be applicable to the valuation of real estate in certain defined situations; such standards will have direct implications for the Committee's final conclusions.

Although some of the matters discussed in the accompanying exposure draft are included in the FASB agenda project, this exposure draft also covers other questions in need of resolution. The Committee believes that issuance of this exposure draft at this time will help focus attention on these important issues and foster the interchange of ideas, thereby assisting all those interested in the improvement of accounting principles.

Sincerely yours,

Thomas P Kelley

Thomas P. Kelley
Director
Accounting Standards

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INTRODUCTION

Background

.01 On June 27, 1975, the Division submitted its Statement of Position No. 75-2, Accounting Practices of Real Estate Investment Trusts, to the Financial Accounting Standards Board. That Statement deals with several subjects, including the measurement and reporting of losses resulting from a REIT's lending activities. The Statement concludes, among other things, that:

> ...in the real estate industry, interest is clearly an economic cost of holding property.... In the case of a REIT, the Division believes that the principle of providing for all losses when they become evident should now require the inclusion of all holding costs, including interest, in determining such losses.

.02 While the Statement notes that its conclusions may also be appropriate for companies "which are not REITs but which are engaged in the business of making loans on or investing in real estate," its scope is specifically restricted to real estate investment trusts.

.03 In its Status Report of September 9, 1975 (No. 28), the FASB publicly reported that it "does not presently contemplate taking any action with respect to the AICPA Statement of Position (on REITs) and has no present plan to add the subject of the AICPA Statement of Position to its agenda." The Status Report also expressed the Board's view that "in recommending a particular method for making a reasonable estimate of loss on loans receivable and foreclosed properties of real estate investment trusts, the

AICPA Statement of Position does not conflict with FASB Statement No. 5." The Status Report took particular note of the Statement of Position's specific recommendations with respect to (1) the inclusion of estimated interest holding costs in determining losses on real estate loans and foreclosed properties, and (2) the calculation of those costs, and continued: "The Board takes no position on either of those features of the recommended method for estimating asset impairment."

.04 In the light of these developments, the Accounting Standards Committee on Real Estate Accounting has considered whether the conclusions in Statement of Position No. 75-2 with respect to the valuation of real estate should be recommended to the FASB as applicable to entities that are not REITs but that are engaged in the business of making loans on or investing in real estate. This Statement of Position is the result of those deliberations and has been prepared by the Committee on behalf of the Accounting Standards Division.

Scope of Statement of Position

.05 This Statement of Position contains the Division's recommendations for accounting by all entities other than REITs, which are covered by Statement of Position No. 75-2, for possible losses in connection with the following types of investments:

(1) "Covered Loans and Foreclosed Properties"

- Loans and receivables directly collateralized by real estate where conditions such as those described in paragraph .08 indicate it is probable that the borrower will not be able to meet his obligations.

- All real estate acquired in settlement of loans or receivables collateralized by real estate.

(2) "Covered Real Estate" (except as noted in paragraph 6 below)

- Land.
- Developed property held for sale in the ordinary course of business.
- Revenue-producing property.
- All other real estate, including real estate under development.

.06 The term "covered real estate" specifically excludes (a) real estate acquired in settlement of loans or receivables collateralized by real estate, which is covered by paragraph .05(1), and (b) the following investments, which involve considerations that merit a study beyond the scope of this Statement of Position:

- Real property used by the owner in the owner's business (e.g., manufacturing facilities, home office space, etc.).
- Revenue-producing property held for investment and not for sale (unless evidence exists that the real estate may be offered for sale).
- Land under, or specifically held for, development into property to be used in the owner's business or into revenue-producing property to be held for investment and not for sale (unless evidence exists that the land may be offered for sale).

.07 If "covered real estate" or "covered loans and foreclosed properties" are subsequently transferred into one of the aforementioned excluded investment categories, the recommendations in this Statement apply to the accounting for such investments up to and including the date of transfer.[1/]

.08 Since this Statement of Position is concerned with accounting for possible losses, the term "covered loans and foreclosed properties" does not include loans and other receivables collateralized by real estate <u>except</u> when conditions indicate it is probable that the borrower will not be able to meet his obligations. Examples of such conditions include, but are not limited to, the following:

- Significant defaults, including those with respect to payments of principal or interest, exist under the terms of the loan agreement.
- Foreclosure proceedings have been or are expected to be initiated.
- The credit-worthiness of the borrower is in doubt because of pending or actual bankruptcy proceedings, the filing of liens against his assets, etc.
- Cost overruns, mechanics' liens, or delays in construction are being experienced on the project which collateralizes the loan or receivable.
- The loan has been renegotiated.
- Adverse market conditions exist with respect to sales or rentals or other external factors cast doubt on the economic viability of the project which collateralizes the loan or receivable.

1/ The net carrying value at the date of transfer should be the amount at which such an investment is transferred into an excluded investment category and should become its new cost basis, subject to any additional future write-downs that may be required by generally accepted accounting principles.

PRESENT PRACTICES

Determination of Allowance for Losses

.09 Entities that have provided an allowance for losses on "covered real estate" or "covered loans and foreclosed properties" have usually followed one of the methods described below:

> Systematic Provision—The provision for losses is determined in a manner intended to result in systematic charges to income on a consistent basis. The provision may be based, for example, on a moving average of prior losses or on a percentage of income, or it may be the amount required to arrive at an allowance which represents a certain percentage of the amounts invested.
>
> Individual Evaluation—The provision for losses is the amount required to create an allowance based on an evaluation of the individual investments.
>
> Combined Method—The provision for losses is comprised of specific amounts for at least major real estate properties and loans, increased by an amount which generally represents a percentage of the amounts invested.

.10 The adequacy of the allowance is normally evaluated in relation to the estimated loss inherent in the investments.

"Covered Loans and Foreclosed Properties"

.11 As previously mentioned, Statement of Position No. 75-2 deals with the measurement and reporting of losses resulting from a REIT's lending activities. That Statement also contains a discussion of the economic factors that affect the real estate loans of REITs and the options available to a REIT in the event of borrower default. In these respects, the information presented in Statement of Position No. 75-2 is also generally characteristic of entities other than REITs that hold "covered loans and foreclosed properties."

"Covered Real Estate"

.12 Real estate is subject to a number of significant risks. Some of these risks are adverse changes in economic conditions, both national and local, and changes in the interest rate paid on borrowed funds when the investment is highly leveraged. Other risks relate to shortages of construction materials, increased cost of materials, increased energy costs, lack of permanent financing, and changes in environmental and zoning regulations. All of these risks, and others, can create problems for investors in "covered real estate" and may reduce the value of a given property.

.13 The risks described above particularly affect an entity that holds "covered real estate," since that entity expects the sales price to enable it to recover its investment, including costs to complete or improve the property, costs to hold the property to the point of sale, and costs to dispose of the property, plus a profit.

.14 Estimating the amount of loss inherent in "covered real estate" entails a comparison of the carrying amount of the asset with the estimated net realizable value of the property. It is generally accepted that the estimated net realizable value of "covered real estate" is the estimated selling price the property will bring if exposed in the open market, allowing a reasonable time to find a purchaser, plus other estimated revenues from the property during the estimated holding period, reduced by at least the following:

- The estimated costs to complete or improve the property to the condition used in determining the estimated selling price.
- The estimated costs to dispose of the property.
- The estimated costs to hold the property to the estimated point of sale (e.g., property taxes, legal fees and other direct holding costs.

.15 There is controversy, however, as to whether estimated costs to hold the property should include an amount for interest. One point of view is that, with limited exceptions, interest has been traditionally considered a period cost and, accordingly, should not be considered in the determination of estimated net realizable value since it is no different from any other period cost. Others believe that interest is an economic cost associated with holding real property and should be considered in the determination of estimated net realizable value.

.16 In addition, some believe that the determination of the allowance for loss should also include a provision for a normal profit on the sale.

.17 However, there are some who believe that the estimated net realizable value of a property should be based on its estimated selling price on an immediate liquidation basis.

.18 Thus there are several different views as to the meaning of the term "estimated net realizable value" when it is applied to real estate. The first reduces the sum of the estimated selling price and other revenues during the estimated holding period by estimated costs to complete or improve and dispose of the property and by estimated direct holding costs. A second reduces that amount by estimated interest holding costs. A third further reduces that amount by an estimated "normal profit" on the sale. A fourth, however, holds that the estimated net realizable value of a property should be based on its estimated selling price on an immediate liquidation basis. The number of variations is also increased by the fact that those who believe interest is a holding cost have suggested several alternatives for calculating the amount to be included in the determination of estimated net realizable value:

- Interest during the estimated sell-out period or stabilization period based upon current market interest rates plus a provision for investor profit.

- Interest during the estimated sell-out period or stabilization period based upon current market interest rates.

- Interest during the estimated holding period based upon the specific cost of money associated with a project.

- Interest during the estimated holding period determined either on the basis of incremental interest rates, average interest rates on all debt, or average cost of money including all debt and stockholders' equity.

THE DIVISION'S CONCLUSIONS

"Covered Loans and Foreclosed Properties"

.19 The Division believes that the conclusions of Statement of Position No. 75-2 with respect to the valuation of real estate by REITs should now also be applied to "covered loans and foreclosed properties" of all entities that are not REITs.[2/] The Division believes that the economic factors that affect the risk of loss on real estate transcend the nature of entities holding "covered loans and foreclosed properties." Although entities that hold loans and other receivables collateralized by real estate vary in their nature and characteristics, generally each entity looks primarily to the real estate to measure the ultimate recoverability of "covered loans and foreclosed properties."[3/] The valuation of "covered loans and foreclosed properties" and the accounting for those measurements should reflect this economic reality.

2/ This conclusion is not intended to preclude entities with large portfolios of loans secured by single family residences or multiple housing with relatively few units from using appropriate statistical methods to apply the recommendations of this Statement of Position in the determination of a required allowance for losses. However, large loans of any type, as well as foreclosed properties, should be reviewed individually.

3/ In situations involving recourse loans or guarantees or other collateral in addition to the primary real estate security, the lender's ability to recover amounts from such sources should also be considered.

"Covered Real Estate"

.20 The Division believes that "covered real estate" should not be carried at an amount in excess of its estimated net realizable value. Any required allowance for losses should be determined on the basis of an evaluation of the recoverability of the individual investments.

.21 Many investors in "covered real estate" have investments in multi-phase developments or developments which involve more than one type of project. The estimated net realizable value of such developments should be determined on an individual project basis. Ordinarily, the components of a "project" in this sense should be relatively homogeneous, integral parts of a whole (e.g., individual houses within a residential tract, individual units within a condominium project, individual lots within a lot subdivision). Therefore, a development consisting of a single family tract, a condominium project and a lot subdivision would generally be evaluated as three separate "projects" due to lack of overall homogeneity. The allocation of costs to these "projects" should be reviewed as a part of the determination of their estimated net realizable value.

.22 Because of the many factors which can affect recoverability, the estimated loss on an individual property may not be the same as the ultimate loss, if any, actually sustained on each. While the individual evaluation method is an estimation technique, it best achieves, in the Division's view, the ultimate objective of determining an allowance for losses which is, in the aggregate, reasonable in the context of the financial statements taken as a whole.

.23 Evaluation of the recoverability of "covered real estate" entails a comparison of the carrying amount of each property with its estimated net realizable value. In this connection, the Division believes that estimated net realizable value should be based on the estimated selling price plus other estimated revenues from the property during the estimated holding period, reduced by:

- The estimated cost to complete or improve such property to the condition used in determining the estimated selling price.
- The estimated costs to dispose of the property.
- The estimated costs to hold the property to the estimated point of sale, including interest, property taxes, legal fees and other direct holding costs.

.24 The estimated selling price should usually be determined on the basis of sale in the ordinary course of business, which would allow a reasonable time to find a willing purchaser. Further, the estimated point of sale should not extend beyond the period reasonably required to dispose of the property. Estimated increases in selling prices during such period should not be considered unless it is probable that such increases will take place. If the intention is to dispose of the property on an immediate sale basis or if the owner does not have the financial ability to hold or develop the property, the estimated selling price should be determined on an immediate liquidation basis.

.25 There are a number of other factors which should be considered in connection with the determination of the estimated selling price of "covered real estate"; some are listed below:

- The current status or nature of the property and its condition.
- The current actual use of the property and the future uses of the property as related to general economic conditions and the population growth in the area.
- The overall suitability of the property for its current or intended use.
- Various restrictions including zoning and other possibilities.
- Comparable prices of other properties in the area.

.26 Interest holding costs should be estimated based on (a) the average cost of all capital (debt and equity) or (b) the entity's accounting policy for capitalizing interest (even if that accounting policy requires the discontinuance of interest capitalization upon completion of construction or at the time net realizable value is reached). The method producing the larger amount of interest holding costs should be used.

.27 In calculating net realizable value, there is a presumption that the amount of interest holding costs should be based on the average cost of all capital unless the amount produced using the entity's accounting policy for capitalizing interest is larger. The Division believes that it would be inappropriate to provide for interest holding costs based on a rate lower than that used by the entity to capitalize interest on the property.

.28 The average cost of all capital should be calculated by dividing debt interest costs by the aggregate of equity capital and debt. Debt interest costs should normally be computed based on the effective interest rate used for recording interest expense at the date of the balance sheet. However, the provisions of agreements entered into prior to the issuance of the financial statements should be considered in determining whether that rate is appropriate. When the entity has negotiated an interest reduction for a specific period, that reduced rate should be presumed to be not available after the end of that period.

.29 The individual comparisons of the carrying amounts of "covered real estate" with their estimated net realizable values should be made in connection with the preparation of all annual and interim reports. This may result in a need to increase or decrease the allowance for losses, with a corresponding charge or credit to income. For example, an increase in the allowance may result from adverse changes in estimates of future selling prices or costs; a decrease may result from recoveries in the values of the properties or the simple expiration of time if all other factors remain unchanged.

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