1993

Proposed statement of position : Identifying and accounting for real estate loans that qualify as real estate investments;Identifying and accounting for real estate loans that qualify as real estate investments; Exposure draft (American Institute of Certified Public Accountants), 1993, Oct. 27

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

EXPOSURE DRAFT

PROPOSED STATEMENT OF POSITION

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

OCTOBER 27, 1993

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

Comments should be received by January 31, 1994, and addressed to
Arleen K. Rodda, Director, Accounting Standards Division, File 3455
AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775

Accounting Standards Executive Committee (1992–1993)

Norman N. Strauss, Chairman
Ernest F. Baugh, Jr.
G. Michael Crooch
H. John Dirks
George P. Fritz
Stuart H. Harden
James E. Healey
Sally L. Hoffman
James A. Johnson
Krista M. Kaland
Robert S. Kay
Aram G. Kostoglian
John M. Lacey
James T. Parks
Edward W. Trott

Task Force on ADC Arrangements

Alex T. Arcady, Chairman
Dorsey L. Baskin, Jr.
Barry P. Robbins

AICPA Staff

John F. Hudson
Vice President
Technical Standards and Services

Arleen K. Rodda
Director
Accounting Standards

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 real estate investments 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 real estate investments. For purposes of applying this proposed SOP, a loan classified and accounted for as a real estate investment is considered 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 accounted for as loans using the criteria set forth in this proposed SOP, (2) debtors, (3) real estate loans resulting from the lender's sale of real estate, (4) permanent mortgage real estate loans on one- to four-family residential properties, or (5) small real estate loans evaluated for impairment by the lender in the aggregate.

The proposed SOP supersedes the guidance in the February 10, 1986, AICPA Notice to Practitioners, *ADC Arrangements* (the third Notice), which was carried forward in the AICPA Accounting Standards Executive Committee (AcSEC) Practice Bulletin 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 or purchased after December 31, 1994. Earlier application is encouraged.

The following highlights significant differences between the provisions of the proposed SOP and the third Notice.

Scope

The proposed SOP clarifies the scope by stating that it applies to all entities that make or acquire real estate loans. The proposed SOP incorporates the consensus reached in the Financial Accounting Standards Board (FASB) Emerging Issues Task Force (EITF) Issue No. 86-21, *Application of the AICPA Notice to Practitioners Regarding Acquisition, Development, and Construction Arrangements to Acquisition of an Operating Property*, that extends the concepts of the third Notice to operating properties.

Expected Residual Profit

The third Notice applies to ADC arrangements in which the lender participates in expected residual profits from the underlying real estate project. The proposed SOP's primary focus is on the assumption of risk. In this regard, while the presence of an expected residual sharing arrangement typically will coincide with classifying a loan as an investment in real estate, it is not a specific criterion for determining the classification.

Loan Characteristics

Both the third Notice and the proposed SOP refer to a borrower's equity investment that is "substantial" to the project. Among other revisions, the proposed SOP clarifies that *substantial* should be evaluated in terms of the minimum initial investment tests described in FASB Statement of Financial Accounting Standards No. 66, *Accounting for Sales of Real Estate*.

Changes in Classification

The proposed SOP, similar to the third Notice, provides that a loan initially classified as an investment may be reclassified as a loan if one or more of the loan characteristics in paragraph 12 of the proposed SOP are met. However, unlike the third Notice, the proposed SOP does not permit or require reclassification from loans to investments unless the underlying loans are renegotiated in other than a troubled debt restructuring.

AICPA

American Institute of Certified Public Accountants

1211 Avenue of the Americas
New York, NY 10036-8775

(212) 596-6200
Fax (212) 596-6213

October 27, 1993

Accompanying this letter is an exposure draft of a proposed statement of position (SOP), *Identifying and Accounting for Real Estate Loans That Qualify as Real Estate Investments.* This proposed SOP has been developed by a task force of the AICPA Accounting Standards Executive Committee (AcSEC) to provide guidance on identifying and accounting for real estate loans that qualify as real estate investments for financial reporting purposes.

Comments on this exposure draft should be sent to Arleen K. Rodda, Director, Accounting Standards Division, File 3455, American Institute of Certified Public Accountants, 1211 Avenue of the Americas, New York, N.Y. 10036-8775, in time to be received by January 31, 1994.

Comments will be reviewed by the task force to determine whether any revisions should be made to the draft before it is sent to AcSEC for approval to issue a final SOP.

Written comments on the exposure draft will be available for public inspection at the AICPA library after March 1, 1994, for one year.

Yours truly,

Norman N Strauss

Norman N. Strauss
Chairman
Accounting Standards Executive Committee

Alex T. Arcady

Alex T. Arcady
Chairman
Task Force on ADC Arrangements

Arleen Rodda

Arleen K. Rodda
Director
Accounting Standards

TABLE OF CONTENTS

PROPOSED STATEMENT OF POSITION

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

INTRODUCTION

1. This statement of position (SOP) provides guidance on identifying and accounting for real estate loans that qualify as real estate investments 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. This SOP supersedes the guidance in the February 10, 1986, AICPA Notice to Practitioners, *ADC Arrangements* (the third Notice), which was carried forward in the AICPA's Accounting Standards Executive Committee (AcSEC) Practice Bulletin 1, *Purpose and Scope of AcSEC Practice Bulletins and Procedures for Their Issuance,* and incorporates the consensus of the Financial Accounting Standards Board (FASB) Emerging Issues Task Force (EITF) Issue 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. In 1986, AcSEC approved the third Notice, which said financial institutions should account for ADC arrangements that meet certain criteria as real estate investments rather than as loans. The third Notice superseded two previous Notices to Practitioners on the same subject — the first Notice, published in the November 1983 *Journal of Accountancy*, and the second (a supplement to the first), published in the November 26, 1984, *CPA Letter*.

3. In EITF Issue No. 84-4, *Acquisition, Development, and Construction Loans*, the EITF initially reached a consensus that the guidance in the first Notice was adequate. Several EITF members, however, indicated that there was considerable diversity in applying 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 ADC arrangements providing for the lender's participation in expected residual profit. EITF Issue No. 86-21 reached a consensus that, although the third Notice addressed financial institution ADC arrangements, preparers and auditors should consider the third Notice's guidance in accounting for shared appreciation mortgages, loans on operating real estate, and real estate ADC arrangements entered into by enterprises other than financial institutions.

5. Although many entities purported to follow the third Notice's guidance, AcSEC's recommendations for identifying and accounting for loans that qualify as real estate investments

---

[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.

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 third Notice's broad principles.

SCOPE

6. This SOP applies to all entities that make or acquire real estate loans. It 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 here. (Those events are discussed in paragraph 20 of this SOP.) It also does not apply to (1) debtor accounting for real estate borrowings, (2) real estate loans resulting from the sale of real estate by the lender (which are covered by FASB Statement of Financial Accounting Standards No. 66, *Accounting for Sales of Real Estate*), (3) permanent mortgage real estate loans on one- to four-family residential properties, or (4) small real estate loans evaluated for impairment by the lender in the aggregate.

7. In addition, this 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. For the purposes of applying FASB Statement of Financial Accounting Standards No. 107, *Disclosures about Fair Value of Financial Instruments*, and FASB Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan,* real estate loans classified and accounted for as real estate investments in accordance with this SOP should not be considered loans. Paragraphs 17 to 22 of this SOP discuss changes in the classification of real estate loans subsequent to inception.

9. When applying this SOP, a loan classified and accounted for as a real estate investment 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. This SOP's guidance does not apply to the project's separate financial statements that otherwise might be prepared.

DEFINITIONS

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

a. *Inception of a Real Estate Loan.* The date of the real estate loan or the loan commitment date, if earlier. The loan should be in writing, signed by the parties in interest to the transaction, and set forth the transaction's specific principal provisions. If any of the principal provisions are yet to be negotiated, such a preliminary agreement or loan commitment does not qualify under 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 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 not funded by the lender. The equity investment of the borrower should not be considered substantial unless the amount or percentage meets the minimum initial investment criteria specified in paragraphs 53 and 54 of FASB Statement No. 66. (Paragraph 51 of this SOP provides additional guidance for determining whether a borrower's initial investment is substantial.) The investment may be in the form of the borrower's cash payments or 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. The borrower's contribution of recently acquired real estate 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 borrower's disposition of the assets. (In evaluating the assets to which the lender has recourse, *substantial* has the same meaning as that used in (a), above.) Those assets have a determinable sales value and are not pledged as collateral under other loans or financing arrangements. To the extent those assets previously were 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 (a), above.)

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 when applying this SOP unless it is probable the conditions will be met.

e. There are noncancelable sales contracts, leases, or lease commitments from creditworthy, independent third parties that will provide, on the real estate project's completion, sufficient net cash flows 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 when applying this SOP unless it is probable the conditions will be met.

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

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

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

14. ***Guarantees.*** Paragraph 12(f), above, identifies a qualifying guarantee as one of the loan characteristics. As described in paragraph 53 of this 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 this, *substantial* has the same meaning as that used in paragraph 12(a).)

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.

15. ***Multiple Funding Arrangements.*** A lender that makes a real estate loan may make or commit to make another loan to the same borrower on or related to the same real estate at or near the same time as the initial loan. The classification of such loans should be determined in the aggregate when applying this 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 paragraphs 12 and 15 of this SOP.

Changes in Classification

17. After a loan is classified initially as either a loan or a real estate investment, its classification generally will not change unless the conditions discussed in paragraphs 18 to 22 of this SOP are met. In particular, paragraph 22 prohibits loans classified initially as loans from being reclassified as real estate investments unless the underlying loans are renegotiated. Further, guidance is provided in paragraph 20 on loans initially classified as loans that subsequently are restructured under troubled circumstances.

18. A real estate loan classified initially as a real estate investment 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 paragraph 12(a) through (f) of this SOP. An example is a loan in which a takeout commitment for the full amount due the lender has been obtained from a creditworthy, independent third-party lender after the inception of the real estate loan. The arrangement thus would meet at least one of the characteristics of a loan described in paragraph 12.

19. In assessing whether the characteristic in paragraph 12(a) is met after making the initial classification, no value should be attributed to unrealized appreciation in the real estate value. Such appreciation should be considered solely in the context of noncancelable sales contracts or leases or lease commitments (that is, by reference to paragraph 12(e)). A change in classification

from a real estate investment to a loan should be accounted for prospectively. AcSEC Practice Bulletin 6, *Amortization of Discounts on Certain Acquired Loans*, provides guidance on accounting for the difference between a loan's carrying amount 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[2] has occurred. If one of those events occurs for a real estate loan classified as a loan, the lender should account for the arrangement in accordance with FASB Statement of Financial Accounting Standards No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, SOP 92-3, *Accounting for Foreclosed Assets*, or AICPA Practice Bulletin 7, *Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed*, as amended by AICPA Practice Bulletin 10, whichever is applicable.

21. If, however, one of the events discussed in paragraph 20 of this SOP occurs for a real estate loan classified and accounted for as a real estate investment, a modification of the loan terms should be considered and reported on as an amendment to the hypothetical partnership agreement, as described in paragraph 23 of this 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 initially classified as a loan subsequently should be reclassified as a real estate investment if none of the characteristics in paragraph 12(a) through (f) of this SOP are met solely due to a renegotiation of the loan terms other than in connection with a troubled debt restructuring. For example, a lender might renegotiate the loan terms and release collateral supporting a guarantee, thereby assuming additional risk.

Accounting for Real Estate Loans Classified as Real Estate Investments

23. A real estate loan classified as a real estate investment 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, which consists of a lender–partner (the contractual lender) and an owner–partner (the contractual borrower), is the real estate owner.

24. 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 loan proceeds 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.

---

[2] FASB Statement No. 114 amends paragraph 34 of FASB Statement No. 15 with regard to in-substance foreclosures. Accordingly, AcSEC will assess the impact of this amendment on Practice Bulletin 7, *Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed*.

25. ***Consolidation, Equity Method, or Cost Method.*** A real estate loan classified as a real estate investment generally should be accounted for by the lender–partner using the equity method. The underlying real estate project should be consolidated if the terms of the lending arrangement result in the lender–partner having a controlling financial interest, because the provisions of Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, as amended by FASB Statement of Accounting Standards No. 94, *Consolidation of All Majority-Owned Subsidiaries*, would be deemed to be met. 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 by 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.

26. ***Accounting for Payments Described as Interest in the Loan Agreement and Related Other Agreements.*** For a real estate loan classified and accounted for as a real estate investment, 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 lender–partner's financial statements, because the lender–partner's initial contribution is, in substance, a preference capital contribution to the hypothetical partnership rather than a loan.

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

28. *Capitalization of Interest by the Lender–Partner.* 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.

29. *Initial Capital Accounts.* At the inception of the hypothetical partnership, hypothetical initial capital accounts should be established for both the owner–partner (that is, 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.

30. *Results of Operations Including Depreciation*. 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 amounts described as coupon interest and 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 classified as a real estate investment, 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 substantial tangible salable assets of the borrower (see paragraph 12(b) herein), 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 No. 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 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.

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 later 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 paragraph 34, above, the owner-partner's hypothetical capital account (the initial balance of which is determined in accordance with the provisions of paragraph 29 of this SOP) should not be reduced below zero.

36. Some real estate loans classified as real estate investments allow the lender-partner's preference payment (coupon interest) to be deferred temporarily if, for example, income before depreciation for a period is inadequate. The deficiency becomes due if the real estate later becomes profitable, 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. An owner-partner's cash payment 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 owner-partner's capital account balance thus should increase, and the lender-partner's capital account balance 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 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 a real estate investment should be based on the characteristics of the transaction at the time of purchase, as described in paragraphs 12 to 16 of this SOP.

Financial Statement Presentation

40. Balance sheet and income statement amounts relating to real estate loans accounted for as real estate investments 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 real estate investments 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 SOP should be applied to real estate loans entered into or purchased after December 31, 1994. However, earlier application is encouraged for loans entered into or purchased during periods for which financial statements previously have not been issued.

42. Paragraphs 18 to 22 of this SOP, which 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 members of AcSEC deemed significant in reaching the conclusions in this 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 SOP, which is to define the criteria that distinguish a real estate loan from a real estate investment, 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, *Accounting for Leases*, 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 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 a real

estate investment, 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 Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*.

Classifying Real Estate Loans

46. ***Expected Residual Profits.*** During the development of this 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 definition'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 of this SOP would indicate 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 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 SOP to also provide for lender participation in more than 50 percent of the expected residual profit, it was determined that the 50 percent requirement should be eliminated.

50. ***Sweat Equity.*** 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.

51. ***Borrower's Equity Investment.*** Paragraph 12(a) of this 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 a real estate investment. As indicated in that paragraph, AcSEC concluded that, in assessing whether a borrower has an equity investment that is substantial to the project, the minimum down payment requirements specified 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 EITF 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."

52. ***Surety Bonds.*** As noted in paragraph 12(c) of this 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.

53. ***Guarantees.*** 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 all the conditions set forth in paragraph 14 of this SOP 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 a real estate investment to a loan, as discussed in paragraphs 18 and 19 in this SOP, the reverse scenario of reclassifying a loan to a real estate investment 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 SOP. It was noted that a loan that ceases to meet the criteria for loan accounting in paragraph 12 of this SOP would likely be categorized as a loan "identified for evaluation" and thus would 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, such that the loan no longer meets those criteria. AcSEC concluded in paragraph 22 of this SOP that such a transaction should be evaluated in the same manner as a new loan arrangement.

Accounting for Real Estate Loans Classified as Real Estate Investments

56. As noted in paragraph 33 of this 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 thus would 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.

Effective Date and Transition

59. Paragraphs 41 and 42 of this SOP specify the effective date and transition provisions, stating that the provisions of the proposed SOP should be applied to real estate loans entered into or

purchased after December 31, 1994, although earlier application is encouraged for loans entered into during periods for which financial statements previously have not been issued. With respect to transition, AcSEC considered whether this SOP's provisions should be required to be applied to existing loans. In that regard, AcSEC concluded the costs that would be incurred to apply the provisions to existing loans would, in many cases, outweigh the benefits to be obtained. For many loans, the information necessary to apply the provisions would not be readily available. In other cases, the necessary information would be extremely costly to obtain. Accordingly, AcSEC concluded that this SOP's provisions should be applied prospectively.

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 SOP. The real estate loan has none of the characteristics described in paragraph 12 and, accordingly, is accounted for as a real estate investment. 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 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):*

	ABC (Lender)	XYZ (Owner)	Total
19X1			
Preference return (coupon interest)	$1,000,000	$ —	$1,000,000
Operating income after preference	—	—	—
Income 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

---

* As noted in paragraphs 32, 33, and 35 of this 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 real estate 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 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	$ —