

Statutory Issue Paper No. 38

Acquisition, Development and Construction Arrangements

STATUS

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Original SSAP and Current Authoritative Guidance: SSAP No. 38

Type of Issue:

Common Area

SUMMARY OF ISSUE

1. Reporting entities may enter into real estate acquisition, development and construction (ADC) arrangements to finance the construction costs in which they have virtually the same risks and potential rewards as those of owners or joint venturers. In some instances, it may be inappropriate to account for such arrangements as loans. Current statutory accounting provides no specific guidance on the accounting for ADC arrangements. GAAP provides specific guidance for when to treat such arrangements as real estate/joint venture investments rather than as loans. This issue paper establishes statutory accounting principles for ADC arrangements that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

2. This paper provides guidance on when to account for ADC arrangements as mortgage loans and when to account for ADC arrangements as investments in real estate or real estate joint ventures. ADC arrangements shall be defined as lending agreements that are made to the owner of property to finance the acquisition, development and construction of real estate projects on the property in which the lender participates in expected residual profits. Expected residual profit is the amount of profit, whether called interest or another name (e.g., equity kicker) above a reasonable amount of interest and fees expected to be earned by the lender. ADC arrangements shall include participations in loans and purchased loans that meet that definition of ADC arrangements.

3. If the lender is expected to receive over 50% of the expected residual profits of the project, the ADC arrangement shall be classified and accounted for as an investment in real estate in accordance with *Issue Paper No. 40—Real Estate Investments*.

4. If the lender is expected to receive 50% or less of the expected residual profits, the ADC arrangement shall be classified and accounted for as a loan or as a real estate joint venture, depending on the circumstances. If any of the characteristics in paragraph 9.b. through 9.e. of AcSEC Practice Bulletin 1, Exhibit I, *ADC Arrangements* (PB1), which is excerpted in the Relevant GAAP Guidance section in paragraph 10 below, or if a qualifying personal guarantee (as defined in PB1) is present, the ADC arrangement shall be classified and accounted for as a construction loan in accordance with Issue Paper No. 37—Mortgage Loans. Otherwise, the ADC arrangement shall be classified and accounted for as a real estate joint venture in accordance with *Issue Paper No. 48—Investments in Joint Ventures, Partnerships and Limited Liability Companies*.

5. The factors that are evaluated in determining the accounting treatment at inception may subsequently change for some ADC arrangements, for example, as a result of a renegotiation of the terms. Consequently, the accounting treatment for an ADC arrangement shall be periodically reassessed, as described in paragraph 20 of PB1 contained in paragraph 10 below. Any changes in classification shall result in a reclassification of the asset at the amount the asset should be reported at under its new

classification with the net effect, if any, charged to income in the period that the change in classification is made.

6. Regardless of whether an ADC arrangement is accounted for as an investment in real estate, a joint venture, or a mortgage loan, the ADC arrangement meets the definition of an asset as defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* and is an admitted asset to the extent it conforms to the requirements of this issue paper.

DISCUSSION

7. The conclusion above adopts PB1. Classifying and accounting for ADC arrangements in accordance with their economic substance rather than their form is consistent with a regulator's need for meaningful and comparable financial information, as stated in the Statement of Concepts. Furthermore, the conclusion is consistent with the conservatism concept in the Statement of Concepts in as much as certain ADC arrangements that otherwise would be accounted for as loans will be accounted for as investments in real estate. Accordingly, to the extent that the ADC project is expected to incur a loss, the lender shall recognize its share of those losses. The conclusion above also adopts *FASB Emerging Issues Task Force No. 86-21, Application of the AICPA Notice to Practitioners regarding Acquisition, Development, and Construction Arrangements to Acquisition of an Operating Property*.

Drafting Notes/Comments

- ADC arrangements may involve related parties, in which case Issue Paper No. 25 - Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties should also be followed.
- *Issue Paper No. 37—Mortgage Loans* addresses accounting for mortgage loans, including construction loans, and addresses impairment and disclosures.
- *Issue Paper No. 40—Real Estate Investments* addresses accounting for real estate investments, including how to account for sales of real estate, construction of real estate, impairment and disclosures.
- *Issue Paper No. 48—Investments in Joint Ventures, Partnerships and Limited Liability Companies* addresses accounting for joint ventures.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

8. Statutory literature does not specifically address ADC arrangements.
9. Some states specifically prohibit the investment in construction/developmental real estate. For example, Texas Insurance Code Chapter 3, *Life, Health and Accident Insurance*, Subchapter C, Reserves and Investments, Art. 3.33 Sec. 4 (1)(2) states:

... nothing in this article shall allow ownership of, development of, or equity interest in any residential property or subdivision, single or multiunit family dwelling property, or undeveloped real estate for the purpose of subdivision for or development of residential, single, or multiunit family dwellings, except acquisitions as provided in Subdivision (4) below, and such ownership, development, or equity interests shall be specifically prohibited;

Generally Accepted Accounting Principles

10. The accounting for ADC arrangements under GAAP is governed by PB1 as follows:
1. Financial institutions may enter into ADC arrangements in which they have virtually the same risks and potential rewards as those of owners or joint venturers. AcSEC believes that, in some instances, accounting for such arrangements as loans would not be appropriate and thus is providing this guidance in determining the proper accounting.

Scope

2. This notice applies only to those ADC arrangements in which the lender participates in expected residual profit, as further described below.

Expected Residual Profit

3. 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.

4. The extent of such profit participation and its forms may vary. An example of a simple form might be one in which the contractual interest and fees, if any, on a condominium project are considered to be at fair market rates; the expected sales prices are sufficient to cover at least principal, interest, and fees; and the lender shares in an agreed proportion, for example, 20 percent, 50 percent, or 90 percent, of any profit on sale of the units.

5. A slightly different form of arrangement may produce approximately the same result. For example, the interest rate and/or fees may be set at a level higher than in the preceding example, and the lender may receive a smaller percentage of any profit on sale of the units. Thus, a greater portion of the expected sales price is required to cover the contractual interest and/or fees, leaving a smaller amount to be allocated between the lender and the borrower. The lender's share of expected residual profit in such an arrangement may be approximately the same as in the preceding example. A different arrangement may cause the same result if the interest rate and/or fees are set at a sufficiently high level and the lender does not share in any proportion of profit on sale of the units. Another variation is one in which the lender shares in gross rents or net cash flow from a commercial project, for example, an office building or an apartment complex.

6. The profit participation agreement may or may not be part of the mortgage loan agreement. Consequently, the auditor should be aware of the possibility that such agreements may exist and should design audit procedures accordingly. Those procedures could include inquiries to, and requests for written representation from, both the lender and the borrower.

7. The accounting guidance in paragraphs 16 and 17 is based on a consideration of the following characteristics of ADC arrangements. A particular ADC arrangement may have one or more of these characteristics.

Characteristics of ADC Arrangements Implying Investments in Real Estate or Joint Ventures

8. As stated in the "Scope" section, this notice applies to an ADC arrangement in which the lender participates in expected residual profit. In addition to the lender's participation in expected residual profit, the following characteristics suggest that the risks and rewards of an ADC arrangement are similar to those associated with an investment in real estate or joint venture:

- a. The financial institution agrees to provide all or substantially all necessary funds to acquire, develop, or construct the property. The borrower has title to but little or no equity in the underlying property.
- b. The financial institution funds the commitment or origination fees or both by including them in the amount of the loan.
- c. The financial institution funds all or substantially all interest and fees during the term of the loan by adding them to the loan balance.
- d. The financial institution's only security is the ADC project. The financial institution has no recourse to other assets of the borrower, and the borrower does not guarantee the debt.

- e. In order for the financial institution to recover the investment in the project, the property must be sold to independent third parties, the borrower must obtain refinancing from another source, or the property must be placed in service and generate sufficient net cash flow to service debt principal and interest.
- f. The arrangement is structured so that foreclosure during the project's development as a result of delinquency is unlikely because the borrower is not required to make any payments until the project is complete, and, therefore, the loan normally cannot become delinquent.

Characteristics of ADC Arrangements Implying Loans

9. Even though the lender participates in expected residual profit, the following characteristics suggest that the risks and rewards of an ADC arrangement are similar to those associated with a loan:

- a. The lender participates in less than a majority of the expected residual profit.
- b. The borrower has an equity investment, substantial to the project, not funded by the lender. The investment may be in the form of cash payments by the borrower or contribution by the borrower of land (without considering value expected to be added by future development or construction) or other assets. The value attributed to the land or other assets should be net of encumbrances. There may be little value to assets with substantial prior liens that make foreclosure to collect less likely. Recently acquired property generally should be valued at no higher than cost.
- c. The lender has 1) recourse to substantial tangible, salable assets of the borrower, with a determinable sales value, other than the ADC project that are not pledged as collateral under other loans; or 2) the borrower has provided an irrevocable letter of credit from a creditworthy, independent third party to the lender for a substantial amount of the loan over the entire term of the loan.
- d. A take-out commitment for the full amount of the financial institution's loans has been obtained from a creditworthy, independent third party. Take-out commitments often are conditional. If so, the conditions should be reasonable and their attainment probable.
- e. Noncancelable sales contracts or lease commitments from creditworthy, independent third parties are currently in effect that will provide sufficient net cash flow on completion of the project to service normal loan amortization, that is, principal and interest. Any associated conditions should be probable of attainment.

Personal Guarantees

10. Some ADC arrangements include personal guarantees of the borrower and/or a third party. AcSEC believes that the existence of a personal guarantee alone rarely provides a sufficient basis for concluding that an ADC arrangement should be accounted for as a loan. In instances where the substance of the guarantee and the ability of the guarantor to perform can be reliably measured, and the guarantee covers a substantial amount of the loan, concluding that an ADC arrangement supported by a personal guarantee should be accounted for as a loan may be justified.

11. The substance of a personal guarantee depends on a) the ability of the guarantor to perform under the guarantee, b) the practicality of enforcing the guarantee in the applicable jurisdiction, and c) a demonstrated intent to enforce the guarantee.

12. Examples of personal guarantees that have the ability to perform would include those supported by liquid assets placed in escrow, pledged marketable securities, or irrevocable letters of credit from a creditworthy, independent third party[ies] in amounts sufficient to provide necessary equity support for an ADC arrangement to be considered a loan. In the absence of such support for the guarantee, the financial statements and other information of the guarantor may be considered to determine the guarantor's ability to perform. Due to the high-risk nature of many ADC arrangements, AcSEC believes financial statements that are current, complete, and include appropriate disclosures and that are reviewed or audited by independent CPAs are the most helpful in this determination.

13. Particular emphasis should be placed on the following factors when considering the financial statements of the guarantor:

- a. Liquidity as well as net worth of the guarantor--There should be evidence of sufficient liquidity to perform under the guarantee. There may be little substance to a personal guarantee if the guarantor's net worth consists primarily of assets pledged to secure other debt.
- b. Guarantees provided by the guarantor to other projects--If the financial statements do not disclose and quantify such information, inquiries should be made as to other guarantees. Also, it may be appropriate to obtain written representation from the guarantor regarding other contingent liabilities.

14. The enforceability of the guarantee in the applicable jurisdiction should also be determined. Even if the guarantee is legally enforceable, business reasons that might preclude the financial institution from pursuing the guarantee should be assessed. Those business reasons could include the length of time required to enforce a personal guarantee, whether it is normal business practice in that jurisdiction to enforce guarantees on similar transactions, and whether the lender must choose between pursuing the guarantee or the project's assets, but cannot pursue both. The auditor should consider obtaining written representation from management regarding its intent to enforce personal guarantees.

Sweat Equity

15. Some ADC arrangements recognize value, not funded by the lender, for the builder's efforts after inception of the arrangement, sometimes referred to as sweat equity. AcSEC believes that sweat equity is not at risk by the borrower at the inception of an ADC project. Consequently, AcSEC believes sweat equity should not be considered a substantial equity investment on the part of the borrower in determining whether the ADC arrangement should be treated as a loan.

Accounting Guidance

16. In the interest of more uniformity in accounting for ADC arrangements, AcSEC believes the following guidance is appropriate:

- a. If the lender is expected to receive over 50 percent of the expected residual profit, as previously defined, 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,^{N1} and SFAS no. 66, Accounting for Sales of Real Estate.^{N2}

^{N1} Statement of Financial Accounting Standards (SFAS) no. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects (Stamford: FASB, 1982).

^{N2} SFAS no. 66, Accounting for Sales of Real Estate (Stamford: FASB, 1982).

- b. If the lender is expected to receive 50 percent or less of the expected residual profit, the entire arrangement should be accounted for either as a loan or a real estate joint venture, depending on the circumstances. At least one of the characteristics identified in paragraph 9.b.-9.e., or a qualifying personal guarantee should be present for the arrangement to be accounted for as a loan. Otherwise, real estate joint venture accounting would be appropriate.
1. In the case of a loan, interest and fees may be appropriately recognized as income subject to recoverability. Statement of Position SOP no. 75-2, Accounting Practices of Real Estate Investment Trusts,^{N3} and the AICPA audit and accounting guide entitled, Savings and Loan Associations,^{N4} provide guidance that may be relevant in those industries in assessing the recoverability of such loan amounts and accrued interest.

^{N3} Statement of Position SOP no. 75-2, Accounting Practices of Real Estate Investment Trusts (New York: AICPA, 1975).

^{N4} Committee on Savings and Loan Associations, Savings and Loan Associations (New York: AICPA, 1979).

2. In the case of a real estate joint venture, the provisions of SOP no. 78-9, Accounting for Investments in Real Estate Ventures,^{N5} and SFAS no. 34, Capitalization of Interest Cost,^{N6} as amended by SFAS no. 58, Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method,^{N7} provide guidance for such accounting. In particular, paragraph 34 of SOP no. 78-9 provides guidance on the circumstances under which interest income should not be recognized.

^{N5} SOP no. 78-9, Accounting for Investments in Real Estate Ventures (New York: AICPA, 1978).

^{N6} SFAS no. 34, Capitalization of Interest Cost (Stamford: FASB, 1979).

^{N7} SFAS no. 58, Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method (Stamford: FASB, 1982).

17. ADC arrangements accounted for as investments in real estate or joint ventures should be combined and reported in the balance sheet separately from those ADC arrangements accounted for as loans.

Other Considerations

18. Transactions have occurred in which the lender's share of the expected residual profit in a project is sold to the borrower or a third party for cash or other consideration. If the expected residual profit in an ADC arrangement accounted for as a loan is sold, AcSEC believes the proceeds from the sale should be recognized prospectively as additional interest over the remaining term of the loan. The expected residual profit is considered additional compensation to the lender, and the sale results in a quantification of the profit. When an ADC arrangement is

accounted for as an investment in real estate or joint venture and the expected residual profit is sold, gain recognition, if any, is appropriate only if the criteria of SFAS No. 66 are met after giving consideration to the entire ADC arrangement including the continuing relationship between the financial institution and the project.

19. If the financial institution was the seller of the property at the initiation of the project, gain recognition, if any, should be determined by reference to SFAS No. 66.

20. The factors that were evaluated in determining the accounting treatment at inception subsequently change for some ADC arrangements, for example, as a result of a renegotiation of the terms. Consequently, the accounting treatment for an ADC arrangement should be periodically reassessed. An ADC arrangement originally classified as an investment or joint venture could subsequently be treated as a loan if the risk to the lender diminishes significantly, and the lender will not be receiving over 50 percent of the expected residual profit in the project. The lender must demonstrate a change in the facts relied upon when initially making the accounting decision, not just the absence of, or reduced participation in, the expected residual profit. For instance, risk may be reduced if a valid take-out commitment from another lender who has the capability to perform under the commitment is obtained and all conditions affecting the take-out have been met, thus assuring the primary lender recovery of its funds. If the lender on the other hand assumes further risks and/or rewards in an ADC arrangement by, for example, releasing collateral supporting a guarantee and/or increasing its percentage of profit participation to over 50 percent, the lender's position may change to that of an investor in real estate. Neither an improvement in the economic prospects for the project or successful, on-going development of the project nor a deterioration in the economic prospects for the project justifies a change in classification of an ADC arrangement. A change in classification is expected to occur infrequently and should be supported by appropriate documentation. The change in factors in an ADC arrangement should be evaluated based on the guidance in this notice and accounted for prospectively.

21. If an ADC arrangement accounted for as a real estate joint venture continues into a permanent phase with the project generating a positive cash flow and paying debt service currently, income should be recognized in accordance with SOP No. 78-9.

22. Regardless of the accounting treatment for an ADC arrangement, management has a continuing responsibility to review the collectibility of uncollected principal, accrued interest, and fees and provide for appropriate allowances. The auditor should determine whether the allowances provided by management are adequate. In connection with this determination, the auditor should review relevant evidential matter including feasibility studies, appraisals, forecasts, non-cancelable sales contracts or lease commitments and information concerning the track record of the developer. In addition, ADC arrangements may involve related parties and the auditor should be aware of such a possibility and design procedures accordingly. Progress information may be less than desirable for the auditor's purpose and may require supplemental procedures. Additional procedures might include on-site inspection of projects or the independent use of experts such as property appraisers or construction consultants to assist in the assessment of the collateral value.

23. Many participations in loans or whole loans are bought and sold by other financial institutions. The accounting treatment for a purchase that involves ADC arrangements should be based on a review of the transaction at the time of purchase in accordance with the guidance in this notice. In applying this guidance, a participant would look to its individual percentage of expected residual profit; for example, a participant who will not share in any of the expected residual profit is not subject to this notice. However, the responsibility to review collectibility and provide allowances applies equally to purchased ADC arrangements. Any reciprocal transactions between institutions, including multi-party transactions, should be viewed in their entirety and accounted for in accordance with their combined effects.

RELEVANT LITERATURE**Statutory Accounting**

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 37—Mortgage Loans*
- *Issue Paper No. 40—Real Estate Investments*
- *Issue Paper No. 48—Investments in Joint Ventures, Partnerships and Limited Liability Companies*

Generally Accepted Accounting Principles

- AcSEC Practice Bulletin 1, Exhibit I, *ADC Arrangements*
- *FASB Emerging Issues Task Force No. 86-21, Application of the AICPA Notice to Practitioners regarding Acquisition, Development, and Construction Arrangements to Acquisition of an Operating Property*

State Regulations

- Texas Insurance Code, Chapter 3, *Life, Health and Accident Insurance*, Subchapter C, Reserves and Investments, Art. 3.33