

## EITF ABSTRACTS

Issue No. 84-4

**Title:** Acquisition, Development, and Construction Loans

**Dates Discussed:** July 24, 1984; November 15, 1984; February 14, 1985; March 28, 1985; May 9, 1985; August 8, 1985; February 6, 1986; March 13–14, 1986

**References:** FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*  
FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133*  
FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*  
FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*  
FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*  
FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*  
FASB Staff Position FIN46-6, “Effective Date of FASB Interpretation No. 46”  
AICPA Audit and Accounting Guide, *Audits of Investment Companies*  
AICPA Notice to Practitioners, *Certain Real Estate Lending Activities of Financial Institutions*, dated November 1983 (referred to as the first Notice)  
AICPA Notice to Practitioners, *ADC Loans*, dated November 26, 1984 (referred to as the second Notice)  
AICPA Notice to Practitioners, *ADC Arrangements*, dated February 10, 1986 (referred to as the third Notice)  
AcSEC Practice Bulletin 1, *Purpose and Scope of AcSEC Practice Bulletins and Procedures for their Issuance*  
SEC Staff Accounting Bulletin No. 71, *Views regarding Financial Statements of Properties Securing Mortgage Loans*  
SEC Staff Accounting Bulletin No. 71A, *Addition to SAB No. 71*  
FSLIC Statement of Policy, *Accounting for Acquisition, Development and Construction Loans as Codified at 12 CFR 571.17*, dated April 18, 1985

## ISSUE

Financial institutions sometimes enter into acquisition, development, and construction loans (ADC loans) in which they have virtually the same risks and potential rewards as those of owners or joint venturers. [Note: See STATUS section.] There is often little risk in such arrangements to the borrower. The lender may advance all or substantially all the necessary

funds to complete a project (including fees and interest), may have a share in the residual profits of the project (an equity "kicker"), and must look to the eventual sale or refinancing of the property for repayment of the advances. Such transactions are often structured in a manner that makes default unlikely because there is no requirement for the borrower to make payments while the project is in progress.

The issues are:

1. The circumstances under which the arrangement should be accounted for as a loan, as an investment, or as an interest in a joint venture
2. How an institution should account for the sale of part of the arrangement, either the loan portion or the equity kicker, if the other portion is retained.

## **EITF DISCUSSION**

The Task Force initially reached a consensus that the guidance in the first Notice was adequate, though some variations in application of the guidance were noted. Subsequently, many members indicated that there was considerable diversity in the application of the first and second Notices. Some suggested that the diversity in practice is attributable to misapplication of the guidance by selectively applying certain specific aspects while ignoring the substance of the transaction. The Task Force's subsequent discussions of ADC loans focused on the developing problems in practice and efforts by the AICPA to develop additional guidance. In response to the diversity in practice, the AICPA issued the third Notice, which contained additional guidance concerning the classification of ADC loans. The third Notice superseded the first and second Notices. The scope of the third Notice includes only those ADC arrangements in which the lender participates in expected residual profit. The third Notice gives specific guidance on accounting for ADC arrangements and on reporting them in financial statements, and states that the guidance should be applied on a prospective basis. The issuance of the third Notice effectively resolves the issues.

During the Task Force's discussion of the third Notice, the SEC Observer indicated that the SEC staff does not view the guidance in the third Notice as prospective only. Rather, he believes a registrant and its independent auditor should evaluate existing and future arrangements in relation to the guidance in the third Notice. In those situations in which application of the third Notice to existing arrangements would result in a different classification of the ADC arrangement based on an analysis of the current facts and circumstances, the balance sheet in financial statements *after* December 31, 1985 should reflect the accounting classification that results from application of the Notice. In those future periods (beginning January 1, 1986), income recognition on such arrangements should be based on the balance sheet classification. The SEC Observer also indicated that any errors made in application of the two prior Notices should be corrected through restatement.

## **STATUS**

The Task Force subsequently discussed whether the guidance in the third Notice applies to the acquisition of operating properties, as well as to ADC loans, under Issue No. 86-21, "Application of the AICPA Notice to Practitioners regarding Acquisition, Development, and Construction Arrangements to Acquisition of an Operating Property." Under that Issue, the Task Force reached a consensus that preparers and auditors should consider the guidance contained in the third Notice in accounting for shared appreciation mortgages, loans on operating real estate, and real estate ADC arrangements entered into by enterprises other than financial institutions.

On August 12, 1987, the SEC staff issued SAB 71, which discusses the filing requirements for financial statements of properties securing mortgage loans. In discussing mortgage loans that in economic substance represent an investment in real estate or a joint venture rather than a loan, SAB 71 incorporates guidance from the third Notice. The SAB also makes reference to the Task Force consensus under Issue 86-21.

In November 1987, the AICPA's Accounting Standards Executive Committee issued Practice Bulletin 1. The guidance contained in the third Notice is reprinted in Exhibit I of Practice Bulletin 1.

On December 15, 1987, the SEC staff issued SAB 71A, which supplements the guidance provided in SAB 71.

On November 2, 1988, the Federal Home Loan Bank Board (FHLBB) withdrew the FSLIC Statement of Policy codified at 12 CFR 571.17, effective November 10, 1988. In a notice published in the November 10, 1988 *Federal Register*, the FHLBB states that all institutions, the accounts of which are insured by the FSLIC or affiliates thereof, should follow generally accepted accounting principles (as currently set forth in the third Notice) in classifying and accounting for ADC arrangements in reports or financial statements filed with the FHLBB or the FSLIC.

Statement 133 was issued in June 1998 and was amended by Statements 137, 138, and 149. The effective date for Statement 133, as amended, is for all fiscal quarters of all fiscal years beginning after June 15, 2000.

Statement 133 generally requires embedded instruments that are derivatives and that are not clearly and closely related to the host contract to be accounted for separately. However, paragraph 10(e)(2) provides a scope exception for contracts that have an underlying that is the price or value of a nonfinancial asset of one of the parties to the contract. (Refer to Statement 133 Implementation Issue No. C5, "Exception Related to a Nonfinancial Asset of One of the Parties," for further guidance.) The equity kicker would typically not be separated from the host contract and accounted for as a derivative because paragraph 12(c) of Statement 133 exempts a hybrid contract from bifurcation if a separate instrument with the same terms as the embedded equity kicker is not a derivative instrument subject to the requirements of Statement 133. Under

paragraph 10(e)(2) of Statement 133, the embedded equity kicker would typically not be subject to the requirements of Statement 133 because the separate instrument with the same terms is not exchange traded and is indexed to nonfinancial assets that are not readily convertible to cash.

A loan with an equity kicker of more than 50 percent of net earnings that is considered to be an investment in real estate under AICPA Practice Bulletin 1 would not be analyzed under Statement 133 as a host loan contract and an embedded equity kicker derivative.

Interpretation 46 and Interpretation 46(R) address consolidation by business enterprises of variable interest entities, which may include structures used to facilitate ADC loans. Interpretation 46 and Interpretation 46(R) require a variable interest entity to be consolidated by an enterprise if that enterprise will absorb a majority of the entity's expected losses or is entitled to receive a majority of the entity's expected residual returns or both.

Interpretation 46 was issued in January 2003. The consolidation requirements of Interpretation 46 apply immediately to variable interest entities created after January 31, 2003. The consolidation requirements apply to older entities in the first fiscal year or interim period beginning after June 15, 2003. Certain of the disclosure requirements apply in all financial statements issued after January 31, 2003, regardless of when the variable interest entity was established.

FSP FIN46-6 deferred the effective date for applying the provisions of Interpretation 46 for:

1. Interests held by a public entity in variable interest entities created before February 1, 2003, if the public entity has not issued financial statements reporting that interest in accordance with Interpretation 46. The application of Interpretation 46 to those interests is deferred until the end of the first period ending after December 15, 2003.
2. Nonregistered investment companies accounting for their investments in accordance with the specialized accounting guidance in the investment company Guide.

Interpretation 46(R) was issued on December 24, 2003, and replaced Interpretation 46. An enterprise with an interest in an entity to which the provisions of Interpretation 46 were not

applied as of December 24, 2003, must apply the effective date and transitions provisions in Interpretation 46(R) to that entity. Application by public companies of Interpretation 46 or Interpretation 46(R) to entities commonly referred to as special-purpose entities is required no later than as of the end of the first reporting period that ends after December 15, 2003. Public enterprises must apply Interpretation 46(R) to all entities no later than the end of the first reporting period that ends after March 15, 2004 (public enterprises other than small business issuers) or December 15, 2004 (small business issuers). Nonpublic enterprises must apply Interpretation 46(R) to entities created after December 31, 2003, immediately and to all other entities by the beginning of the first annual period beginning after December 15, 2004. An enterprise that has applied Interpretation 46 to an entity prior to the effective date of Interpretation 46(R) shall either continue to apply Interpretation 46 until the effective date of Interpretation 46(R) or apply Interpretation 46(R) at an earlier date.

No further EITF discussion is planned.