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).

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 esi(rm)8ap

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.

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*.

- 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.
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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

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

- 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*

- 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*

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