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Guideline

Subject: **Accounting for READC Project Financing Arrangements**

No: **D-2** **Date:** **May 1994**

This guideline provides criteria to assist in distinguishing between READC (Real Estate Acquisition Development and Construction) project financing arrangements that may be treated as loans and those that should be treated as equity portfolio investments for accounting purposes. The guideline does not affect the classification of loans and investments for purposes of the legislated limits on interests in real property.

The guideline does not apply where (i) the lender has control over the borrower as defined in Section 1590 of the CICA Handbook; or (ii) the lender is able to exercise significant influence over the borrower as described in Section 3050 of the CICA Handbook; or (iii) the lender and the borrower jointly control the READC project being financed as described in Section 3055 of the CICA Handbook.

The guideline applies to all federally regulated deposit-taking institutions, including authorized foreign banks in respect of their business in Canada – foreign bank branches (FBBs), entering into READC project financing arrangements.

Page

Canada

READC Project Financing Arrangements

In READC project financing arrangements, there is usually a considerable length of time, sometimes a year or more, between when the loan advances are made and when interest payments first come due. Such financings may also provide for the lender to receive a payment(s) which is contingent on events related to the financial success of the project itself, and which is in addition to interest and other payments which must be made irrespective of the project's success.

The Office is of the view that, when the characteristics of READC project financing arrangements are such that the nature of the revenue is akin to that from an equity portfolio investment, this revenue should be recognized in accordance with the accounting principles appropriate to such investments.

Classification Criteria

For purposes of this guideline, "expected earnings" means total payments expected to be received from the project except repayment of loan principal; and "contingent component" means that portion of expected earnings that contractually depends on events related to the project being financed which may or may not occur.

An arrangement should be classified as a loan if, at the time the arrangement is made, payments of interest and fees are based on a predetermined schedule, and the lender's total expected earnings from the arrangement either:

- do not include a contingent component; or

- include a contingent component that does not exceed 15 per cent of the lender's total expected earnings, and the arrangement meets at least one of the following conditions:

    a) At the commencement of the arrangement the borrower's equity investment in the project equals at least 25 per cent of the estimated cost of the real estate project being financed, that is not funded by the lender or any affiliate of 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 tangible assets. The value attributed to the land or other assets should be the current market value 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.

b) Under the arrangement at least 35 per cent of the loan outstanding at any point in time is secured by one of the following:

   i) recourse to pledged tangible saleable assets of the borrower (net of encumbrances and selling expenses), other than the real estate project; or

   ii) an irrevocable letter of credit from a creditworthy third party; or

   iii) a guarantee from a creditworthy third party, where the substance of the guarantee and the ability of the guarantor to perform can be reliably measured, and the guarantee can be practically enforced in the applicable jurisdiction.

c) At the commencement of the arrangement a take-out commitment for the full amount due to the financial institution has been obtained from a creditworthy, independent third party. The conditions of these commitments should be reasonable and their attainment probable.

d) At the commencement of the arrangement legally enforceable sales contracts, leases, or lease commitments from creditworthy, independent third parties exist that will provide sufficient net cash flow on completion of the project to service loan amortization of principal and interest for a period of time considered reasonable in the circumstances. The attainment of any conditions associated with such contracts or commitments should be probable.

An arrangement failing to qualify as a loan under any one of the above criteria should be classified as an equity portfolio investment.

Where the terms of the READC project financing arrangement give the borrower the right to be released from any one of the loan conditions outlined above, the condition subject to release should not be considered in determining the classification of the arrangement.

Where a lender makes or commits to make another loan to the same borrower on or related to the same READC project at or near the time of the initial arrangement, the classification of such an arrangement should be determined in the aggregate.

The terms of a READC project financing arrangement, that are evaluated in determining the classification at the time the arrangement is made, may subsequently change if the lender and the borrower renegotiate the arrangement and agree to changes to the original agreements.

When a READC project financing arrangement classified initially as a loan is renegotiated as a result of the weakened financial condition of the borrower, the new terms are not subject to re-evaluation under the above criteria.

When a READC project financing arrangement is renegotiated for reasons other than the weakened financial condition of the borrower, the new terms should be evaluated under the above criteria to determine whether the original classification of the financing arrangement should continue or be changed.

Accounting Treatment

Once the classification of a READC project financing arrangement is determined, generally accepted accounting principles applicable to loans or equity portfolio investments should be applied to the arrangement as appropriate in the circumstances of the particular arrangement.

Any contingent component that the financial institution is entitled to receive from the READC project financing arrangements classified as loans should be recognized as income only when it is received or receivable (i.e., on the date it is contractually due). If, however, reasonable assurance does not exist with respect to the ultimate collectibility of the contingent component, it should be recognized only when received.

The accounting for fees on READC project financing arrangements classified as loans should conform with the treatment outlined in the October 1987 accounting guideline entitled "Fees and costs associated with lending activities" in the Handbook of the Canadian Institute of Chartered Accountants.

When a READC project financing arrangement classified initially as a loan is renegotiated as a result of the weakened financial condition of the borrower, the lender may be left with either a restructured loan or a combination of a restructured loan and assets acquired in satisfaction of a portion of the prior arrangement. Alternatively, in the event of foreclosure, the lender may acquire other assets such as project shares or real estate. A restructured READC loan and any assets acquired as a result of renegotiation or foreclosure should be accounted for in accordance with generally accepted accounting principles applicable to restructured loans and/or foreclosed assets as appropriate to the circumstances of the renegotiation or foreclosure.

A READC project financing arrangement which has been renegotiated for reasons other than the weakened financial condition of the borrower and which has been re-evaluated under the classification criteria will be accounted for in accordance with generally accepted accounting principles appropriate to the classification determined for the renegotiated arrangement.

Earnings from READC project financing arrangements classified as equity portfolio investments should be recognized only to the extent received or receivable (i.e., on the date it is contractually due). READC project financing arrangements classified as equity portfolio investments should not be combined, for reporting purposes, with READC project financing arrangements classified as loans. If material, the carrying amount of READC project financing arrangements accounted for as equity portfolio investments should be disclosed separately under securities either on the balance sheet or in the notes to the annual financial statement, or in the OSFI annual return prepared by FBBs. Earnings from READC project financing arrangements classified as equity portfolio investments should be recorded as income from securities.

Record of Classification

Financial institutions are required to keep a record with each material READC project financing arrangement that would provide OSFI's examiners with the following information with respect to the particular arrangement. At the time the arrangement is made the information required is:

- the classification of the arrangement;
- an explanatory note supporting the classification of the arrangement; and
- a summary of the rights and obligations of the parties to the arrangement pertinent to the classification decision.

Subsequently, an update of the above-noted information will be required only when the READC project financing arrangement has been renegotiated resulting in a change in classification.

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