

Joint Statement

Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Board of Governors of the Federal Reserve System

For immediate release

Interagency Guidance on Accounting for Dispositions of Other Real Estate Owned

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Purpose

This issuance provides guidance with respect to the appropriate accounting for dispositions of other real estate owned (OREO). This guidance generally conforms regulatory reporting requirements for sales of OREO with generally accepted accounting principles (GAAP).

Background

Banks often sell parcels of OREO property and provide financing for these transactions. These transactions should be accounted for in accordance with the Instructions to the Consolidated Reports of Condition and Income (Call Reports). Beginning with the June 30, 1993 report date, the instructions for OREO in Call Report Schedule RC-M were revised to eliminate certain minimum down payment requirements which exceeded those required under GAAP. Accordingly, the primary guidance for sales of OREO is Statement of Financial Accounting Standards No. 66, "Accounting for Sales of Real Estate" (SFAS 66).

SFAS 66 establishes five different methods of accounting for sales of real estate. The different methods are based on the legal form of the transaction, the type of property sold, the amount of down payment and other factors. However, in the past, many banks have only used two of these methods: the full accrual method or the deposit method. While the full accrual method accounts for the transaction as a sale of the real estate, the deposit method does not.

The full accrual method under SFAS 66 requires an initial investment (down payment) based on specific guidelines. Some banks have concluded that if the initial down payment amount was insufficient to qualify for the full accrual method, the deposit method must be used instead. Additionally, although SFAS 66 provides criteria regarding when it is appropriate to subsequently switch to another accounting method and recognize the sale, these banks have generally continued using the deposit method and classifying the asset as OREO until the transaction qualified for the full accrual method.

Although the deposit method is appropriate in certain circumstances, the inappropriate use of this method does not properly characterize a transaction as a sale of the real estate when, in fact, a valid sale has occurred. However, other appropriate methods specified in SFAS 66 recognize the

sale. Furthermore, the full accrual, installment, and reduced-profit methods permit, in appropriate circumstances, the recording of the resulting loan as an earning asset.

The distinction between loans and OREO is important to users of bank financial statements. Bank analysts and others customarily include OREO in a bank's nonperforming assets and often use the level of nonperforming assets as one of the factors in the evaluation of a bank's financial condition.

Hence, the inappropriate use of the deposit method may cause a bank to report higher levels of OREO than are required under generally accepted accounting principles and regulatory reporting requirements, thereby causing nonperforming assets to be overstated.

Accordingly, this issuance summarizes the circumstances when it is appropriate to use each of the five methods prescribed in SFAS 66. The actual accounting standard and other relevant guidance should also be consulted as they contain specific and more detailed requirements and guidance.

Accounting Guidance

SFAS 66 establishes the following methods to account for dispositions of real estate, and applies to all transactions in which the seller provides financing to the buyer of the real estate. If a profit is involved in the sale of real estate, each method sets forth the manner in which the profit is to be recognized. Regardless of which method is used, however, any losses on the disposition of real estate should be recognized immediately.

Full Accrual Method - Under the full accrual method, the disposition is recorded as a sale. Any profit resulting from the sale is recognized in full and the asset resulting from the seller's financing of the transaction is reported as a loan. This method may be used when the following conditions have been met:

- A sale has been consummated;
- The buyer's initial investment (down payment) and continuing investment (periodic payments) are adequate to demonstrate a commitment to pay for the property;
- The receivable is not subject to future subordination; and
- The usual risks and rewards of ownership have been transferred.

Guidelines for the minimum down payment that must be made in order for a transaction to qualify for the full accrual method are set forth in the Appendix A to SFAS 66. These vary from 5 percent to 25 percent of the property sales price. These guideline percentages vary by type of property and are primarily based on the inherent risk assumed for the type and characteristics of the property. To meet the continuing investment criteria, the contractual loan payments must be sufficient to pay the loan off over the customary loan term for the type of property involved. Such periods may range up to 30 years for loans on single family residential property.

Installment Method - Dispositions of OREO that do not qualify for the full accrual method may qualify for the installment method. This method recognizes a sale and the corresponding loan.

Any profits on the sale are only recognized as the bank receives payments from the purchaser/borrower. Interest income is recognized on an accrual basis, when appropriate.

The installment method is used when the buyer's down payment is not adequate to allow use of the full accrual method but recovery of the cost of the property is reasonably assured if the buyer defaults. Assurance of recovery requires careful judgment on a case-by-case basis. Factors which should be considered include: the size of the down payment, loan to value ratios, projected cash flows from the property, recourse provisions, and guarantees.

Since default on the loan usually results in the seller's reacquisition of the real estate, reasonable assurance of cost recovery may often be achieved with a relatively small down payment. This is especially true in situations involving loans with recourse to borrowers who have verifiable net worth, liquid assets, and income levels. Reasonable assurance of cost recovery may also be achieved when the purchaser/borrower pledges additional collateral.

Cost Recovery Method - Dispositions of OREO that do not qualify for either the full accrual or installment methods are sometimes accounted for using the cost recovery method. This method recognizes a sale and the corresponding loan, but all income recognition is deferred. Principal payments are applied as a reduction of the loan balance and interest increases the unrecognized gross profit. No profit or interest income is recognized until either the aggregate payments by the borrower exceed the recorded amount of the loan or a change to another accounting method is appropriate (i.e., installment method). Consequently, the loan is maintained on nonaccrual status while this method is being used.

Reduced-Profit Method - This method is used in certain situations where the bank receives an adequate down payment, but the loan amortization schedule does not meet the requirements for use of the full accrual method. The method recognizes a sale and the corresponding loan. However, like the installment method, any profit is apportioned over the life of the loan as payments are received.

The method of apportionment differs from the installment method in that profit recognition is based on the present value of the lowest level of periodic payments required under the loan agreement.

Since sales with adequate down payments are generally not structured with inadequate loan amortization requirements, this method is seldom used in practice.

Deposit Method - The deposit method is used in situations where a sale of the OREO has not been consummated. It may also be used for dispositions that could be accounted for under the cost recovery method. Under this method a sale is not recorded and the asset continues to be reported as OREO. Further, no profit or interest income is recognized. Payments received from the borrower are reported as a liability until sufficient payments or other events have occurred which allow the use of one of the other methods.

The above discussion represents a condensed summary of the methods included in SFAS 66 for accounting for sales of real estate. Bankers and examiners should refer to SFAS 66 for a more

complete description of the accounting principles that apply to sales of real estate, including the determination of the down payment percentage.