Insights

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Financial Institutions

Evaluating Loan Impairment and Debt Restructuring in Today's Economy

The distress in the U.S. economy at this time is causing slowdowns in either the amount or timing, or both, of payments by debtors on their loans. Loans may be consumer loans, such as credit cards or automobile loans; mortgage and construction loans; and commercial loans. Concern about loan collectibility affects all who are lenders; however, financial institutions are most affected.

FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, states, "A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement." As used in this Statement, all "amounts due according to the contractual terms" means that both the contractual interest payments and the contractual principal payments of a loan will be collected as scheduled in the loan agreement.

The following are examples of loans that would be considered impaired:

- A construction loan is well secured, but due to delays in construction primarily related to an economic downturn, the project will be delayed. The only source of repayment is sale of the completed project. As a result of the construction delay, the financial institution will not receive the principal amount at contractual maturity, even though the financial institution eventually expects to collect the full amount of the principal due. This loan meets the definition of an impaired loan.
- The financial institution originates a loan to a borrower to develop raw land. There is no significant source of secondary support for the loan (i.e., the guarantor does not have liquid assets). The loan is performing due to an interest reserve. Due to a delay in the project, the loan is renewed for six months and a new interest reserve is established for the new loan term. Due to a decline in real estate values, the capitalization of interest has increased the loan-to-value ratio well above the financial institution's policy limit. This loan meets the definition of an impaired loan.

In today's economic environment, many debtors experience financial difficulties that result in debt restructuring. When a debtor is experiencing financial difficulties, it is important to be able to discern whether the ensuing debt restructuring is a "troubled debt restructuring" so as to be able to apply the proper accounting to the transaction.

A troubled debt restructuring is a restructuring of debt in which the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. That concession either stems from an agreement between the creditor and the debtor or is imposed by law or a court. For example, a creditor may restructure the terms of a debt to alleviate the burden of the debtor's near-term cash requirements, and many troubled debt restructurings involve modifying terms to reduce or defer cash payments required of the debtor in the near future to help the debtor attempt to improve its financial condition and eventually be able to pay the creditor. Or, for example, the creditor may accept cash, other assets, or an equity interest in the debtor in satisfaction of the debt though the value received is less than the amount of the debt because the creditor concludes that step will maximize recovery of its investment.

As shown in these examples, a troubled debt restructuring is often thought of as a restructuring in which a portion of the principal is forgiven or interest payments are eliminated for a period of time. A troubled debt restructuring, however, may include other modifications of the terms of a debt, such as an extension of the maturity date at a stated

interest rate that is lower than the current market rate for new debt with similar risk. Therefore if the inherent risk of a loan has increased, renewal at the existing interest rate may be a troubled debt restructuring because that interest rate is below what a market participant would require in interest.

FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, provides more examples of modifications of terms of debt that result in a troubled debt restructuring. Accounting guidance for troubled debt restructurings can be found in Statement No. 114

Disclosure of Fair Value Measurements Related to Impaired Loans

FASB Statement No. 157, *Fair Value Measurements*, defines fair value, establishes a framework for measuring fair value, and requires disclosures about fair value measurements. When measuring loan impairment based on the appraised value of the collateral, Statement No. 157 will likely have an impact on related disclosures for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years.

First, financial institutions will need to determine where to place each impaired loan measurement in the Statement No. 157 fair value hierarchy (i.e., Level 1, 2, or 3). Unless the collateral is sold shortly after the end of the reporting period, it is unlikely that the fair value measurement related to an impaired loan would fall into Level 1 in the fair value hierarchy. However, since appraisals are often based on comparable sales, a Level 2 input, many fair value measurements related to impaired collateral-dependent loans will fall into Level 2. However, financial institutions need to review appraisals carefully to determine whether the comparable assets are truly similar to the asset being measured and whether those sales were within a reasonable time period. If an outdated appraisal is adjusted for current market conditions, the adjustment may result in a Level 3 fair value measurement.

Second, paragraph 33 of Statement No. 157 requires certain disclosures for assets that are measured at fair value on a nonrecurring basis. Impaired loans that are measured based on a loan's observable market price or the fair value of the collateral are considered to be measured at fair value on a nonrecurring basis. Thus, financial institutions will be required to disclose the fair value measurements related to impaired loans and the level within the fair value hierarchy in which the fair value measurements fall. Additional disclosures are required for Level 3 fair value measurements. Further, the valuation techniques used to measure the fair value of impaired loans will be required to be disclosed in annual periods.

When Statement No. 157 is initially applied (whether in full or under the partial deferral), paragraph 39 states that disclosures required by the Statement, including those required in annual periods only, be disclosed in the first interim period (including financial information included in Form 10-Q by public entities).

Statement No. 157 is available in full at http://www.fasb.org/pdf/aop_FAS157.pdf.

Public Sector

McGladrey & Pullen Responds to Proposed Reporting for Endowment Funds

To provide guidance on the net asset classification of donor-restricted endowment funds for a not-for-profit organization (NPO) that is subject to an enacted version of the Uniform Prudent Management of Institutional Funds Act of 2006, the Financial Accounting Standards Board (the Board) proposed FASB Staff Position (FSP) No. FAS 117-a, *Endowments of Not-for-Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of the Uniform Prudent Management of Institutional Funds Act, and Enhanced Disclosures*, in February 2008. McGladrey & Pullen, LLP supports the issuance of the proposed FSP and believes it would enhance the reporting of endowments. We have issued a comment letter related to the content and effective date of the FSP, which states that we believe the guidance for net asset classification of donor-restricted endowment funds is appropriate and can be consistently applied in practice. Our comment letter includes our concern that many smaller organizations with years ending as soon as June 30, 2008 might find it difficult to meet all of the accounting and reporting requirements within such a limited time after the issuance of the final FSP. We believe an effective date of annual periods ending after December 15, 2008 for all NPOs is more reasonable. Alternatively, we suggested the Board consider a delayed effective date for NPOs under a certain size.

International

ISA Revises Requirements for Written Representations

The International Auditing and Assurance Standards Board (IAASB) recently released International Standard on Auditing (ISA) 580 (Revised and Redrafted), *Written Representations*. This revised Standard requires the auditor to request management to provide written representations on two fundamental matters: (a) That it has fulfilled its responsibility for the preparation and presentation of the financial statements; and (b) That it has provided the auditor with all relevant information and that all transactions have been recorded and are reflected in the financial statements. The auditor may request other written representations during the course of the audit, and other ISAs also include requirements for the auditor to request certain written representations with respect to specific matters.

In addition, ISA 580 (Revised and Redrafted) requires appropriate action by the auditor when written representations are not provided by management or are considered to be unreliable. The ISA makes clear that although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any matters. Furthermore, the fact that management has provided written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management's responsibilities or about specific assertions.

The IAASB also recently released ISA 560 (Redrafted), Subsequent Events. The redrafting of ISA 560 provides more clarity as to the requirements of the Standard, but does not incorporate any substantive changes. The complete set of clarified ISAs, including newly revised standards such as ISA 580 (Revised and Redrafted), is effective for audits of financial statements for periods beginning on or after Dec. 15, 2009.

The ISAs are available in full at The IFAC Bookstore.

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