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Hot Topic

Update on major accounting and auditing activities

FASB proposes to clarify troubled debt restructuring guidance

Contents

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Summary

On 12 October 2010, the FASB issued a proposed Accounting Standards Update (proposed ASU)[1] to clarify the accounting guidance on identifying troubled debt restructurings for creditors.[2]

While troubled debt restructurings can occur from either the perspective of the debtor or the creditor, the FASB's proposed clarifications apply only to creditors that restructure receivables.

The proposed ASU would clarify that:

- Creditors are explicitly prohibited from using the borrower's effective rate test in evaluating whether a restructuring constituted a troubled debt restructuring.
- If a debtor does not otherwise have access to funds at a market rate for debt with similar risk characteristics as the restructured debt, the restructuring would be considered to be below a market rate.
- A restructuring that results in a temporary or permanent increase in the contractual interest rate cannot be presumed to be at a rate that is at or above market.
- A borrower that is not currently in default may still be considered to be experiencing financial difficulty when payment default is considered "probable in the foreseeable future."
- A restructuring that results in an insignificant delay in contractual payments may still be considered a troubled debt restructuring.

The FASB believes there has been diversity in practice related to identifying and disclosing troubled debt restructurings, and this diversity has been amplified over the last several years given the economic conditions. The proposed ASU will likely have the greatest effect on financial institutions such as banks.

The proposed ASU would be effective on a prospective basis for interim and annual periods ending after 15 June 2011. The proposed disclosure requirements would be applied retrospectively to restructurings occurring on or after the beginning of the

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[1] Proposed ASU, *Clarifications to Accounting for Troubled Debt Restructurings by Creditors*.

[2] ASC 310-40, *Receivables — Troubled Debt Restructurings by Creditors (formerly FAS 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings).*

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earliest period presented. As such, companies should not wait to begin evaluating the new requirements. Companies may find that changes are needed to both systems and internal controls as a result of the new requirements.

The comment letter period is open until 13 December 2010.

Scope

The proposed ASU would apply to all reporting entities that modify (or restructure) loans in a troubled debt restructuring. A troubled debt restructuring occurs if 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. The recent economic environment has resulted in an increased number of loan modifications, many of which have been deemed troubled debt restructurings.

Clarifications

Despite the recent increased volume in loan modifications, the FASB believes that some companies are not appropriately identifying modifications as troubled. The FASB believes making certain clarifications to the guidance could help further standardize the identification and reporting of troubled debt restructurings.

The proposed ASU would preclude a creditor from applying debtor guidance in evaluating whether a restructuring constitutes a troubled debt restructuring. This proposed change involves adding one sentence to the codification that states a creditor should not apply the guidance in ASC 470-60-55-10.[3] The troubled debt restructuring guidance for debtors indicates that a creditor is deemed to have granted a concession if the debtor's effective borrowing rate on the restructured debt is less than the effective borrowing rate of the old debt immediately before the restructuring. There are indications that this test has been used by creditors to determine whether modifications are troubled debt restructurings.

Another proposed change includes clarifying the guidance on determining whether a concession has been granted. If a debtor does not otherwise have access to funds at a market rate for debt with similar risk characteristics as the restructured debt, the restructuring would be considered to be below a market rate and therefore should be considered a troubled debt restructuring.

How we see it

This concept has often been expressed as whether the borrower could "go across the street" to another bank and obtain the same loan at the same terms. If not, it is often presumed that the lender has granted a concession. In addition, the proposed ASU implies that the inability to obtain new debt with similar risk characteristics automatically indicates financial difficulty.

The proposed ASU also indicates that a temporary or permanent increase in the contractual interest rate as a result of a restructuring does not preclude the restructuring from being considered a troubled debt restructuring, because the new contractual interest rate could still be below market interest rates for new debt with similar terms.

The proposed ASU would include indicators that a creditor should consider in determining whether a debtor is experiencing financial difficulties. These indicators, sourced from the debtor guidance, include:

- The debtor is currently in default on any of its debt.
- The debtor has declared or is in the process of declaring bankruptcy.
- There is significant doubt as to whether the debtor will continue to be a going concern.
- Currently, the debtor has securities that have been delisted, are in the process of being delisted, or are under threat of being delisted from an exchange.
- Based on estimates and projections that encompass only the current business capabilities, the creditor forecasts that the debtor's entity-specific cash flows will be insufficient to service the debt (both interest and principal) in accordance with the contractual terms of the existing agreement through maturity.
- Absent the current modification, the debtor cannot obtain funds from sources other than the existing creditors at an effective interest rate equal to the current market interest rate for similar debt for a nontroubled debtor.

Notwithstanding the indicators above, the following two factors provide determinative evidence that the debtor is not experiencing financial difficulty (both must be met):

- The debtor is currently servicing the old debt and can obtain funds to repay the old prepayable debt from sources other than the existing creditors (without regard to the current modification) at an effective interest rate equal to the current market interest rate for a nontroubled debtor.
- The creditors agree to restructure the old debt solely to reflect a decrease in current market interest rates for the debtor or positive changes in the creditworthiness of the debtor since the debt was originally issued.

[3] ASC 470-60-55-10, *Debt — Troubled Debt Restructurings by Debtors — Implementation Guidance and Illustrations — General — Distinguishing Between a Troubled Debt Restructuring and a Modification — Determining Whether the Creditor Granted a Concession.*

How we see it

This clarification allowing for the explicit use of the indicators from the debtor guidance likely will not result in any significant changes. Because there has historically been more guidance specific to debtors than to creditors,[4] many companies have already adopted policies of looking to the debtor guidance and using these criteria as indicators of debtor financial difficulty from the creditor's perspective. The proposed ASU, however, now explicitly states that a creditor should use the indicators, and codifies them directly within the creditor guidance.

The proposed ASU also includes an explicit statement that a creditor may conclude that a debtor is experiencing financial difficulties, even though the debtor is not currently in default, if a creditor determines that payment default is probable in the foreseeable future.

This is further supported by views expressed by the SEC staff in 2007 and 2008 in the context of qualifying special-purpose entities (QSPEs) and the ability to modify loans when default is "reasonably foreseeable."[5]

Finally, the proposed ASU clarifies that restructurings resulting in insignificant delays in cash flows may still be considered troubled debt restructurings.

How we see it

This proposed change could have a significant effect on the identification and disclosure of troubled debt restructurings, as some companies have adopted policies that modifications resulting in short-term, insignificant delays are not considered troubled debt restructurings. For example, some companies have adopted policies that modifications shorter than three months are not troubled debt restructurings, notwithstanding that other than the short-term nature of the modification, all other aspects of a troubled debt restructuring generally exist in these circumstances.

Effective date and transition

For purposes of identifying and disclosing troubled debt restructurings, the proposed ASU would be effective for interim and annual periods ending after 15 June 2011 (i.e., Q2 2011 for calendar year-end companies), applied retrospectively to restructurings occurring on or after the beginning of the earliest period presented. That is, the identification and disclosure of troubled debt restructurings that were not previously identified and disclosed as such will cover all periods presented in the financial statements (i.e., 2011 and 2010 for Q2 2011 reporting).

How we see it

The FASB initially intended the clarifications to be effective concurrent with the portion of ASU 2010-20[6] that relates to modifications (i.e., Q1 2011 for calendar year-end companies). Most companies will now begin complying with the disclosure requirements of ASU 2010-20 in Q1 2011, with the potential for adjustments as a result of applying this proposed ASU beginning in Q2 2011. Because of this overlap, the FASB is proposing to allow early adoption of any final guidance from this project.

For purposes of measuring the impairment of a receivable restructured in a troubled debt restructuring, the proposed clarifications would be effective on a prospective basis for interim and annual periods ending after 15 June 2011, with retrospective application permitted.

How we see it

Because the clarifications in the proposed ASU could result in many modifications being classified as troubled debt restructurings, there will be an increased number of measurements under ASC 310-10-35[7] that were previously subject to ASC 450-20[8] (especially for short-term modifications). As these loan modifications may result in little to no changes in expected cash flows on a present value basis, application of the proposed ASU (i.e., measuring impairment individually rather than collectively on modified loans deemed to be troubled debt restructurings) could potentially affect a company's overall allowance for credit losses.

If the impairment measurement provisions are applied prospectively, a company would disclose the total recorded investment and the allowance for credit losses as of the end of the period of adoption related to those receivables that are considered impaired under ASC 310-10-35 as a result of the clarifications for which impairment was previously measured under ASC 450-20.

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4 The EITF released additional guidance specific to debtors in EITF 02-4, "Determining Whether a Debtor's Modification or Exchange of Debt Instruments is within the Scope of FASB Statement No. 15" (now codifed in ASC 470-60, *Debt — Troubled Debt Restructurings by Debtors*).

5 This view can be found in a letter on the SEC website: http://www.sec.gov/info/accountants/staffletters/hanish010808.pdf.

6 ASU 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*.

7 ASC 310-10-35, *Receivables — Overall — Subsequent Measurement*.

8 ASC 450-20, *Contingencies — Loss Contingencies*.

How we see it

This disclosure would provide only the total amount of the receivables and the allowance for credit losses for those modified loans deemed troubled debt restructurings that were previously subject to ASC 450-20. It would not represent the totals of all newly identified troubled debt restructurings, because many of the commercial loans may already have been individually measured for impairment under ASC 310-10-35.

Convergence

IFRS does not have guidance on troubled debt restructurings. Therefore, these proposed clarifications do not affect convergence.

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