

Heads Up

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Troubleshooting FASB Addresses TDRs

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Yesterday, the FASB issued [ASU 2011-02](#),¹ which clarifies when a loan modification or restructuring is considered a troubled debt restructuring (TDR). The accounting for and disclosures about troubled assets (e.g., loans and receivables)² continue to be important to financial organizations as well as to their investors and regulators. Recent focus has been on modifications³ made to loans. Under U.S. GAAP, when a loan's terms⁴ have been modified, the creditor (i.e., the lender) must evaluate whether the modification represents a TDR. Possible effects of a conclusion that a modification is a TDR include the following:

- A lender may need to perform a different impairment measurement analysis.⁵
- A lender would have to provide additional financial statement disclosures.⁶

In evaluating whether a modification of a loan represents a TDR, an entity must use judgment to determine whether (1) the debtor (i.e., the borrower) is experiencing financial difficulty and (2) the lender has granted a concession to the borrower. The complexity of this evaluation, coupled with the increasing number of loan modifications, notably for residential mortgages but also for commercial real estate loans during the past year, prompted the FASB to develop additional guidance and clarify existing TDR requirements. The ASU is intended to result in more consistent identification of TDRs by lenders.

Key Provisions

Is a Debtor Experiencing Financial Difficulty?

The ASU amends ASC 310-40 to include the indicators from ASC 470-60 that a lender should consider in determining whether a borrower is experiencing financial difficulties (e.g., debtor default, debtor bankruptcy, or concerns about the future as a going concern are all indicators of financial difficulty). It further clarifies that a borrower could be experiencing financial difficulty even if it is not currently in default but default is probable in the foreseeable future.

¹ FASB Accounting Standards Update No. 2011-02, *A Creditor's Determination of Whether Restructuring Is a Troubled Debt Restructuring*.

² For simplicity, the remainder of the *Heads Up* uses only the term "loans" in reference to all types of debt.

³ Modifications are also referred to as restructurings.

⁴ For example, the interest rate, payment terms, principal balance, and due date(s).

⁵ For example, an entity must apply ASC 310 to evaluate TDR loans for impairment. (For titles of *FASB Accounting Standards Codification* (ASC or "Codification") references, see Deloitte's "[Titles of Topics and Subtopics in the FASB Accounting Standards Codification](#).")

⁶ For example, TDR loans are considered impaired loans in accordance with the disclosure requirements of ASC 310-40.

Editor’s Note: The following example illustrates the “probable in the foreseeable future” principle:

Assume that (1) a borrower enters into an interest-only mortgage in which it only pays interest on the principal balance for the first five years and (2) after the five-year interest-only period, the principal balance is then repaid over 25 years. Further assume that the borrower is not currently in default on the mortgage (in the fourth year of the five-year interest-only period). However, because the mortgage’s payments will be adjusted to a significantly higher amount upon the expiration of the interest-only period, the lender determines that, in the absence of any modification, the borrower’s default is probable in the foreseeable future. Therefore, the lender may conclude that the borrower is experiencing financial difficulty.

Was a Concession Granted?

The guidance in the rest of the ASU addresses whether the lender has granted a concession to the borrower. The ASU notes that:

- A borrower’s inability to access funds at a market interest rate for a new loan indicates that the modification was executed at a below-market rate and therefore may indicate that a concession was granted.

The ASU notes that a borrower’s inability to access funds at a market interest rate for a new loan indicates that the modification was executed at a below-market rate and therefore may indicate that a concession was granted.

Editor’s Note: This guidance is intended to clarify the principle in ASC 310-40-15-8, which indicates that a “debtor in a troubled debt restructuring can obtain funds from sources other than the existing creditor in the troubled debt restructuring, if at all, only at effective interest rates (based on market prices) so high that it cannot afford to pay them.” The recent economic downturn led some to question how to apply this principle when markets no longer exist or are severely hampered. Some lenders may have concluded that when markets no longer exist, this principle did not apply (i.e., that no evaluation of whether another creditor would lend to the borrower at nontroubled rates was required). The ASU clarifies that the principle does apply. However, the FASB also indicates in the ASU’s Basis for Conclusions “that the mere absence of a market rate [does] not automatically result in a [TDR] because credit markets occasionally contract severely.” In these situations, lenders may be well advised to look to broader markets (i.e., not just the local lending market) to evaluate whether the borrower could access funds at a nontroubled market rate. Alternatively, the creditor may place more emphasis on whether the borrower is experiencing financial difficulty in determining whether there has been a TDR.

- A modification that permanently or temporarily increases a loan’s contractual interest rate does not preclude the restructuring from being considered a concession because the rate may still be below market.
- A modification that results in an insignificant delay in contractual cash flows is not considered to be a concession. The ASU provides examples to assist lenders in determining whether a delay resulting from a restructuring is insignificant (more on this below).

The ASU also amends ASC 310-40 to clarify that a lender is explicitly precluded from performing the borrower’s effective interest rate test,⁷ described in ASC 470, to determine whether a modification is a TDR.

⁷ The effective interest rate test indicates that a lender has granted a borrower a concession “if the [borrower’s] effective borrowing rate on the restructured debt is less than the effective borrowing rate of the old debt immediately before the restructuring.” See ASC 470-60-55-10.

Editor’s Note: Lenders sometimes modify loans so that the effective interest rates of the loans increase as a result of the modification (e.g., a lender modifying a teaser interest rate into a fixed interest rate for a loan). If the lender were to use the borrower’s effective interest rate test as described in ASC 470, the lender would conclude that the modification is not a concession because the effective interest rate increased (and thus that no TDR had occurred). The FASB concluded that the use of the effective interest rate test in ASC 470 is not appropriate for the creditor’s evaluation (i.e., it was not intended for the creditor’s evaluation).

Is the Delay in Payment Insignificant?

As stated above, a modification that results in an insignificant delay in contractual cash flows is not considered a concession. The ASU provides the following factors that may indicate that a modification that results in a delay in contractual cash flows is insignificant:

- a. The amount of the restructured payments subject to the delay is insignificant relative to the unpaid principal or collateral value of the debt and will result in an insignificant shortfall in the contractual amount due.
- b. The delay in timing of the restructured payment period is insignificant relative to any one of the following:
 1. The frequency of payments due under the debt
 2. The debt’s original contractual maturity
 3. The debt’s original expected duration.

In addition, the ASU notes that a lender must also consider the cumulative effect of previous restructurings when determining whether the current delay is insignificant. The ASU provides examples to illustrate these factors, some of which are reprinted in the [appendix](#) to this *Heads Up*.

Editor’s Note: The subsequent measurement guidance for a lender’s determination of whether a loan is impaired states that an insignificant delay or shortfall in amount of payment would not lead to a lender’s concluding that a loan is impaired. The FASB determined that the notion of an insignificant delay or shortfall in amount of payment is equally applicable to a creditor’s determination of whether it has granted a concession. The Board added the factors and examples to help establish some consistency in how the insignificant delay concept is applied in practice.

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Effective Date and Transition

The ASU applies to both public and nonpublic entities as described below.

Public Entities

For TDR identification and disclosure purposes, the guidance is effective for the first interim or annual period beginning on or after June 15, 2011, and is to be applied retrospectively to modifications occurring on or after the beginning of the annual period of adoption. Thus, an entity is required to apply the ASU’s guidance to determine whether modifications (1) that were not previously considered TDRs and (2) that have occurred since the beginning of the annual period of adoption (e.g., January 1, 2011, for a calendar-year-end entity) would now be considered TDRs. Early adoption is permitted.

For newly identified TDRs that have occurred since the beginning of the earliest period presented and that remain outstanding in the period of adoption, the effect, if any, of the change in the method of calculating impairment under the loss contingency guidance of ASC 450-20 to that in ASC 310-10 is to be reflected in the period of adoption (e.g., the third quarter of 2011 for a calendar-year-end public entity). Entities are required to disclose separately the total recorded investment and allowance for credit losses for newly identified TDRs attributable to the ASU as of the end of the period of adoption.

An entity must make the previously deferred (see ASU 2011-01⁸) disclosures for TDRs required by ASU 2010-20⁹ in the first interim or annual period beginning after June 15, 2011.

Editor's Note: The TDR provisions of ASU 2010-20 require entities to disclose quantitative and qualitative information about TDRs, including how financing receivables were modified and the financial effects of the modifications. They also require separate disclosure of recurring TDRs (i.e., TDR's that occurred within the previous 12 months for which there has been a payment default during the current period).

Nonpublic Entities

The ASU is effective for annual periods ending on or after December 15, 2012, including interim periods within those annual periods. Early adoption is permitted for any interim period of the fiscal year of adoption; however, if a nonpublic entity¹⁰ elects to early adopt, the guidance is to be applied retrospectively to modifications occurring on or after the beginning of the annual period of adoption.

Editor's Note: The ASU did not amend the effective date of the TDR provisions of ASU 2010-20 for nonpublic entities. Accordingly, the TDR-related disclosures of ASU 2010-20 are required for a nonpublic entity's first annual reporting period ending after December 15, 2011.

The ASU is effective for annual periods ending on or after December 15, 2012, including interim periods within those annual periods.

Tax Considerations

For federal income tax purposes, lenders are generally allowed a bad debt deduction when a receivable becomes wholly or partially worthless. One of the criteria under Internal Revenue Code (IRC) Section 166 to demonstrate worthlessness is that the lender must "charge off" the receivable for financial statement purposes. Therefore, if a lender determines under the ASU that it has a TDR, and that the TDR ultimately results in a permanent impairment of a portion of its receivable, the lender should analyze the impairment under IRC Section 166 to determine whether a tax deduction may be allowed. The determination of deductibility is based on specific facts and circumstances.

⁸ FASB Accounting Standards Update No. 2011-01, *Deferral of the Effective Date of Disclosures About Troubled Debt Restructurings in Update No. 2010-20*.

⁹ FASB Accounting Standards Update No. 2010-20, *Disclosures About the Credit Quality of Financing Receivables and the Allowance for Credit Losses*.

¹⁰ The Codification Master Glossary defines a nonpublic entity, as used in this context, as follows:

Any entity that does not meet any of the following conditions:

- a. Its debt or equity securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally.
- b. It is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).
- c. It files with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market.
- d. It is controlled by an entity covered by the preceding criteria.

Appendix — Examples of a Creditor's Evaluation of Whether a Delay in Payment Resulting From a Restructuring Is Insignificant

The examples below, reproduced from the ASU's Implementation Guidance and Illustrations, indicate how a creditor might evaluate whether a delay in payment resulting from a restructuring is insignificant.

Example 3: Commercial Real Estate Debt With Balloon Payment

310-40-55-16 A restructuring that results in only a delay in payment that is insignificant is not a concession. This Example illustrates the guidance in paragraphs 310-40-15-17 through 15-18 for determining whether a delay in payment is insignificant. This Example assumes that the debtor is experiencing financial difficulties and is not intended to illustrate the determination of whether a debtor is experiencing financial difficulties.

310-40-55-17 A creditor originates a seven-year loan to a debtor. The debt:

- a. Has a fixed interest rate
- b. Is collateralized by commercial real estate
- c. Requires monthly interest payments
- d. Requires a balloon principal payment at maturity.

310-40-55-18 At origination, the debtor expects to repay the principal by refinancing the debt with the real estate held as collateral. That is, the collateral is the primary source of payment of the debt's principal balance, whether through a refinancing of the debt or a sale of the property. However, before maturity, the fair value of the collateral was less than the principal amount due at maturity, and as a result of market conditions, the debtor is unable to refinance the debt. The debtor plans to sell the property to repay the debt and requests an extension of the debt's maturity date to allow time to liquidate the property. In response to the debtor's financial difficulties, the creditor grants the debtor a three-month extension of the debt maturity date. At the time that this extension was granted, the debtor had not yet identified a buyer for the collateral.

310-40-55-19 The restructuring results in a delay in payment that is not insignificant. Although the delay in timing of payment is insignificant (relative to the frequency of payments due, the debt's original contractual maturity, and the debt's original expected duration), the creditor expects a significant shortfall in cash flows relative to the contractual amount due when the property is sold because the property is the sole source of repayment.

Example 4: Residential Mortgage Debt — Temporary Payment Deferral

310-40-55-20 A restructuring that results in only a delay in payment that is insignificant is not a concession. This Example illustrates the guidance in paragraphs 310-40-15-17 through 15-18 for determining whether a delay in payment is insignificant. This Example assumes that the debtor is experiencing financial difficulties and is not intended to illustrate the determination of whether a debtor is experiencing financial difficulties.

310-40-55-21 A debtor obtains a 30-year mortgage loan that requires monthly principal and interest payments. In year 4, the debtor experiences financial difficulties and misses two payments. On the basis of the debtor's financial hardship, the debtor and the creditor agree on a forbearance arrangement and repayment plan. Under the terms of the forbearance arrangement and repayment plan, the creditor agrees not to take any foreclosure action if the debtor increases its next four monthly payments such that each payment includes one fourth of the delinquent amount plus interest. The agreement does not result in the creditor charging the debtor interest on past due interest. At the end of the forbearance arrangement, the debtor will:

- a. Have repaid all past due amounts
- b. Be considered current in relation to the debt's original terms
- c. Have resumed making monthly payments set out under the debt's original terms.

310-40-55-22 The restructuring results in a delay in payment that is insignificant. At the time of the forbearance arrangement, the creditor expects to collect all amounts due for the periods of delay. Furthermore, the length of delay resulting from the forbearance arrangement is considered insignificant in relation to the frequency of payments due, the debt's original contractual maturity, and the debt's original expected duration.

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