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FASB Addresses Troubles With Restructurings

by Adrian Mills and Stephen McKinney, Deloitte & Touche LLP

On October 12, 2010, the FASB issued a proposed ASU[1] that clarifies when a loan modification or restructuring is considered a troubled debt restructuring (TDR). The proposed ASU is not a direct response to the foreclosure issues that have dominated the business press in recent weeks. However, the step before foreclosure is often a loan modification or restructuring, which can have potential accounting and disclosure consequences if the modification or restructuring is deemed a TDR.

The accounting and disclosures for troubled assets (e.g., loans and receivables)[2] continue to be important to financial organizations as well as to their investors and regulators. A recent focus has been modifications[3] made to loans. Under U.S. GAAP, when a loan's terms[4] 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 may have to provide additional financial statement disclosures.[6]

The accounting and disclosures for troubled assets (e.g., loans and receivables) continue to be important to financial organizations as well as to their investors and regulators.

Editor's Note: The proposed ASU comes on the heels of the FASB's recently issued ASU on the disclosure requirements for financing receivables (ASU 2010-20[7]). Under ASU 2010-20, entities must provide new, more comprehensive disclosures about TDRs. For more information about ASU 2010-20, see Deloitte's July 22, 2010, *Heads Up*.

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 during the past year,[8] prompted the FASB to develop additional guidance and clarify existing TDR requirements. The proposed ASU is intended to result in more consistent identification of TDRs by lenders.

The proposed ASU would be effective for interim and annual periods ending after June 15, 2011. Retrospective application would be required for certain disclosures (see further discussion below regarding the effect of the proposed ASU on disclosures). Comments on the proposed ASU are due by December 13, 2010.

1 FASB Proposed Accounting Standards Update, *Clarifications to Accounting for Troubled Debt Restructurings by Creditors*.
2 For simplicity, the remainder of this *Heads Up* only uses the term "loans" when referring to the provisions of the proposed ASU.
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) 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.
7 FASB Accounting Standards Update No. 2010-20, *Disclosures About the Credit Quality of Financing Receivables and the Allowance for Credit Losses*.
8 One common loan modification program is the U.S. Treasury's Making Home Affordable Program (HAMP). The most recent report on HAMP activity is available here.

The Proposed Changes

The FASB's proposed clarifications are intended to help the lender determine whether a modification is a TDR. The Codification Master Glossary defines a TDR as a restructuring of debt in which the lender, "for economic or legal reasons related to the [borrower's] financial difficulties grants a concession to the [borrower] that it would not otherwise consider." The proposed ASU 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." The remaining clarifications address whether the lender has granted a **concession** to the borrower and include the following:

- A lender is explicitly precluded from performing the borrower effective rate test[9] in ASC 470 to determine whether a modification is a TDR.
- A borrower's inability to access funds at a market interest rate for the new loan indicates that the modification was executed at a below-market rate and therefore should be considered a TDR.
- A modification that permanently or temporarily increases a loan's contractual interest rate does not necessarily mean that the modification is not a TDR because the rate may still be below market.
- An insignificant delay in payment resulting from a modification can lead a creditor to conclude that the modification is a TDR.

The proposed ASU 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."

Editor's Note: Under current guidance, insignificant delays are to be ignored in the assessment of whether a loan is impaired. Some lenders may have extended this guidance to assessments of whether a modification is a TDR. The proposed ASU clarifies that a modification may be considered a TDR as a result of an insignificant delay — in other words, an insignificant delay is a factor that should be considered along with other terms of a modification in the determination of whether a TDR has occurred.

In addition, the proposed ASU would amend 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.

Editor's Note: The FASB included guidance on indicators of financial difficulty in this proposed ASU because the guidance in ASC 470-60 applies to borrowers as well as to a creditor's assessment of a modification as a TDR. One of these indicators states that a borrower may be experiencing financial difficulty if it is currently in default on any of its debt. The FASB further clarified that even when a borrower is not **currently** in default, default that is "probable in the foreseeable future" may indicate that a borrower is experiencing financial difficulty.

For example, 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.

[9] The effective 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.

Entities that do not choose retrospective application would be required to disclose separately the total recorded investment and allowance for credit losses for newly identified TDRs as of the end of the period of adoption.

Effective Date and Transition

The proposed ASU would apply to both public and nonpublic entities.

For TDR identification and disclosure purposes, the guidance would be effective for interim and annual periods ending on or after June 15, 2011, and would be applied retrospectively to modifications occurring on or after the beginning of the earliest period presented. Thus, an entity would be required to apply the proposed ASU's guidance to determine whether modifications that were not previously considered TDRs and that have occurred since the beginning of the earliest period presented (e.g., January 1, 2009, for a calendar-year-end entity) would now be considered TDRs. If the entity concludes that a modification would have been a TDR under the proposed ASU, the entity would need to provide the disclosures required by ASC 310-40, and potentially those required by ASU 2010-20 (see Editor's Note below), for the newly identified TDRs.

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 would be reflected in the period of adoption (e.g., the second quarter of 2011 for a calendar-year-end public entity). However, retrospective application would be permitted. Entities that do not choose retrospective application would be required to disclose separately the total recorded investment and allowance for credit losses for newly identified TDRs as of the end of the period of adoption.

Editor's Note: The TDR provisions of ASU 2010-20 are effective prospectively for interim or annual periods beginning after December 15, 2010[10] (e.g., the quarter ended March 31, 2011, for calendar-year-end public entities). Upon adoption of the proposed ASU, an entity would not be required to provide the ASU 2010-20 disclosures for periods before the first quarter of 2011 because ASU 2010-20 was not effective and is not retrospectively applied.

[10] ASU 2010-20 has different effective dates depending on whether the disclosures relate to information as of the end of a period or activity during a period. The TDR-related provisions of ASU 2010-20 only require certain disclosures for activity; accordingly, those provisions are effective for the first interim or annual period beginning after December 15, 2010.

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