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Proposed statement of position : Accounting for foreclosed assets;Accounting for foreclosed assets; Exposure draft (American Institute of Certified Public Accountants), 1990, Dec. 11

American Institute of Certified Public Accountants. Accounting Standards Division. Accounting Standards Executive Committee

EXPOSURE DRAFT

PROPOSED STATEMENT OF POSITION

ACCOUNTING FOR FORECLOSED ASSETS

DECEMBER 11, 1990

Prepared by the Accounting Standards Executive Committee,
Accounting Standards Division,
American Institute of Certified Public Accountants

Comments should be received by March 11, 1991, and addressed to
Dionne McNamee, Technical Manager, Accounting Standards Division, File 2700,
AICPA, 1211 Avenue of the Americas, New York, N.Y. 10036–8775

SUMMARY

This proposed statement of position (SOP) provides guidance for financial reporting of foreclosed assets after foreclosure. Briefly, the proposed SOP recommends the following:

- There is a presumption that foreclosed assets will be sold.

- Foreclosed assets that will be sold should be carried at the lower of cost or fair value.

- Periodic net cash payments related to foreclosed assets held for sale should be charged to income; periodic net cash receipts related to foreclosed assets held for sale should be credited to the assets' carrying amount; no depreciation or amortization expense should be recognized.

- The carrying amount of foreclosed assets held for the production of income instead of sale should not exceed net realizable value; revenue and expense cash flows are recognized in income; depreciation or amortization expense is recognized.

The provisions of this statement would be effective for financial statements as of a date after the statement is issued in final form and for periods ending on that date or later.

This exposure draft has been sent to--

- State society and chapter presidents, directors, and committee chairpersons.

- Organizations concerned with regulatory, supervisory, or other public disclosure of financial activities.

- Organizations concerned with financial reporting of financial institutions.

- Persons who have requested copies.

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Accompanying this letter is an exposure draft of a proposed statement of position (SOP), Accounting for Foreclosed Assets, and its summary.

The purpose of the exposure draft is to solicit comments from preparers, auditors, and users of financial statements and from other interested parties. The proposed SOP would amend SOPs 75-2 and 78-2, Accounting Practices of Real Estate Investment Trusts, and the following AICPA Audit and Accounting Guides:

- Audits of Banks
- Audits of Credit Unions
- Audits of Finance Companies (Including Independent and Captive Financing Activities of Other Companies)
- Audits of Property and Liability Insurance Companies
- Savings and Loan Associations
- Audits of Stock Life Insurance Companies

Accounting for foreclosed assets after acquisition is diverse in current practice. The provisions of this proposed SOP would eliminate that diversity. Eliminating that diversity would also be responsive to concerns of Congress and thrift and banking regulators.

It will be helpful if respondents refer to specific paragraph numbers and include reasons for any suggestions or comments.

Comments are specifically requested concerning the transition specified in paragraph 13. Is information generally available to determine the fair value of foreclosed assets at balance sheet dates earlier than the effective date? If so, would restatement of previously issued financial statements or a cumulative effect adjustment as of the beginning of the year in which this SOP is first applied be practical, feasible, and cost-effective? If so, should one or both of those alternatives be permitted or required?

Comments on the exposure draft should be sent to Dionne McNamee, Technical Manager, Accounting Standards Division, File 2700, American Institute of Certified Public Accountants, 1211 Avenue of the Americas, New York, N.Y. 10036-8775, in time to be received by March 11, 1991.

Written comments on this exposure draft will become part of the public record of the AICPA and will be available for public inspection at the AICPA's offices for one year after March 11, 1991.

Yours truly,

Walter Schuetze

Paul Rosenfield

Walter Schuetze, CPA
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(1989-1990)

ACCOUNTING FOR FORECLOSED ASSETS

1. Financial Accounting Standards Board (FASB) Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings (issued in 1977), paragraph 28, requires that creditors account for foreclosed assets[1] "at their fair value at the time of the restructuring [acquisition of the asset from the debtor]."[2]

2. Paragraph 29 of FASB Statement No. 15 requires the following: "After a troubled debt restructuring, a creditor shall account for assets received in satisfaction of a receivable the same as if the assets had been acquired for cash." That requirement has been interpreted in different ways.

3. The American Institute of Certified Public Accountants (AICPA) Industry Audit Guide Audits of Stock Life Insurance Companies (1972), page 36, requires that foreclosed real estate be carried at the lower of cost (less accumulated depreciation) or market value, net of any encumbrances. Paragraphs 17 and 21 of Statement of Position (SOP) 75-2, Accounting Practices of Real Estate Investment Trusts (as amended by SOP 78-2), require that estimated losses on individual

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[1] As used in this SOP, the term foreclosed assets includes both personal and real property received in satisfaction of a receivable.

[2] Fair value is defined in paragraph 13 of FASB Statement No. 15 as follows:

> The fair value of the assets transferred is the amount that the . . . [creditor] could reasonably expect to receive for them in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value of assets shall be measured by their market value if an active market for them exists. If no active market exists for the assets transferred but exists for similar assets, the selling prices in that market may be helpful in estimating the fair value of the assets transferred. If no market price is available, a forecast of expected cash flows may aid in estimating the fair value of assets transferred, provided the expected cash flows are discounted at a rate commensurate with the risk involved.[6]
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> [6] Some factors that may be relevant in estimating the fair value of various kinds of assets are described in paragraphs 88 and 89 of APB Opinion No. 16 [Business Combinations], paragraphs 12-14 of APB Opinion No. 21, Interest on Receivables and Payables, and paragraph 25 of APB Opinion No. 29, Accounting for Nonmonetary Transactions.

loans and properties be based on net realizable value.[3] The AICPA Audit and Accounting Guide Savings and Loan Associations (1979), pages 38 and 41, is consistent with SOPs 75-2 and 78-2. The AICPA Industry Audit Guide Audits of Banks (1983), page 74, states that subsequent to foreclosure, a loss on foreclosed real estate should be recognized if cost cannot be recovered through sale or use, but does not indicate how the loss is to be measured.[4] The AICPA Industry Audit Guide Audits of Finance Companies (1988), paragraph 2.33, is consistent with SOPs 75-2 and 78-2 and Savings and Loan Associations. The AICPA Audit and Accounting Guides Audits of Credit Unions and Audits of Property and Liability Insurance Companies do not address accounting for foreclosed assets.

4. In practice, accounting by creditors for foreclosed assets, particularly real estate assets, has been diverse. After acquisition, some enterprises have continued to write down the carrying amount of foreclosed assets for subsequent, further declines in fair value; others have not. After acquisition, some enterprises have discounted projected cash flows related to foreclosed assets in estimating "net realizable value" of those assets; others have not.[5] After acquisition, some enterprises have recognized cash flows related to foreclosed assets in income as revenues and expenses; others have not. After acquisition, some enterprises have recognized depreciation or amortization expense related to foreclosed assets; others have not.

5. Sections 4(b)(1) and 4(b)(2)(A) of the Home Owners' Loan Act of 1933 as amended by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 generally provide that the director of the Office of Thrift Supervision prescribe uniform accounting and disclosure standards for savings associations, to be used in determining associations' compliance with applicable regulations, and incorporate generally accepted accounting principles into those standards to the same degree that such principles are used to determine compliance with regu-

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[3] Net realizable value is defined in SOP 75-2, Accounting Practices of Real Estate Investment Trusts, as follows:

> With respect to a REIT, estimated net realizable value means the estimated selling price a property will bring if exposed for sale in the open market, allowing a reasonable time to find a purchaser, reduced by (a) the estimated cost to complete and improve such property to the condition used in determining the estimated selling price, (b) the costs to dispose of the property, and (c) the estimated costs to hold the property to the estimated point of sale, including interest, property taxes, legal fees and other cash requirements of the project [paragraph 17]. The interest rate should be . . . based on the average cost of all capital (debt and equity) [paragraph 21].

[4] The Preface to Audits of Banks indicates that "whether interest cost-to-carry should be a factor in determining the net realizable value of restructured real estate loans and other real estate" is under study.

[5] This inconsistency was noted by the Emerging Issues Task Force in EITF Issue 87-5.

lations prescribed by federal banking agencies. Section 1215 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 also provides the following:

> Before the end of the 1-year period beginning on the date of the enactment of this Act [August 9, 1989], each appropriate Federal banking agency (as defined in section 3(q) of the Federal Deposit Insurance Act) shall establish uniform accounting standards to be used for determining the capital ratios of all federally insured depository institutions and for other regulatory purposes. Each such agency shall report annually to the Chairman and ranking minority member of the Committee on Banking, Housing, and Urban Affairs of the Senate and the Chairman and ranking minority member of the Committee on Banking, Finance and Urban Affairs of the House of Representatives any differences between the capital standards used by such agency and capital standards used by any other such agency. Each such report shall contain an explanation of the reasons for any discrepancy in such capital standards, and shall be published in the Federal Register.

6. The chairman of the Federal Home Loan Bank Board (now the Office of Thrift Supervision) in 1987 asked the American Institute of Certified Public Accountants to address the inconsistency between banks and savings and loan associations in accounting for foreclosed real estate assets. The AICPA Accounting Standards Executive Committee (AcSEC) attempted to eliminate this inconsistency in 1988 and 1989 but was unable to do so at that time and referred the matter to the FASB. On April 4, 1989, after the AICPA had concluded that it could not eliminate this inconsistency and would refer the matter to the FASB, the chairman of the Federal Home Loan Bank Board wrote to the chairman of the Securities and Exchange Commission (SEC) asking that the SEC or its staff remove this inconsistency for public reporting entities. The SEC has not eliminated the inconsistency for public reporting entities. The chairman of the Federal Deposit Insurance Corporation, in a letter to the FASB dated November 8, 1989, asked the FASB to assist in developing "uniform accounting standards among depository institutions." In that letter, the chairman stated that "the accounting treatment in practice for certain transactions among participants in the financial services industry seems to be more a reflection of the type of charter than the substance of the transaction." Furthermore, the chairman "urge[d] the FASB to reconcile the different accounting practices outlined in [AICPA] guides for thrifts, banks, and finance companies."

7. Most enterprises do not intend to hold foreclosed assets for the production of income but intend to sell them; in fact, some laws and regulations applicable to financial institutions require the sale of foreclosed assets.

8. AcSEC has now concluded that all enterprises, not just financial institutions, should account for foreclosed assets in the same way, and that is the primary objective of this proposed SOP. Another objective is to make all of the AICPA audit and accounting guides and SOPs consistent on this matter. Achieving those objectives will be responsive to the needs of Congress and the thrift and banking regulators described in paragraphs 5 and 6.

CONCLUSIONS

9. AcSEC has concluded that there is a presumption that foreclosed assets will be sold and not held for the production of income; that presumption may be rebutted by a preponderance of the evidence. If the presumption of sale is not rebutted, or if an enterprise intends to sell (or is required to sell) a foreclosed asset, either because a law or regulation requires such action or because the management of the enterprise voluntarily has so concluded, the asset should be classified in the balance sheet as held for sale and subsequently carried at the lower of cost or fair value.[6] Cost of the asset is the fair value (as defined in FASB Statement No. 15) of the asset at the date of foreclosure plus cash payments for capital additions and improvements to the asset and, if applicable, related capitalized interest subsequent to the date of foreclosure.[7] If the cost of the asset plus the estimated cost to sell the asset exceeds its fair value, the excess should be recognized as a valuation allowance; if the fair value of the asset subsequently increases, the valuation allowance should be reduced; increases or decreases in the valuation allowance should be charged or credited to income. (See appendix A for illustrations.) (See appendix B regarding in-substance foreclosed assets.)

10. Because most foreclosed assets are held for sale and not for the production of income, there should be no "results of operations"--revenues and expenses--during the holding period. Except for cash payments for capital additions or improvements and any related capitalized interest, postforeclosure net cash payments related to a foreclosed asset should be charged to income for each reporting period as a loss on holding the asset; net cash receipts during each reporting period should reduce the carrying amount of the asset.[8] No depreciation or amortization expense should be recognized. After foreclosure, the carrying amount of a foreclosed asset held for sale should not exceed its fair value reduced by the estimated cost to sell the asset (see paragraph 9).[9]

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[6] See note 2 above for the definition of fair value. However, broker-dealers, futures commission merchants, and other enterprises that account for assets at market value or fair value should not change their accounting for foreclosed assets.

[7] The effect of cash payments should be recognized on the accrual basis (that is, when the liability for the cash payment arises). Further, if certain conditions are met, interest is required to be added to the carrying amount of the asset pursuant to FASB Statement No. 34, Capitalization of Interest Cost, as amended.

[8] The effect of cash payments or receipts should be recognized on the accrual basis (that is, when the liability or receivable for the cash payment or receipt arises).

[9] FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects, was extracted by the FASB from SOP 78-3, Accounting for Costs to Sell and Rent, and Initial Rental Operations of, Real Estate Projects; SOP 80-3, Accounting for Real Estate Acquisition, Development, and Construction Costs, and the AICPA Industry Audit Guide Accounting for Retail Land Sales. These documents did not, in the opinion of AcSEC, apply to foreclosed real estate held for sale. AcSEC therefore believes that FASB Statement No. 67 does not apply to and should not be applied to foreclosed real estate held for sale.

The principal amount of any debt to which the asset is subject should be reported as a liability and not deducted from the carrying amount of the asset (see appendix A).

11. If the management of an enterprise intends to hold a foreclosed asset for the production of income instead of sale and that intent is not inconsistent with its ability to do so or with laws or regulations and the manner in which the laws or regulations are administered by federal or state regulatory agencies, the fair value of the foreclosed asset at the time of foreclosure becomes the cost of the asset. Subsequent cash flows related to the asset should be recognized conventionally,[10] and depreciation or amortization expense should be recognized based on cost. The carrying amount of the asset held for the production of income may not exceed net realizable value.[11] The principal amount of any debt to which the asset is subject should be reported as a liability, not deducted from the carrying amount of the asset.

12. If a foreclosed asset is classified as held for sale at the time of foreclosure and it is subsequently decided that the asset will not be held for sale but for the production of income, the asset should be reclassified, and its then net carrying amount becomes the cost for purposes of subsequent accounting, including depreciation and amortization expense.

13. This SOP should be applied to all foreclosed assets in financial statements for periods ending on or after [date shortly after final issuance of this SOP, which is expected to be before December 31, 1991], with earlier application permitted. For many enterprises, adoption of this proposed SOP will result in a change in accounting principle. The nature of the change should be disclosed in the financial statements of the period in which the change is made. However, because AcSEC believes that determining the cumulative effect of the change in accounting principle will be either impossible or possible only at great cost

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[10] By "conventionally" it is meant that revenue and expense cash flows are recognized in income on the accrual basis. Cash payments for capital additions or improvements, and any related interest capitalized pursuant to FASB Statement No. 34, the effect of which should be recognized on the accrual basis, are added to the cost of the foreclosed asset.

[11] Paragraph 24 of FASB Statement No. 67 and the definition of net realizable value in FASB Statement No. 67 read, in part, as follows:

> 24. The carrying amount of a real estate project, or parts thereof, held for sale or development and sale shall not exceed net realizable value. If costs exceed net realizable value, capitalization of costs associated with development and construction of a property shall not cease, but rather an allowance shall be provided to reduce the carrying amount to estimated net realizable value . . . .
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> Net Realizable Value
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> The estimated selling price in the ordinary course of business less estimated costs of completion (to the stage of completion assumed in determining the selling price), holding, and disposal.

for enterprises that do not have available the fair value of foreclosed assets at earlier balance sheet dates, any adjustment arising from initial application of this SOP should be included in operating income in the period in which the change is made, and no restatement of previously issued financial statements or cumulative effect adjustment as of the beginning of the year this SOP is first applied is required.

14. This SOP amends the following:

a. SOP 75-2, Accounting Practices of Real Estate Investment Trusts, paragraphs 15-23, 25, 27, 28, 29a, 29b, and 29c

b. SOP 78-2, Accounting Practices of Real Estate Investment Trusts, paragraph .06

c. AICPA Industry Audit Guide Audits of Banks, pages xii, 74, and 75

d. AICPA Audit and Accounting Guide Savings and Loan Associations, pages 38, 41, and 42

e. AICPA Audit and Accounting Guide Audits of Finance Companies, paragraphs 2.33 and 2.34

f. AICPA Audit and Accounting Guide Audits of Credit Unions, page 48

g. AICPA Industry Audit Guide Audits of Property and Liability Insurance Companies, paragraphs 5.23 and 5.26

h. AICPA Industry Audit Guide Audits of Stock Life Insurance Companies, page 36

APPENDIX A

ILLUSTRATIONS

	Case A	Case B	Case C	Case D	Case E
Fair value of collateral asset at date of foreclosure	91	97	87	90	87
Capital additions to collateral asset after foreclosure	7	-	21	14	21
Net cash receipts from collateral asset after foreclosure	-	(2)	-	-	-
Cost of collateral asset at date of balance sheet	98	95	108	104	108
Fair value of collateral asset at date of balance sheet	96	95	111	101	110
Excess of cost over fair value	2	0	(3)	3	(2)
Estimated cost to sell collateral asset	2	2	2	2	3
Valuation allowance	4	2	-	5	1
Net carrying amount at date of balance sheet	94	93	108	99	107

IN-SUBSTANCE FORECLOSED ASSETS

B-1. FASB Statement No. 15 also applies to in-substance foreclosed assets; paragraph 34 of FASB Statement No. 15 reads as follows:

> 34. A troubled debt restructuring that is in substance a repossession or foreclosure by the creditor, or in which the creditor otherwise obtains one or more of the debtor's assets in place of all or part of the receivable, shall be accounted for according to the provisions of paragraphs 28 and 33 and, if appropriate, 39.

B-2. Paragraphs 5-9 of AICPA Practice Bulletin 7, Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed (April 1990), read as follows:

> 5. A creditor should consider collateral for a loan in-substance foreclosed if all the following criteria are met:
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> 1. The debtor has little or no equity in the collateral, considering the current fair value[1] of the collateral; and
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> 2. Proceeds for repayment of the loan can be expected to come only from the operation or sale of the collateral; and
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> 3. The debtor has either--
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>   (a) formally or effectively abandoned control of the collateral to the creditor, or
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>   (b) retained control of the collateral but, because of the current financial condition of the debtor, or the economic prospects for the debtor and/or the collateral in the foreseeable future, it is doubtful that the debtor will be able to rebuild equity in the collateral or otherwise repay the loan in the foreseeable future.
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> 6. If all the criteria in paragraph 5 are met, the collateral for the loan has been in-substance foreclosed and the reporting should reflect that determination in conformity with paragraph 34 of FASB Statement No. 15: That is, such a loan should be reported the way a creditor would report receipt of collateral in satisfaction of a loan receiv-

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[1] Fair value is defined in paragraph 13 of FASB Statement No. 15 as "the amount that the debtor could reasonably expect to receive . . . in a current sale between a willing buyer and a willing seller, that is, other than a forced or liquidation sale." The AICPA's Guide for the Use of Real Estate Appraisal Information provides guidance on evaluating appraisals of real estate used to determine fair value.

able. Such a loan should be reclassified to the category or categories of the collateral, and the recorded investment in the loan should be reduced to the fair value of the collateral, which establishes a new cost basis in the same manner as a legal foreclosure. The excess of the recorded investment in the loan receivable over the fair value of the collateral should be recognized as a loan loss in the current period to the extent that it is not offset against previously established allowances for uncollectible amounts or other valuation accounts.

7. If conditions that led to the conclusion that collateral for a loan has been in-substance foreclosed change and the criteria for in-substance foreclosure in paragraph 5 are clearly no longer met, the subsequent reporting should be as follows: The collateral should be reclassified to a loan receivable and the probable estimated future cash receipts in excess of the carrying amount of the asset should be amortized as interest revenue over the remaining life of the loan, even if the effect is to recognize an unusually high effective interest rate.

8. That reporting is consistent with the answer to the question addressed in FASB Technical Bulletin 79-7, Recoveries of a Previous Writedown under a Troubled Debt Restructuring Involving a Modification of Terms, which says that "the amount of the direct writedown should not be reversed."

9. The Accounting Standards Executive Committee (AcSEC) expects that the applicability of paragraph 7 would be rare. A formal modification of terms of the underlying loan would not, by itself, result in reversal of the in-substance foreclosure. Market conditions would have to improve substantially or the debtor would have to rebuild equity in the collateral by a substantial investment not financed by the lender.