The Trouble with Troubled-Debt Standards

ASU NO. 2010-20

On July 21, 2010, the FASB issued Accounting Standards Update (ASU) No. 2010-20, “Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses.” ASU No. 2010-20 amends Topic 310, Receivables, and other topics of the FASB’s Accounting Standards Codification™ (ASC) so as to significantly change the disclosures that reporting entities must make about their financing receivables.

Under ASU No. 2010-20, a financing receivable is a financing arrangement that (1) represents a contractual right to receive money on demand, on fixed dates, or on determinable dates and (2) is recognized as an asset in the creditor entity’s statement of financial position (i.e., the balance sheet). Examples of financing receivables include:

- Loans receivable (both originated and acquired),
- Trade accounts receivable,
- Notes receivable,
- Credit-card issuers’ card accounts receivable, and
- Lessors’ capital-lease receivables.

ASU No. 2010-20 explicitly excludes some items from the definition of a financing receivable, such as debt securities within the scope of ASC Topic 320, Investments—Debt and Equity Securities. Additionally, some items that meet the definition of a financing receivable are excluded from the scope of ASU No. 2010-20—most notably, short-term trade accounts receivable.

Some of the amendments to U.S. GAAP that are documented in ASU No. 2010-20 modify existing requirements with regard to disclosures about financing receivables.
Other amendments establish new requirements for additional disclosures. In both cases, the amendments require disclosures to be made on a disaggregated basis, that is, for specific subsets of the reporting entity's portfolio of financing receivables rather than for the portfolio as a whole.

The changed disclosure requirements stated in ASU No. 2010-20 focus on the credit losses that may be associated with a reporting entity's financing receivables. As a creditor, a reporting entity experiences a credit loss when a debtor fails to pay, in full and on schedule, any amount due. Under some circumstances, the creditor entity will recognize a credit loss for accounting purposes before non-payment, partial payment, or late payment actually occurs. But regardless of when the entity recognizes a credit loss, the entity presents the loss on its income statement and reduces the net carrying amount of the associated financing receivable on its balance sheet. A write-down of a financing receivable that results from recognizing a credit loss is generally known as an “allowance for credit losses,” but it may also be called a “loan provision,” “credit reserve,” or “impairment.”

The objective of the amendments in ASU No. 2010-20 is for each reporting entity to provide disclosures that facilitate financial-statement users' evaluation of:

◆ The nature of credit risk (i.e., the risk of incurring credit losses) inherent in the entity's portfolio of financing receivables;
◆ How credit risk is analyzed and assessed in arriving at the allowance for credit losses; and
◆ Changes in the allowance for credit losses and the reasons for those changes.

**TDR Disclosures**

According to FASB ASC paragraph 310-40-15-5, the restructuring of a debt constitutes a TDR when “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.” Among the provisions of ASU No. 2010-20 are new requirements for reporting entities to disclose:

◆ The nature and extent of TDRs that occurred during the period and their effect on the allowance for credit losses, and
◆ The nature and extent of financing receivables modified as TDRs within the previous 12 months that defaulted during the reporting period and their effect on the allowance for credit losses.

Furthermore, reporting entities are required to provide the above disclosures for each class of financing receivables. ASU No. 2010-20 defines a class of financing receivables as a group of financing receivables that is determined on the basis of all of the following:

◆ The initial measurement attribute of the financing receivables (for example, amortized cost or the present value of future cash flows expected to be received);
◆ The risk characteristics of the financing receivables; and
◆ The reporting entity's method for monitoring and assessing credit risk.

For nonpublic entities, the disclosure amendments of ASU No. 2010-20 are effective for annual reporting periods ending on or after December 15, 2011. For public entities:

◆ The disclosures as of the end of a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010.
◆ The disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010.

Both public and nonpublic entities are required to provide comparative disclosures for reporting periods ending after initial adoption. The amendments in ASU No. 2010-20 encourage, but don’t require, comparative disclosures for earlier reporting periods that ended before initial adoption.

**Two EDs**

On October 12, 2010, the FASB issued an exposure draft (ED) of a proposed ASU, “Clarifications to
Accounting for Troubled Debt Restructurings by Creditors.” The proposed ASU would amend ASC Subtopic 310-40 to clarify which restructurings constitute TDRs. The proposed clarifications would be effective on a prospective basis for interim and annual periods ending after June 15, 2011, with retrospective application permitted.

In response to the ED, some of the FASB’s constituents raised concerns that the introduction of new TDR disclosure requirements in one reporting period followed by a change in what constitutes a TDR shortly thereafter would be burdensome for public-company preparers and might not provide financial-statement users with useful information. Constituents asked the FASB to defer the public-company effective date of the TDR disclosure requirements in ASU No. 2010-20 to be concurrent with the effective date of the clarified guidance on determining what constitutes a TDR. At that point, the effective date of the TDR disclosures for public entities will be set to match the effective date of the clarified guidance on determining what constitutes a TDR. In another departure from ASU No. 2010-20, the December 2010 ED proposes that the new TDR disclosure requirements would be applied retrospectively to the beginning of the fiscal year of adoption.

Because the clarified guidance on determining what constitutes a TDR is scheduled to be finalized before the amendments of ASU No. 2010-20 become effective for non-public entities, there will be no change to that existing effective date for TDR disclosures by non-public entities as stated in ASU No. 2010-20.

At its January 4, 2011, meeting, the FASB affirmed its previous decision to synchronize the effective date for TDR disclosures by public entities with the effective date of the clarifications proposed in the October 2010 ED. Final versions of the October and December 2010 EDs are expected to be issued shortly.

The Financial Instruments ED
Serving as a backdrop for the TDR-related changes described above is the FASB’s proposed ASU, “Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities,” that was issued as an ED on May 26, 2010. That ED proposed changes to both creditors’ and debtors’ accounting for TDRs, but the ED probably will be modified substantially before being finalized in the second quarter of 2011, which means anything could happen with regard to its TDR provisions.

Not surprisingly, setting standards related to TDRs through a piecemeal approach has confused financial-statement preparers. U.S. accounting and finance professionals will certainly need to pay close attention to the FASB’s standards-setting process in order to understand TDR-related changes as they are finalized. SF

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