

STATEMENT OF THE  
FINANCIAL ACCOUNTING STANDARDS BOARD  
TO THE  
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS  
COMMITTEE ON ENERGY AND COMMERCE  
HOUSE OF REPRESENTATIVES

NOVEMBER 7, 1985

The Financial Accounting Standards Board (FASB) appreciates this opportunity to submit this statement to the Subcommittee in response to Chairman Dingell's letter of October 29, 1985. The pronouncements of the FASB apply broadly to all business enterprises that prepare financial statements in accordance with generally accepted accounting principles (GAAP), including thrift institutions. Additional, industry specific, guidance is found in the American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide, Savings and Loan Institutions, FASB Statement No. 65, Accounting for Mortgage Banking Activities, and FASB Statement No. 72, Accounting for Certain Acquisitions of Banking or Thrift Institutions, and FASB Interpretation No. 9, Applying APB Opinions No. 16 and 17 When a Savings and Loan Association or a Similar Institution Is Acquired in a Business Combination Accounted for by the Purchase Method.

The term "GAAP" is a specialized term in the preparation of general purpose financial statements and in the practice of public accounting. The objective of general purpose financial statements is to provide useful, representationally faithful information to a wide group of investors, creditors, and other users. Although the objectives of regulatory reporting may parallel those for general purpose financial reporting, that is not always the case. The special needs of regulators may differ from those of the users of general purpose financial statements. The FASB acknowledges the resulting separation of regulatory and general purpose reporting requirements as a natural result of these differing needs and objectives. However, the Board has consistently maintained that accounting measurements should be neutral and unbiased. Revising financial statements, for example, so that certain institutions will meet regulatory net worth requirements does little for the credibility of financial reporting.

In accordance with the Subcommittee's request, this submission addresses the topics listed below. Some of these topics were discussed at a meeting between the subcommittee staff (both majority and minority staff were present) and the staff of the FASB on June 7, 1985.

1. Economic and regulatory pressures on the thrift industry and the role of accounting information in the industry.
2. The accounting model based on historical cost as it is applied by thrift institutions.
3. Accounting for loan fees.

4. Accounting for real estate acquisition, development, and construction (ADC) loans.
5. Accounting for repurchase agreements.
6. Accounting for business combinations in the thrift industry.

### The Thrift Industry and the Role of Accounting

Thrift institutions have historically borrowed short-term funds, through pass-book accounts, and loaned on a long term basis, for residential mortgages. This relationship caused few problems when interest rates were stable. The dramatic changes in interest rates during the 1970's and 1980's, coupled with increased competition for both deposits and mortgage loans, significantly changed the industry's historical borrowing/lending relationships. Institutions were faced with portfolios of long-term, fixed interest rate mortgages and liabilities made up largely of short-term, high interest rate deposits. As a result, in periods of rising interest rates, earnings on long-term assets tended to remain constant while interest costs of short-term borrowings tended to increase. If rates increased enough and the institution's asset mix did not change, net losses resulted.

Like other regulated financial institutions, thrifts must maintain a minimum level of net worth for regulatory purposes. As a result, thrifts are reluctant to liquidate portfolios of long term fixed-interest assets if doing so will cause them to incur a loss thereby reducing net worth. Thus, interest rate volatility and the need to meet regulatory net worth requirements have led the management of some institutions to enter into

transactions that are, perhaps in part, designed either to avoid reduction of net worth by deferring recognition of losses or to increase net worth by accelerating recognition of income.

For example, institutions are often faced with the need to obtain cash either to lend or to meet regulatory liquidity requirements. One potential source of cash is the sale of assets. When assets are reported in the financial statements at a cost in excess of current market value, however, a sale of those assets would result in a loss and a corresponding decrease in net worth. When that reduction in net worth is unacceptable to an institution, management may transfer assets to others in exchange for cash but structure the transaction as a borrowing and thus avoid recognition of a loss. Such a transaction may often have many attributes similar to those of a sale of assets.

In addition, management may adopt accounting practices or structure transactions that permit recognition of income in the current period that might otherwise be reported in future periods. Such accounting practices alter only the timing of income recognition, not the amount of income earned from a transaction. Accelerated recognition of income is helpful in meeting current net worth requirements, but may be at variance from GAAP, which requires that income be recognized as it is earned.

The Federal Home Loan Bank Board (FHLBB) requires institutions under its jurisdiction to follow GAAP when reporting to the Board unless different regulatory accounting principles (RAP) apply. Faced with widespread weakness in the thrift industry regulators have, on some occasions, prescribed accounting practices that provide a means for institutions to

meet minimum net worth requirements. The FASB or its staff has reviewed and commented on a number of such regulatory accounting proposals. In each case, the Board or its staff has acknowledged that a regulatory body may have specific needs or objectives that lead it to depart from GAAP. However, each response has emphasized the importance of following GAAP in general purpose financial statements provided to shareholders, depositors, and other users of financial information.

The following briefly summarized differences between RAP and GAAP have been addressed in correspondence between the FASB staff and various thrift industry regulatory and professional bodies.

1. Net worth certificates issued under provisions of the "Net Worth Certificate Act" are treated as assets by recipient institutions reporting financial information under RAP. The certificates do not meet the GAAP definition of an asset. (Letters attached; J.T. Ball, FASB Assistant Director of Research and Technical Activities, to Mr. James O. Sivon, Minority Staff Director of the House Committee on Banking, Finance and Urban Affairs, dated May 19, 1982, and to Roger Cason, Chairman of the AICPA Accounting Standards Executive Committee, dated November 23, 1983)

2. Appraised Equity Capital, the excess of the appraised value of certain fixed assets over their cost, is included in the RAP definition of net worth for institutions that participate in the Net Worth Certificate program. Other institutions may elect to use appraised equity capital for reporting under RAP. GAAP does not allow the use of appraised values to increase reported amounts of net worth. (Letter attached; J.T. Ball to the FHLBB Office of Communications, dated October 12, 1982. This letter was written  
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in response to proposed regulations which the FASB staff understood would not include appraised equity capital in the body of financial statements. The staff's current understanding is that RAP financial statements prepared by some mutual thrift institutions do include appraised equity capital.)

3. Losses realized on the sale of certain interest bearing assets may be deferred in financial statements prepared in accordance with RAP. GAAP does not allow the deferral of realized losses. (Letter attached; J.T. Ball to the FHLBB Office of General Counsel, dated September 11, 1981)

#### The Accounting Model

The thrift industry uses the historical cost model of accounting, as do most businesses in the United States. Under this model, assets are generally stated in terms of their original dollar cost. For example, if a thrift institution loans \$100, that is the amount used to record that loan in the thrift's accounts. As long as the loan is intended to be held until maturity, the recorded amount is not adjusted for interim fluctuations in value brought on by interest rate changes.

The historical cost model generally looks at assets such as mortgage loans on a "hold to maturity" basis. The current market value of some institution loan portfolios may be, at times, significantly less than the portfolio's historical cost because of changes in interest rates. However, evaluating an institution's financial condition solely on the current market value of its assets ignores the fact that the original costs will be recovered if the assets are held to maturity. The key question then becomes, "Can a thrift hold its long-term low-yielding assets to maturity?"

Accountants have distinguished assets that are held for sale in the normal course of business (inventory assets) from the investments that management intends to hold to maturity as described above. The historical cost accounting model values inventory at the lower of cost or market. Mortgage banking, the practice of originating loans for sale to investors rather than to hold to earn interest, is addressed by FASB Statement No. 65, Accounting for Certain Mortgage Banking Activities. Some have asserted that the character of business of some thrift institutions in today's market resembles more the activities of mortgage banking than of traditional thrift practice. If that is the case, the provisions of Statement 65 require that loans held for sale be valued at the lower of cost or market.

The liabilities of thrift institutions are generally short-term but are also subject to market fluctuations. The historical cost accounting model does not adjust the reported amount of liabilities based on changes in interest rates. Since deregulation, however, thrift institution deposits have become very rate sensitive. That is, depositors, (particularly large depositors) tend to move funds between institutions if interest rates offered are not competitive. As a result, significant portions of the deposit liabilities of thrift institutions are generally priced at or close to market rates of interest.

#### Accounting for Loan Fees

Although loan fees were charged in some parts of the country for many years, fees were generally 1% of the loan amount or less until recently. The practice of charging higher origination fees or, "points," began after the

upward pressure on the cost of funds resulted in interest rates that could not be passed on in mortgage interest rates because of state usury laws. Charging higher loan origination fees provided a way to increase the return on loans without violating the usury limits.

As this practice developed, both the thrift industry regulators and the public accounting profession took the position that these fees were an adjustment of loan yield, or said another way, additional interest.

However, both the regulators and the accounting profession allowed loan fees to be recognized in the current period to the extent costs were incurred in originating loans. The remainder, if any, was deferred and recognized as income over the life of the loan. The practical result of those conclusions was the immediate recognition of fees totaling approximately 1% of the loan balance with the remainder deferred and recognized over the expected life of the loan.

In 1979 the FHLBB revised its rule to allow immediate fee recognition of approximately double the amount originally provided. In response, the accounting profession reaffirmed the principle that the amount of fees to be recognized should be limited to costs incurred.

A task force formed in 1981 by the Accounting Standards Executive Committee (AcSEC) of the AICPA studied the issue of accounting for loan fees and costs and submitted its findings to AcSEC in 1983. The task force concluded that loan origination is integral to lending money and fees collected for origination should be recognized over the life of the loan as interest. The task force also concluded that loan costs should be deferred and amortized over the loan life as part of the cost associated with interest revenues and

defined those costs more strictly than existing guidance. In September 1983, AcSEC referred the issues paper to the FASB for consideration.

The FASB placed a project on accounting for loan fees and costs on its technical agenda and a study of the subject was started in February 1984. In May 1985, after extensive analysis of comments received in response to an FASB Invitation to Comment issued in June 1984, the Board directed the staff to proceed with the development of an Exposure Draft of a Standard expressing its tentative conclusions on four basic issues.

First, the accounting for loan fees and origination and acquisition costs should be consistent for all types of lending.

Second, loan origination is integral to lending and related fees should be amortized as an adjustment to the yield of the related loan.

Third, a fee received for a loan commitment may be either integral to lending or for a separate service depending on the nature of the commitment.

Finally, the incremental direct origination and acquisition costs of a loan should be capitalized and amortized over the loan's life.

#### Real Estate Acquisition, Development, and Construction (ADC) Loans

ADC loans made by thrift institutions have been a subject of recent interest though it should be recognized that other financial institutions make similar loans. Consequently the accounting issues involved are not limited to the thrift industry. At the heart of the issue is the question, "When  
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does a transaction, characterized and structured as a loan, display more of the attributes of an investment in real estate rather than a loan?"

#### ADC Loans Generally

"ADC loan" is a generic term used to describe a variety of lending practices that are extensions of construction lending. The key features of an ADC loan are summarized below:

1. An ADC loan funds all, or substantially all, of the costs of acquiring undeveloped real estate, developing the real estate for construction, and construction of commercial or residential buildings.
2. The loan fees and interest accruing to the ADC loan are funded out of loan proceeds.
3. The ADC lender participates in the ultimate profitability of the real estate project. This participation may be an explicit sharing of sale proceeds. A similar result can be obtained if interest rates and fees are set at a level that produces the same payment to the lender, providing the project is sold for the expected amount. A financial institution making an ADC loan might also share in gross rents or operating cash flow from a commercial project or apartment building.

4. The ADC loan is usually secured only by the project being financed, with perhaps the personal guarantee of the borrower.
  
5. ADC loans do not typically require that the developer make any repayment before completion of the project.

#### Characterization of the Transaction

The ADC loan shares a number of attributes in common with transactions that are accounted for as investments. For example, partnerships in which one party provides financial resources and another party provides development skills are common in the real estate industry. The financing partner is typically entitled to a return of contributed capital with an agreed rate of return and some share of any ultimate profit. The financing partner is at risk for at least the funds provided and reaps the reward of the investment through successful completion and sale of the project. The similarity between the risks and rewards of an ADC loan and those of the investment described above have led some to contend that ADC loans should be characterized as real estate investments, following the fundamental principle that accounting should reflect the economic substance of a transaction rather than the form of the transaction.

This position was taken in report of the House Committee of Government Operations entitled "Federal Home Loan Bank Board Supervision and Failure of Empire Savings and Loan Association of Mesquite, Texas".

[M]any of Empire's "loans" for real estate acquisition and development were in fact investments, with the borrower taking few risks and Empire bearing the major risk of an equity participant. Nevertheless, Empire treated the "income" from the points and fees charged on these "loans" as income up-front rather than, as required in the case of an investment, when the property is sold or otherwise disposed of.

The characterization of an ADC transaction as an investment in real estate could have implications beyond those alluded to in the quotation above. FHLBB regulations can place a thrift institution under increased regulatory supervision if the amount of direct investment in real estate exceeds certain limits. Some institutions could exceed those direct investment levels if their ADC transactions were considered to be real estate investments.

Others contend that a loan, legally made and properly structured as such, should not be reconstrued by accountants. They argue that the making of ADC loans is within the Congressionally mandated powers of a savings and loan institution. They further maintain that the lending institution has rights and powers as a lender that are not typically held by investors. In addition, they point out that ADC lending shares many attributes with long established construction lending practice.

## Recognition of Income

If an ADC loan is considered to be an investment, recognition of income from interest and loan fees is inappropriate. The institution would recognize income only when the property was sold in accordance with FASB Statement No. 66, Accounting for Sales of Real Estate. Prior to sale, the institution would capitalize interest costs, based on the institution's cost of funds, as described in FASB Statement No. 34, Capitalization of Interest, and would reduce the amount of the investment for any fees and interest received.

If the ADC loan is treated as a loan, interest and loan fees would be included in income, subject to consideration of the loan's overall recoverability. The current and proposed accounting for loan fees is described in a separate section of this submission.

## Collectibility

Whether or not a loan will ultimately be repaid is a major issue in the accounting for any loan. The amount of risk accepted by a lender in an ADC transaction increases the attention that must be given to collectibility. It is difficult for management, auditors, and regulators to judge the ultimate collectibility of an ADC loan while development is progressing. Since the loan typically funds its own interest and requires no payment before completion of the project, it is almost impossible for the loan to be in default during the development period.

Some have contended that the ADC loan accounting problem is a question of collectibility. To the extent that collectibility is in question, the current accounting guidance is applied to ADC transactions in the same fashion as it is to other lending. There does not seem to be a need for new guidance, dealing specifically with collectibility of ADC transactions.

#### Guidance on ADC Loan Accounting Issues

The accounting profession first addressed ADC transactions in November 1983 when AcSEC issued a Notice to Practitioners entitled, "Certain Real Estate Lending Activities of Financial Institutions." The Notice provided criteria that should be used to determine whether an ADC transaction should be reported as a loan or as an investment. That Notice became the basis for FHLBB rules proposed in October 1984 and finalized in FHLBB rule 85-291 on April 18, 1985. A second AcSEC Notice to Practitioners entitled, "Notice to Practitioners on ADC Loans," was issued in November 1984, providing additional guidance.

The members of the FASB Emerging Issues Task Force have discussed ADC Loan accounting issues at a number of Task Force meetings and have recently agreed that guidance is needed beyond the two Notices. The AICPA is drafting a third Notice that will consolidate the guidance provided in the two prior Notices as well as clarify certain language in the prior Notices. At the same time, the FASB staff understands that AcSEC plans to form a task force to study broader accounting issues raised by real estate lending that provides substantially all of the cost of a project and funds interest and loan fees from the loan proceeds.

In summary, the three principal issues in accounting for ADC transactions are being addressed as follows:

Characterization of the transaction is being addressed through AcSEC Notices to Practitioners and FHLBB rulemaking.

Recognition of income should be resolved when appropriate characterization of the transaction is determined. ADC transactions characterized as loans are included in the scope of the FASB project on accounting for loan fees.

The evaluation of collectibility and accounting when an ADC loan is deemed not fully recoverable is addressed by the accounting guidance that applies to all lending.

#### Repurchase Agreements

The accounting for repurchase agreements has also been the subject of recent study and concern. In the summer of 1984, the Financial Corporation of America restated earnings for the first half of that year as the result of an SEC objection to its accounting practice involving certain repurchase agreements. More recently, the failures of ESM Government Securities, Inc. and Bevill, Bresler & Schulman Asset Management Corporation resulted in large losses for many of their repurchase agreement customers.

In a repurchase agreement an entity with a short-term cash shortage and securities it doesn't presently need contacts a broker and exchanges the securities for cash. Simultaneously, the entity agrees to repurchase the

securities from the broker at a specific time in the future for the original exchange amount plus additional compensation (interest) for allowing the use of cash. Although structured as a sale and repurchase of the securities<sup>1</sup>, the substance of the transaction is a collateralized borrowing by the "seller" and a loan by the "buyer." The accounting follows this substance.

Various organizations, including the AICPA, the SEC, and the Governmental Accounting Standards Board have moved to investigate and address the financial reporting implications of those losses and of repurchase agreements in general. The staff of the FASB is monitoring the activities of these organizations. The proposals that have resulted from consideration of repurchase agreements call for increased disclosure, rather than for a change in the accounting of the transactions themselves. Most of the problems surrounding the recent losses incurred by thrift institutions from repurchase transactions are not accounting issues, as such. Institutions that sustained losses in the much publicized failures of government securities dealers seem to have done so through 1) a failure to understand or protect against the risks involved or 2) alleged fraud committed by the dealers involved.

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<sup>1</sup> The sale and repurchase structure was originally conceived to provide the purchaser/lender access to collateral without the difficulty of perfecting a security interest.

While not directly related to the recent losses described above, there is one issue in the accounting for repurchase transactions that could have implications for the thrift industry. Some repurchase transactions call for the repurchase of exactly the same security as that delivered while others allow the repurchase of securities that are different. Borrowing/lending accounting is allowed for the later transactions as long as the securities returned are substantially the same even though not exactly the same. (For example, repurchase transactions involving U.S. Treasury securities of the same type with the same coupon and maturity) The characterization of a repurchase agreement as a borrowing/lending is not considered appropriate when the securities returned are not substantially the same as those held prior to the transaction. In that case, the transaction is accounted for as a sale and a gain or loss is recorded.

Accounting guidance indicates that mortgage backed securities can be used in repurchase transactions involving the return of different but substantially the same securities. Some, however, have questioned the appropriateness of that accounting. They point out that each group of mortgage loans set aside (a loan pool) to back the securities is unique in the way the underlying loans will repay. As a result, they maintain that other pools cannot be considered to be substantially the same.

Resolution of this issue could have significant implications for thrift industry accounting. If pools of mortgages and mortgage-backed securities are not considered to be substantially the same as other pools, then the repurchase transactions in those pools would no longer justify accounting treatment as a borrowing. Absent that treatment, many institutions might

elect not to be participants in the repurchase marketplace for mortgage backed securities.

The issue of "substantially the same" has been addressed in an AICPA proposed Statement of Position. The AICPA is in the process of exposing this Statement of Position for comment.

### Business Combinations

A business combination occurs when two or more incorporated or unincorporated businesses are brought together into one accounting entity. The single entity carries on the activities of the previously separate, independent enterprises. The authoritative accounting literature regarding business combinations is Accounting Principles Board Opinions No. 16 and 17, Business Combinations and Intangible Assets, FASB Interpretation No. 9, Applying APB Opinions No. 16 and 17 When a Savings and Loan Association or a Similar Institution Is Acquired in a Business Combination Accounted for by the Purchase Method, and FASB Statement No. 72, Accounting for Certain Acquisitions of Banking or Thrift Institutions. Opinion 16 sets forth the general principles to be applied in accounting for a business combination as a purchase. Opinion 17 discusses the appropriate accounting for the intangible assets that may be recognized in a business combination accounted for as a purchase. Interpretation 9 provides guidance in the application of purchase accounting to an acquisition of a financial institution. Statement 72 addresses the amortization of the unidentifiable intangible asset (goodwill) recognized in certain financial institution business combinations

accounted for by the purchase method. Statement 72 also addresses the accounting for the receipt of regulatory assistance in connection with a business combination.

#### Purchase Method

In a business combination accounted for as a purchase, the acquiring corporation must allocate the cost of the acquisition to the bundle of assets acquired and liabilities assumed. The purchase method adheres to traditional principles of accounting for the acquisition of assets. Once this allocation is made to the tangible and identified intangible assets acquired and liabilities assumed, there may exist a residual premium that the acquirer has paid for any number of reasons. This difference between the cost of an acquired company and the sum of the fair values of tangible and identifiable intangible assets less liabilities is recorded as goodwill.

In purchase accounting, the business combination is viewed as an exchange that results from bargaining between independent parties. Each party to the business combination bargains on the basis of its assessment of the current status and future prospects of each company as a separate enterprise and as a contributor to the operations of the combined enterprise. The acquiring enterprise is considered to have paid consideration that was established by the bargaining of independent parties. The acquiring company accounts for the assets and liabilities acquired at their fair value as an allocation of the purchase price.

## Goodwill

Goodwill is recognized when a business combination is accounted for using the purchase method and the purchase price paid exceeds the fair value of the net assets acquired. Acquiring companies are often willing to pay more for another company than would be dictated by the fair value of the net tangible assets. That excess price may be attributable to a number of identified intangible factors, such as the value of an established customer base, management team, unique products, specialized manufacturing or marketing techniques, or the prospect for future earnings.

Opinion 17 requires that the cost of acquired intangible assets, including goodwill, be "amortized by systematic charges to income over the period estimated to be benefited." The Opinion goes on to stipulate that the amortization period cannot exceed 40 years. The Opinion also provides for an ongoing assessment of the amortization period. Should this assessment indicate that the period to be benefited differs from original estimates, the Opinion requires that the remaining amortization be changed.

## Application of Business Combinations to the Thrift Industry

In February 1976, the FASB issued Interpretation 9 to address the application of Opinions 16 and 17 when a financial institution is acquired in a business combination accounted for by the purchase method.

Interpretation 9 provides that the acquiring enterprise should determine any identifiable intangible assets related to the acquisition and amortize them over their estimated lives in accordance with Opinion 17. Interpretation 9 also provides that any goodwill should be amortized using the straight-line

method unless a company demonstrates that another systematic method is more appropriate. An accelerated method would be appropriate and may be used to amortize goodwill when a company demonstrates that the amount assigned to goodwill represents an amount paid for factors whose benefits will decline at a diminishing rate over their expected lives.

In February 1983, the FASB issued Statement 72 in response to concern that the application of Opinions 16 and 17 to the acquisition of certain financial institutions produced postcombination operating results that were not reliable. Statement 72 amended Opinion 17 and Interpretation 9 with regard to the amortization of the unidentifiable intangible asset (goodwill) recognized in certain business combinations. Statement 72 provides that if, and to the extent that, the fair value of liabilities assumed exceeds the fair value of identifiable assets acquired in the acquisition of a banking or thrift institution, the unidentifiable intangible asset recognized generally is amortized to expense by the interest method over a period no longer than the estimated remaining life of the long-term interest-bearing assets acquired.

The Board selected this amortization pattern as an industry-specific standard that represented a pragmatic solution to the anomalous effect on postcombination earnings that resulted from the use of an extended life for goodwill. The Board believed that any unidentifiable intangible asset should be amortized over a relatively short period because of the uncertainty about the nature and extent of the estimated future benefits related to that asset. The Board maintained that a financial institution's use of a 40-year maximum amortization period of goodwill in the face of existing economic and competitive uncertainties confronting the banking and

thrift industries was inappropriate. The Board concluded that more explicit guidance was needed to improve the relevance and reliability of financial reporting. The Board noted that use of a 40-year maximum amortization period for goodwill produced financial results that lacked economic substance, that destroyed both consistency of reporting by the enterprise and comparability among similar enterprises, and had the capacity to mislead users and damage the credibility of financial reporting.

Statement 72 does not address the accounting for a takeover of an institution by regulatory authorities. Such actions have typically resulted in either liquidation of the institution, in which case the institution ceases to exist or acquisition of the troubled institution by another institution with federal assistance, in which case the provisions of Statement 72 may apply. Recent developments in the thrift industry, specifically the Federal Savings and Loan Insurance Corporation's Management Consignment Program (MCP), raise accounting questions that had not previously been at issue.

In recent months, the Federal Savings and Loan Insurance Corporation (FSLIC) instituted the MCP Program. Under the MCP Program, the FSLIC has closed a number of financial institutions whose savings accounts it insures and has reopened these institutions by transferring substantially all the assets and liabilities of the prior association to a newly chartered federal association. The FSLIC enters into a management agreement with another financial institution to oversee the day to day operations of the new institution.

The FASB has recently developed a means to deal with such emerging accounting issues. The Board's Emerging Issues Task Force was formed to assist the Board by identifying and defining emerging issues promptly. The background of the Task Force, its development, and its operations are described in the Board's February 20, 1985 submission to the Subcommittee, pages 49 to 52. The Federal Home Loan Bank Board has asked that the Task Force discuss the accounting issues that arise from the MCP at the November 7, 1985 Task Force meeting. The Board expects that the discussion of issues at that meeting will provide it with additional information concerning the background of the Program and the transactions involved. The Board also expects that the discussion will be helpful in determining what, if any, Board action is needed.

#### FSLIC Management Consignment Program

The principal accounting issue of the MCP Program centers on what the appropriate basis of accounting for the newly chartered institution should be at the date of its creation and on an ongoing basis.

The FASB staff has reviewed the Issues Summary that was prepared by the FHLBB staff for discussion purposes at the Emerging Issues Task Force meeting. The FASB staff has not had substantive discussions with representatives of the FHLBB, FSLIC, or the major accounting firms on this issue. Based on a review of the information that has been made available to us by the FHLBB, the FASB staff has identified the following issues:

Is the formation of a new savings and loan association and the acquisition of the assets and liabilities of the old savings and loan association a business combination? The business combinations discussed in Opinion 16 and Statement 72 are the result of an arms-length transaction by one enterprise to acquire another enterprise. If the acquisition of an institution and its subsequent caretaking pending future sale or liquidation is not considered a business combination then the accounting guidance provided for in Opinion 16 would probably not be applicable. While no specific accounting standard is applicable to this type of event arising on a nonarms-length basis (a reorganization), Opinion 16 suggests that a new basis of accounting may not be appropriate.

Is the MCP Program a temporary step by the FSLIC to minimize losses to the FSLIC insurance fund? One of the features of the MCP Program is the replacement of the management of the financial institution with a group of managers recognized by the FSLIC as more able to operate the thrift. If the group of managers is able to improve the financial condition of the thrift, the FSLIC has indicated that such thrift institutions would then be sold to other healthier thrifts or allowed to pursue an initial public offering. If a turnaround cannot be achieved, the FSLIC would pursue other alternatives. If the MCP Program represents a caretaking or trust activity, then a new basis of accounting may not be appropriate.

Although the transaction may not be considered a business combination, would the significance of the action undertaken suggest that presentation of financial information of the new savings and loan association on a fair value basis is appropriate? If the thrift is being operated in an interim stage pending sale or liquidation, fair value accounting may be appropriate

since the enterprise in question no longer has the ability or intent to realize the historical carrying amounts of assets by holding such assets to maturity.

The accounting for each MCP situation may differ given the facts and circumstances relating to the FSLICs actions. In addition, discussions at the November 7, 1985 meeting of the Emerging Issues Task Force may raise points not previously considered by the FASB staff.

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The Financial Accounting Standards Board appreciates this opportunity to provide the Subcommittee with a background of accounting issues in the thrift industry. The Board and its staff continue to monitor developments in this area through the Board's Emerging Issues Task Force. The preceding submission discussed what the Board believes to be significant issues with broad implications for the thrift industry. In addition, the Emerging Issues Task Force has addressed a number of narrower issues that relate to thrift institutions and to financial institutions generally. The subcommittee staff has previously been provided with Task Force materials on those issues.

In addition, the FASB staff is analyzing the need for additional efforts to establish broad standards that would aid in resolving both present issues regarding financial instruments and transactions and the issues that seem sure to arise in the future. The staff is pursuing the possibility that the overall problem should be approached as several separate questions, including how relationships between particular assets and liabilities affect their recognition in the balance sheet, how some kinds of financial instruments should be measured, how debt and equity securities can be better distinguished, and how the creation of separate legal entities affects the accounting. The staff plans to make recommendations concerning an agenda decision to the Board early next year.



# Financial Accounting Standards Board

HIGH RIDGE PARK, STAMFORD CONNECTICUT 06905 203-329-8401



Assistant Director  
Research and Technical Activities

May 19, 1982

Mr. James O. Sison  
Minority Staff Director  
Committee on Banking, Finance and Urban Affairs  
2129 Rayburn House Office Building  
Washington, D.C. 20515

Dear Mr. Sison:

As requested by your letter of May 17, the staff of the Financial Accounting Standards Board (FASB) has reviewed the provisions of a bill entitled "Net Worth Guarantee Act" (H.R. 6267) to determine if a thrift institution should recognize the stated amount of net worth guarantees issued to it by a regulatory insurance agency (i.e. FDIC, FSLIC, NCUA) in its financial statements prepared in accordance with generally accepted accounting principles (GAAP). Specifically, you indicated a concern that those guarantees would not result in an increase in a thrift's net worth under GAAP and questioned what the accounting treatment of the guarantees would be under GAAP.

The staff's views on your question are set forth in this letter. These comments should not be regarded as an expression of the position of the Board.

Based on our reading of the bill, the FASB staff understands that:

1. A guarantee of net worth would be a commitment by the U.S. Government for the Secretary of the Treasury to pay a specified amount to the receiver of a thrift in the event the thrift is closed and only in that event.
2. That commitment would be evidenced by guarantees of net worth issued by a regulatory insurance agency without the transfer of cash or other resources.



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3. Until a thrift is closed, there are no future cash flows directly attributable to the guarantee. A guarantee of net worth cannot be converted to cash, assigned to another entity, sold, etc.
4. The required annual reductions in the amount of a thrift's guarantees of net worth do not entail the transfer of cash or other resources from the thrift to the regulatory insurance agency.

It is not clear to the FASB staff whether the ultimate beneficiary of this guarantee would be holders of uninsured deposits and other uninsured creditors, the regulatory insurance agency, or both. We assume that one intent of the bill is to extend, in effect, deposit insurance coverage to previously uninsured depositors and other uninsured creditors in the amount of the guarantee. If, on the other hand, the assistance represents only a promise of the U.S. Government to pay a specified amount to a regulatory insurance agency of the U.S. Government, it would have, in our view, no effect on outsiders. In any event, however, the thrift itself would not receive any proceeds of the guarantee.

The question of whether the receipt of a guarantee of net worth would result in an increase in the net worth of a thrift under GAAP has two parts. First, a determination must be made as to whether the guarantee of net worth qualifies as an asset of the thrift institution under GAAP. If that is answered in the affirmative, a determination must then be made as to whether the asset results from a borrowing by the thrift or from an infusion to its net worth by the regulatory insurance agency. The FASB staff has not addressed the second issue because, in our opinion, the net worth guarantee does not constitute an asset under GAAP based on the following guidance from existing accounting literature:

Statement of Financial Accounting Concepts No. 3, Elements of Financial Statements of Business Enterprises, states:

- o Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events (paragraph 19). An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to



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May 19, 1982  
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contribute directly or indirectly to future net cash inflows, (b) a particular enterprise can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the enterprise's right to or control of the benefit has already occurred (paragraph 20).

- o The common characteristic possessed by all assets and economic resources is "service potential" or "future economic benefit," the capacity to provide services or benefits to the entities that use them. In a business enterprise, that service potential or future economic benefit eventually results in net cash inflows to the enterprise. That characteristic is the primary basis of the definition of assets in this Statement (paragraph 22).
- o To have an asset, a business enterprise must control future economic benefit to the extent that it can benefit from the asset and generally can deny or regulate access to that benefit by others, for example, by permitting access only at a price (paragraph 115). Thus, an asset of a business enterprise is future economic benefit that the enterprise can control and thus can, within limits set by the nature of the benefit or the enterprise's right to it, use as it pleases. The enterprise having an asset is the one that can exchange it, use it to produce goods or services, exact a price for others' use of it, use it to settle liabilities, hold it, or perhaps distribute it to owners (paragraph 116).
- o Only present abilities to obtain future economic benefits are assets under the definition . . . (paragraph 122). The definition excludes from assets items that may in the future become an enterprise's assets but have not yet become its assets. An



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enterprise has no asset for a particular future economic benefit if the transactions or events that give it access to and control of the benefit are yet in the future (paragraph 123).

The FASB staff believes that a guarantee of net worth lacks the first and second essential characteristics of an asset and should not be recognized as an asset under GAAP by a thrift. The guarantee, in our opinion, cannot be considered a probable future economic benefit that has been obtained by and is under the control of the thrift because the thrift itself will never realize any cash flows that are directly or indirectly attributable to the guarantee.

We are not aware of any instances where the potential benefits of insurance currently are recognized as assets in financial statements prepared in accordance with GAAP. For example, a net worth guarantee appears similar in substance to the present insurance on qualified deposits of thrifts and that insurance is not an asset of the thrift. Similarly, insurance provided to pension plan participants by the Pension Benefit Guaranty Corporation is not an asset of the pension plan.

In summary, it is the opinion of the FASB staff that a guarantee of net worth would not be recognized as an asset of a thrift institution under GAAP. Accordingly, a guarantee would not result in an increase in a thrift's net worth under GAAP. It should be understood, however, that these views do not address the definition of net worth for regulatory purposes.

If I can be of any further assistance in this matter please contact me.

Very truly yours,

*J. T. Ball*

J. T. Ball

cc: Paul Nelson  
Majority Staff Director

JTB:677D

# Financial Accounting Standards Board

HIGH RIDGE PARK, STAMFORD, CONNECTICUT 06905 | 203-329-8401



Assistant Director  
Research and Technical Activities

November 23, 1983

Mr. Roger Cason, Chairman  
Accounting Standards Executive  
Committee  
American Institute of Certified  
Public Accountants  
1211 Avenue of the Americas  
New York, NY 10036

Dear Mr. Cason:

I am writing in response to your letter dated October 25, 1983 informing the FASB of the Accounting Standards Executive Committee's (AcSEC) views concerning the Federal Savings and Loan Insurance Corporation (FSLIC) net worth certificate program.

The FASB staff reviewed the FSLIC net worth certificate program and concluded that an FSLIC note given to a savings and loan institution (S&L) in exchange for a net worth certificate from the S&L should not be reported as an asset by the S&L in its financial statements purporting to be prepared in conformity with generally accepted accounting principles. That conclusion was based on the definition of an asset in FASB Concepts Statement No. 3 and the closely linked relationship of the note to the simultaneously issued net worth certificate. The FASB staff recognizes that the Federal Home Loan Bank Board (FHLBB) may reach a different conclusion for regulatory accounting purposes.

Although not addressed by AcSEC, the FASB staff also concluded that, if recognized, the net worth certificate given to FSLIC in exchange for the promissory note would meet the definition of a liability under Concepts Statement 3 rather than equity. Again, we recognize that the FHLBB may require different accounting for regulatory reporting purposes.

The Board considered the staff's conclusions at its November 16 Board meeting and were of the unanimous opinion that an increase in net worth does not result from the issuance of the net worth certificate in exchange for the note. A majority of the Board was also of the opinion that the note should not be recognized as an asset when received in exchange for the net worth certificate.



Mr. Roger Cason  
November 23, 1983  
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Because those conclusions are contrary to the majority view stated in your letter dated October 25, we suggest that the AcSEC position not be publicized.

However, if AcSEC decides to announce its position in The CPA Letter (as discussed in the minutes of the June 8-10, 1983 AcSEC meeting), we request that the FASB's disagreement with that position be included in that announcement. Although we do not expect the Board to add the matter to its technical agenda, the staff is prepared to issue a Technical Bulletin to communicate the FASB's views broadly on this matter.

Very truly yours,

A handwritten signature in cursive script that reads "J. J. Ball".

J.T. Ball  
JTB/1638P

cc: Roger Cason, Main Hurdman, NY  
Paul Rosenfield, AICPA, NY  
Sandra Johnigan, Chairman, AICPA Savings & Loan Committee

# Financial Accounting Standards Board

HIGH RIDGE PARK, STAMFORD, CONNECTICUT 06905 · 203 · 329 · 8401



Assistant Director  
Research and Technical Activities

October 12, 1982

Director, Information Services Section  
Office of Communications  
Federal Home Loan Bank Board  
1700 G Street, N.W.  
Washington, D.C. 20552

Re: Proposed Rule-Amendments to Net-Worth and  
Statutory-Reserve Requirements

Dear Sir:

The staff of the Financial Accounting Standards Board (FASB) has reviewed the above referenced proposed rule issued for comment by the Federal Home Loan Bank Board (FHLBB). The staff's comments are set forth in this letter.

The FHLBB proposes to allow savings and loan associations to include "Appraised Equity Capital" as an off-balance-sheet item in computing statutory reserves. We understand the FHLBB has the responsibility to assess the viability of insured associations in carrying out its responsibilities under the National Housing Act and that statutory net worth is one of the measures used in making that assessment. The proposal constitutes a redefinition of net worth for statutory purposes and as such would not affect reporting in financial statements prepared on the basis of either generally accepted accounting principles or regulatory accounting principles. Accordingly, the FASB staff has no comment on that portion of the proposal.

The Supplementary Information section of the proposal requests comments "on the issues which would be raised by a broad mark-to-market approach in which the current value of all assets and liabilities would reflect market value." In its conceptual framework project on accounting recognition, the FASB is addressing



Director, Information Services Section  
October 12, 1982  
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issues related to determining, for purposes of general purpose financial reporting, the most decision-useful attribute of an asset or liability to measure (e.g., current value, replacement cost, historical cost). The Board has not yet reached any conclusions on that issue.

The FASB staff is reluctant to provide comments on the broad issue of mark-to market accounting in the context of this limited proposal. If the FHLBB does propose a specific mark-to market approach in regulatory financial statements for all assets and liabilities, the FASB staff will consider submitting comments at that time.

Very truly yours,

A handwritten signature in cursive script that reads "J. J. Ball".

J.T. Ball  
JTB:0869D/

# Financial Accounting Standards Board

HIGH RIDGE PARK, STAMFORD, CONNECTICUT 06905 203-329-8401



Assistant Director  
Research and Technical Activities

September 11, 1981

Public Information Officer  
Office of General Counsel  
Federal Home Loan Bank Board  
1700 G Street, N.W.  
Washington, D.C. 20552

RE: Proposed Rules Permitting Deferral of Gains and Losses from the  
Sale of Mortgage Assets

Dear Sir:

The staff of the Financial Accounting Standards Board (FASB) has reviewed the proposed rule concerning the treatment of gains and losses from the sale of mortgage assets that was released for comment by the Federal Home Loan Bank Board (FHLBB) on August 13, 1981. The staff's views are set forth in this letter. Although several members of the Board had an opportunity to review a draft of this letter, it has not been considered by the entire Board and these comments should not be regarded as an expression of the position of the Board.

Our review was made with the understanding that the FHLBB has the authority to establish accounting rules to be followed for regulatory reporting as part of its supervisory and regulatory responsibilities for Savings and Loan Associations (S&L's). The FASB, on the other hand, has the objective of establishing standards for general purpose financial accounting and reporting for all entities. The FHLBB's Insurance Regulations require institutions to use generally accepted accounting principles (GAAP) except where other accounting practices are specifically authorized. Thus, although regulatory accounting may differ from financial accounting, in many cases they will be the same.



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As described below, the proposed deferral accounting conflicts with GAAP, and the staff believes that the adoption of the proposed rule would result in major differences between general purpose financial statements prepared on the basis of GAAP and those prepared for regulatory purposes. The FASB staff also believes that adoption of the proposed rule would have an undesirable effect on industry credibility and could produce misleading information. An alternative approach to the problem is presented herein for your consideration.

The proposed rule, 563c.14 of Subpart B, "Other Accounting Requirements," states, in part:

Gains and losses (net of related income taxes) resulting from disposition of mortgage loans and mortgage-related securities . . . shall be recognized at the time such gains and losses are realized: provided, that an institution may, at its option, elect to defer and amortize all gains and losses . . . resulting from such disposition . . . .

The release containing the proposed rule indicates that both GAAP and regulatory accounting principles (RAP) currently require an S&L to recognize "the full amount of the loss on a sale in the period of sale" and to report the "resulting loss of income and erosion of its net worth resulting from the difference between the market value and book value of the sold assets." The release continues:

The accounting requirement that institutions recognize the entire loss or gain on the sale of mortgages in the period of sale is predicated on the concept that such sale is a completed transaction, representing a termination of the value of the asset to the institution. It is the Board's view that these accounting rules disregard management intent to reinvest the proceeds so as to increase future profitability and reduce future interest-rate risk. Thus, by not considering the use of the proceeds from such sales, the present rules fail to account for the on-going nature of the institution's business and the fact that releasing funds currently invested in mortgages and mortgage-related securities permits improvement of a stream of future earnings and cash flows.

The Board believes that current accounting rules, by failing to reflect the true economic consequences of a sale and



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reinvestment of the proceeds, effectively inhibit institutions from selling mortgages and mortgage-related securities when it would be in their best interest to do so. Therefore, the Board is proposing to amend its accounting rules . . . to allow deferral of gains and losses on the disposition of mortgage loans and mortgage-related securities, in order to encourage institutions to obtain the economic benefits of a mortgage asset disposition program and reinvestment of the proceeds without incurring regulatory net-worth deficiencies. [Emphasis added.]

The proposed rule is in direct conflict with GAAP as explained on page 34 of the AICPA Audit and Accounting Guide, Savings and Loan Associations, which states:

Generally accepted accounting principles require that gain or loss be recognized at the time of sale of loans or participations. However, if at the end of any reporting period it is apparent that the association intends to sell certain loans and the anticipated sale will result in a loss, the association should establish an allowance for losses. The allowance for losses should be deducted from the related asset in the statement of financial condition. Gains and losses should not be deferred as new loan yield adjustments. [Emphasis added.]

The FASB staff disagrees with the assertion included in the release that current accounting rules fail to reflect the true economic consequences of a sale and reinvestment of the proceeds. Current accounting rules for gains and losses on the sale of assets produce financial information consistent with the objectives set forth in FASB Concepts Statement No. 1, Objectives of Financial Reporting by Business Enterprises. Those objectives, which identify the goals and purposes of financial reporting, include, among others:

- o Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions...
- o Financial reporting should provide information to help present and potential investors and creditors or other users in assessing the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans. [Emphasis added]... People engage in investing, lending, and



similar activities primarily to increase their cash resources. The ultimate test of success (or failure) of those activities is the extent to which they return more (or less) cash than they cost...

- o Financial reporting should provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity) and the effects of transactions, events, and circumstances that change resources and claims to those resources...
- o Financial reporting should provide information about an enterprise's financial performance during a period... The primary focus of financial reporting is information about an enterprise's performance provided by measures of earnings and its components... Information about enterprise earnings and its components measured by accrual accounting generally provides a better indication of enterprise performance... Accrual accounting attempts to record the financial effects on an enterprise of transactions and other events and circumstances that have cash consequences for an enterprise in the periods in which those transactions, events, and circumstances occur rather than only in the periods in which cash is received or paid by the enterprise...

In addition, the FASB has adopted definitions of the basic elements of financial statements. Paragraph 19 of Concepts Statement 3, Elements of Financial Statements of Business Enterprises, defines assets as follows:

Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

Deferred losses on the sale of mortgage loans would not constitute assets under the above definition. No future economic benefits relating to the mortgage receivables sold would exist after the sale transaction.

The FASB staff believes that the sale of mortgage receivables by an S&L and the subsequent reinvestment of the proceeds are separate transactions and should be reported as such in the periods in which they occur, just as is now required by both GAAP and RAP. Viewing those two transactions as a single transaction anticipates the future profits of reinvestment and offsets losses that have occurred with profits that have not and may never occur.

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We further believe that changing RAP so that S&Ls will not appear to have sustained decreases in their net assets would be a disservice to the users of the financial statements. A better approach, in our opinion, would be to re-examine the regulatory tests applied to evaluate the adequacy of net worth levels of an S&L. Revising the tests, as was done by the FHLBB in November 1980 (Resolution No. 80-694), would be a direct approach to the problem and would avoid reporting as though losses and decreases in net assets had not occurred. Such misinformation might well result in the loss of credibility for institutions that report it and regulations that encourage it. We further observe that deferrals of gains and losses would obfuscate the results of many future periods; because all or most deferrals would be losses, future operations would be penalized by amortization of previously deferred losses.

If you would like to discuss these matters further, please contact me.

Very truly yours,

*J. T. Ball*  
J. T. Ball

JTB:380D