

# Financial Accounting Standards Board

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MARSHALL S. ARMSTRONG, Chairman of the Board

February 14, 1977

Senator William Proxmire  
Chairman  
Committee on Banking, Housing  
and Urban Affairs  
United States Senate  
Washington, D. C. 20510

Dear Senator Proxmire:

In my reply to your January 27, 1977 letter concerning the Financial Accounting Standards Board's December 30, 1976 Exposure Draft, "Accounting by Debtors and Creditors for Troubled Debt Restructurings," some background information may be helpful in putting the matter in perspective. First, however, I can assure you that, for reasons I will set forth below, the FASB proposals do not involve accounting favoritism, and the proposed effective date of June 30, 1977 does not constitute a six-month grace period.

The FASB issued an Exposure Draft on accounting by debtors for troubled debt restructurings in November 1975 in response to requests to consider the matter as an emerging accounting problem and held a public hearing on that Exposure Draft in December 1975. Respondents to that Exposure Draft expressed divergent views regarding appropriate accounting. About the same time, attempts by the City of New York to resolve its financial difficulties focused attention on accounting by creditors. As a result of those developments, the FASB undertook a broader coordinated study of accounting by both debtors and creditors for debt restructurings and issued a Discussion Memorandum in May 1976. A Discussion Memorandum is a neutral exposition of the issues on a particular matter and is designed to solicit comments, views, and reasoning on the subject; it contains no Board conclusions or proposals. That Discussion Memorandum comprehended nontroubled as well as troubled debt restructurings and discussed several possible ways for debtors and creditors to account for restructurings, the most controversial of which was to record a creditor's claim or a debtor's obligation at its market value at the time of restructuring or to record an asset (e.g., stock or real estate) transferred to satisfy a debt in a restructuring at the asset's market value at the time of transfer.



The FASB received 894 written responses to the Discussion Memorandum and heard 37 oral presentations at a public hearing on July 27-30, 1976. A substantial number of the respondents focused on and expressed concern about the possibility that creditors might have to revalue restructured receivables at market prices. Some commentators estimated that accounting for restructurings at market value would cause multi-billion-dollar write-downs by banks, resulting in severe economic consequences to the banking industry, the credit markets, and the nation as a whole. Despite the FASB's reiteration that it intended to consider accounting for restructured debt within the existing so-called historical cost accounting framework and did not intend to change that framework fundamentally by action on restructured debt, considerable misunderstanding of the point was evident both in certain reports in the press and in many of the responses that referred to the Discussion Memorandum as a proposal for "current-value accounting." As you know, that term ordinarily implies revaluation of assets and liabilities each time financial statements are issued, which would involve significantly fundamental changes in the existing accounting framework.

After considering the issues raised in the Discussion Memorandum and the responses received, the FASB concluded that the prevailing accounting practice for nontroubled debt restructurings was satisfactory and that the scope of the Exposure Draft should therefore be limited to accounting for troubled debt restructurings. According to the Exposure Draft, a troubled debt restructuring occurs "if the creditor is compelled by economic or legal considerations related to the debtor's financial difficulties to grant relief to the debtor that cannot meet its obligations on the debt." In general, the Exposure Draft proposes that the effects of modifying terms of continuing debt (usually by deferring or reducing amounts the debtor is required to pay the creditor) be recognized as reduced interest expense (debtor) or interest income (creditor) for periods between the restructuring and maturity. That is, as long as the amount loaned is required to be repaid under the restructured terms, the restructuring is accounted for as having the effect of reducing the return (interest income) to the creditor or cost of borrowing (interest expense) to the debtor rather than as resulting in an immediate loss to the creditor or gain to the debtor followed by normal interest income or interest expense. The Exposure Draft also proposes (1) that assets transferred be accounted for at their fair values, with the debtor recognizing a gain or the creditor recognizing a loss at the time of restructuring, and (2) that the creditor recognize an additional loss (or perhaps occasionally a gain) when it sells the asset received in the restructuring if the fair value of the asset differs from the fair (present) value of a new receivable accepted in the sale. (I enclose an item from Business Week, February 21, 1977, "The FASB Moves to Close a Loophole," that illustrates the latter provision. The bank in the illustration would also recognize a loss at the time of restructuring under the accounting proposed in the Exposure Draft if the amount of loan and interest cancelled exceeded the \$900,000 fair value of the asset received.)

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The Board's conclusions set forth in the Exposure Draft are necessarily tentative. A final Statement of Financial Accounting Standards will be issued only after all interested parties have had an opportunity to bring to the Board's attention additional information, arguments, and evidence, and the Board has considered those comments and responses. In that regard, your letter has been included among the responses to the Exposure Draft. A copy has been distributed to each Board Member for his consideration, and one has been included in the public file of the project.

The multibillion-dollar write-downs previously mentioned in the press were apparently based on the possibility that commercial banks might be required to revalue all restructured receivables to market values, including those not involving debtors in troubled situations. The effect of that requirement would have been for banks and other creditors to recognize significant losses at the time of many, if not most, restructurings, although, if debtors met the new terms of the restructured debt, creditors' losses would usually have been offset in future periods by increased earnings. In that context, press characterizations of the accounting proposed in the Exposure Draft by descriptions such as "a conventional and relatively mild accounting treatment" are not surprising.

Those characterizations are less significant than the fact that the FASB carefully considered the information obtained through its due process and tentatively concluded that the accounting proposed would provide the best accounting within the existing accounting framework. In this matter, as in others, the FASB attempted to be evenhanded, taking into consideration the legitimate concerns and needs of those who use financial statements, the business enterprises that issue them, and the public in general.

Your letter states that you are "troubled by the aspect of the proposal which grants forgiveness from the write-down requirement to loans renegotiated before next June 30," and you observed that "a grace period of this magnitude appears unwarranted." I wish to make three points in response.

First, the six months between December 31, 1976 and June 30, 1977 are not properly called a grace period, and no write-downs are proposed to be forgiven. Under the FASB's due process, which is intended to ensure adequate fact gathering and consideration of all legitimate views, a final Statement concerning this controversial matter cannot possibly be issued before April 30, 1977 and might take somewhat longer. The Board decided that under the circumstances, June 30, 1977 was the most reasonable effective date, not only because it is the end of a quarterly reporting period for many, if not most, institutions affected by the Exposure Draft but also because it is less likely to require changing in the final Statement than if April 30 or May 31 were chosen. The Board also concluded that requiring retroactive application of the proposed accounting to troubled debt restructurings occurring before the



effective date was unlikely to significantly enhance the comparability of financial statements because past restructurings are generally non-recurring events.

Although accounting methods used by some creditors for troubled debt restructurings in which receivables are satisfied by receipt of real estate or other assets before June 30, 1977 may defer the timing of loss recognition compared with the methods proposed in the Exposure Draft, no accounting method can avoid recognizing losses. For example, if a creditor accepts an asset worth less than the amount of the receivable satisfied, recognition of the loss can be deferred no later than the time the asset is sold. No existing or proposed accounting method can forgive losses that actually have occurred.

Second, the Exposure Draft proposes that creditors disclose certain information, such as the effective interest rate and the range of maturities, about each major category of receivables whose terms have been modified in troubled debt restructurings, including receivables modified by troubled debt restructurings occurring before June 30, 1977. Accordingly, if the Exposure Draft is adopted, financial statement users should receive information about receivables modified by troubled debt restructurings occurring on or before June 30, 1977 as well as those occurring afterwards.

Third, if the Exposure Draft is adopted, it would not necessarily result in creditors' recognizing significant additional losses in accounting for most troubled debt restructurings because the losses have already been recognized. A creditor is expected to consider a debtor's financial difficulties, if any, in estimating an allowance for uncollectible amounts, regardless of whether those difficulties are likely to culminate in a restructuring. The Exposure Draft is concerned with accounting for troubled debt restructurings and does not change accounting for estimated uncollectible receivables, but an earlier FASB Statement (No. 5, "Accounting for Contingencies") specifically requires that kind of appraisal. Recent earnings of banking institutions disclose that a number of them recognized particularly large losses on receivables estimated to be uncollectible during 1975 and 1976.

Your letter requested an estimate of the dollar volume of write-downs affected by the effective date. The Board has no way to predict the number of troubled debt restructurings that will occur before June 30, 1977, the effective date proposed in the Exposure Draft, or the aggregate difference between the receivables to be satisfied and fair values of assets to be received in those restructurings. In the light of the background and explanations I have given earlier in this letter, however, the Board is confident that, if the Exposure Draft is adopted, the amounts will be relatively small, not the newspaper headlines' "multi-billion" amounts.

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A copy of the Exposure Draft and other related material that may be of interest to you or your staff is enclosed for your convenience.

I hope that this letter is responsive to and allays your concerns. If you should desire additional information about the matters addressed in this letter, please let me know.

Sincerely,

*Marshall S. Armstrong*  
Marshall S. Armstrong

MSA:kjp  
Enclosures

bcc: Board Members  
J.T. Ball  
G.R. Hildebrand  
M.A. Pinto  
G.J. Staubus  
R. Van Riper  
B.L. Brown (for files)  
R.B. Hiden, Jr., S&C



Enclosures

1. Financial Accounting Standards Board,  
Proposed Statement of Financial Accounting Standards,  
"Accounting by Debtors and Creditors for Troubled  
Debt Restructurings," December 30, 1976.
2. Financial Accounting Standards Board,  
Discussion Memorandum,  
"Accounting by Debtors and Creditors When Debt Is  
Restructured," May 11, 1976.
3. Financial Accounting Standards Board,  
"Excerpts from the Opening Statement of  
Marshall S. Armstrong, Chairman,  
Financial Accounting Standards Board,  
at the Public Hearing on Accounting by Debtors and  
Creditors When Debt Is Restructured, July 27-30, 1976,  
New York City."
4. Selected earnings releases for the fourth quarter  
and the year ended December 31, 1976, as reported in  
The Wall Street Journal:

January 14, 1977	J. P. Morgan & Co.; Chemical New York Corp.
January 19, 1977	Citicorp; Chase Manhattan Corp.; Manufacturers Hanover Corp.; Bankers Trust New York Corp.
January 24, 1977	BankAmerica Corp..
January 25, 1977	First Chicago Corp.
5. "The FASB Moves to Close a Loophole," from Business Week,  
February 21, 1977.