Comment

By Gordon Yale

How Accountants Fumbled On 2 Crucial Issues for Thrifts

Last spring, with little fanfare and hardly a yawn from the financial press, the accounting profession changed or proposed changes to long-standing rules for accounting for certain types of loans commonly made by thrift institutions.

The relative silence which greeted these changes is remarkable, for had similar promulgations been effective in the late 1970s and early 1980s when the issues were first raised, it is likely the savings and loan scandal would have surfaced earlier and more dramatically.

Further, the new rules and proposals may well have attenuated some of the most costly and abusive practices which thrifts used to fabricate profits and net worth in the 1980s.

While some accounting practitioners continue to reel under the weight of dozens of actions alleging audit negligence and several national firms have been staggered by massive settlements with government and other plaintiffs, there has been very little public discussion about the adequacy of the accounting rules and other professional guidance for firms auditing savings and loan institutions.

Unwelcome Questions

That new and proposed rules, in significant instances, are substantially more stringent than what was in force during most of the 1980s, raises a number of unwelcome questions about the effectiveness of standard-setting as well.

Thus far, these questions have been deflected by far more withering criticism of the Federal Home Loan Bank and Congress over their early, permissive response to the savings and loan crisis. What then, would more stringent accounting rules have accomplished?

For one, a quick, unambiguous professional response to difficult and material accounting issues would have created substantial risk of litigation for those firms otherwise willing to make self-serving interpretations of unclear rules or guidelines.

Ambiguity will always be a defense in negligence cases, but once generally accepted accounting principles (GAAP) are clearly established, departures from such standards are difficult to justify to the courts.

Secondly, clear and specific guidance would have leveled the competitive playing field. Ambiguity over what constituted GAAP created a climate which permitted competing firms to profit from the conservative accounting positions of more responsible practitioners.

In turn, rewarding permissiveness produced economic constituencies within the profession that may have led to the policy stalemates that have only now been broken.

The fact is, on some crucial thrift issues, the accounting profession reacted painfully late. The purpose of this article, then, is to trace the genesis of two of these issues – equity participation ADC loans and troubled debt restructurings – and to understand some of the forces that shaped them.

Rate Risk for Credit Risk

The story of equity participation loan accounting probably began as it should have, with a practitioner identifying a potential problem with a new form of transaction and attempting to solve it. The year was 1982 and the thrift industry, beset with a persistently high cost of funds but locked into largely long-term, low-return home mortgage portfolios, was bleeding red ink.

ON EQUITY *participation ADC loans and troubled debt restructurings, the profession reacted painfully late.*

Regulatory relief, which permitted a number of new and artificial inclusions to required net worth, propped up some institutions but didn't solve the fundamental industry problems of small or negative interest spreads and mismatched maturities on interest-earning assets and interest-paying liabilities.

Consulting firms and aggressive thrift managers quickly realized that acquisition, development, and construction (ADC) lending would not only ameliorate the maturity mismatches (since typically the loans repriced in one year or less), but that such transactions would also generate substantial, and more importantly, current fee income.

During the mid-1980s, when spreads between cost of funds and interest income remained relatively narrow, fee income was a major source of revenue for many thrifts and often meant the difference between profit and loss.

And it was in search of additional fee income that many in the industry exchanged interest rate risk for credit risk at almost precisely the wrong time.

THERE HAS BEEN *little public discussion about the adequacy of the accounting rules and other professional guidance for firms auditing savings and loans.*

In 1982, KPMG Peat Marwick had the largest thrift audit practice in the country. Because of the size of its presence, Peat was exposed to an increasingly common form of ADC lending that became known as equity participation.

In many instances, equity participation loans provided that the lender commit all necessary funds to acquire, develop and complete the project, including origination and commitment fees as well as reserves to cover interest from acquisition through completion.

Often, while these loans provided for developer fees, they required no cash equity, no borrower guarantees and no recourse, leaving the lender wholly at risk on the project. In return, the lender received substantial origination and commitment fees and a percentage of the equity in the profits, if any.

By late 1982, Peat's national office began questioning the accounting treatment for these equity participation loans, reasoning that the loans were more characteristically investments. By the end of the year, Peat circulated memoranda to the field which required, under some circumstances, the deferral by lending institutions of self-funded fee and interest income.

While the lender could capitalize interest while the project remained a "qualifying project," fees and interest in excess of that capitalized could not be recognized as income until a bona fide sale was made to an independent third party.

Clients began to flee Peat.

Dispute Continued

The then-existing support for the Peat position in the literature was a matter of debate. Tom Bloom, former chief accountant of the Federal Home Loan Bank in the mid-1980s and now a partner of Kenneth Leventhal, strongly believed that the literature was sufficient to force the deferral of fee and interest income. Even so, the exodus of Peat's clients continued in 1983.

In March 1983, Walter Schuetze, a senior Peat partner, former FASB board member, and currently chief accountant for the Securities and Exchange Commission, took the issue of equity participation loans to the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants, of which he was also a member.

By November, AcSEC published a "Notice to Practitioners" in the Journal of Accountancy, but as we shall see, the dispute did not end there.

In part, the 1983 notice stated: "Financial institutions, particularly savings and loan associations, increasingly are entering into real estate acquisition, development, or construction loans on which they have virtually the same risks and potential rewards as those of owners or joint venturers.

"The American Institute of CPAs accounting standards executive committee believes that, in some instances, accounting for such arrangements as loans may not be appropriate and is providing guidance in this notice to assist practitioners in determining the proper accounting."

The AcSEC executive committee defined those transactions in which the lender had a participation interest in the residual profits and which "usually have most of the following characteristics" as investments or joint ventures. Those characteristics included:

- A lender commitment to provide all or substantially all necessary funds to acquire property and complete the project. The borrower has title to, but little or no equity in, the underlying property.
- The lender funds the loan commitment or origination fees or both by including them in the amount of the loan.
- The lender completely funds interest during the term of the loan by adding interest to the loan balance.
- The loan is secured only by the ADC project. The lender has no recourse to other assets of the borrower, and the borrower does not guarantee the debt.

Illogical Position

The executive committee notice provided that loans with equity participations greater than 50% should be treated as investments, which would force the deferral of all interest and fee income by the lender.

In the case of loans with equity participations 50% or less, the transaction was to be accounted for as a joint venture, with a prorata portion of interest and fee income to be deferred.

Offsetting factors included substantial borrower equity in the project "that is not funded by the lender," lender recourse to "substantive net asscts" of the borrower apart from project itself, an irrevocable letter of credit for the full amount and term of the equity participation loan, a takeout commitment with attainable conditions, or a noncancelable sales contract sufficient to produce cash flows to service normal loan amortization.

The notice should have ended

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the controversy over equity participation loans, but it didn't. For one thing, AcSEC notices were fairly low on the hierarchy of what constituted GAAP.

According to Arthur R. Wyatt, a former executive committee chairman and FASB member, a senior technical partner at Arthur Andersen, and a professor of accountancy at the University of Illinois, the perception in 1983 was that "AcSEC had no real authority to set standards without the concurrence of the FASB. AcSEC was attempting to provide guidance, but there were differences of opinion among accounting firms of whether such guidance meant anything."

Donald J. Kirk, a former FASB chairman and board member, believed such arguments were "nonsense and a conscious effort to evade reality."

Also, the AcSEC position didn't go far enough. In essence, AcSEC defined the accounting for equity participation loans by the prospect of potential rewards in addition to the potential risks of the transaction.

The position was illogical, for if the lender made an inferior deal, assuming the same risks of the transaction, but without an equity kicker as an additional reward, no interest or fee income need have been deferred. Only now, 10 years later, has the profession moved to redress the issue.

The issue of equity participation ADC loans continued to fester. The Emerging Issues Task Force (EITF), a creation of the Financial Accounting Standards Board, acknowledged the inconsistent application of the 1983 "Notice to Practitioners" and in November 1984, stated plainly that there was some opinion "shopping" on the issue.

While the EITF surveyed its members to determine prevailing practice, the FASB stood by a July 1984 decision that guidance provided by the 1983 "Notice to Practitioners" was "adequate."

At AcSEC and within the regulatory bodies, the issue moved forward. The AICPA Savings and Loan Committee published a second "Notice to Practitioners" in the November 1984 issue of the CPA Letter, an AICPA publication.

The second notice cautioned practitioners that personal guarantees, which ameliorated the accounting for ADC loans under some circumstances, were not uniformly enforceable in all jurisdictions.

Further, the Federal Home Loan Bank Board issued draft regulatory proposals which adopted both the 1983 and 1984 notices. Regulatory blessing by the FHLBB of the notices was significant because of AcSEC's relatively low standing as a promulgating body of accounting standards.

The FHLBB regulation, however, merely repeated AcSEC language and made no attempt to extend investment accounting to those high risk loans which did not provide for equity participations by the lender.

Still, given the divisions of opinion on the legitimacy of AcSEC, the FHLBB regulation was not without meaning. "I can remember one meeting," Mr. Wyatt said, "where we attempted to get agreement from all AcSEC members that we would abide by an AcSEC notice if we reached consensus on the content of the notice. One firm refused such an agreement."

AMBIGUITY *will always be a defense, but once generally accepted accounting principles are clearly established, departures are difficult to justify.*

Thus, when the FHLBB promulgated its regulation on accounting for acquisition, development and constructions loans in April 1985, the issue of authority was finally overcome.

But the issue of whether the accounting was to be driven solely by the lenders' risk instead of lenders' risk and reward may only be resolved now. AcSEC in June forwarded to the FASB for review an exposure draft of the proposed statement of position.

The draft statement differed significantly from the previous notices in that equity participation was no longer a classification criterion.

Fundamental Questions

Why didn't the FASB provide its imprimatur early in the process, particularly when it knew there was some opinion "shopping" on the issue? And finally, why has it taken so long for the profession to propose what is now being proposed as the proper accounting for ADC loans?

A stock description of the 1980s invariably begins with a vivid recital of how President Reagan's ideological imperative of less government practically translated to an era of permissive regulation, if not the outright deregulation, of key institutions and industries, which, in turn, assured future abuse.

To some degree, the model fits the thrift industry and the accounting profession's attempt to provide adequate rules and guidelines.

"It was a difficult period," said John W. Hoyt, an AcSEC member in 1983-84 and a partner of McGladrey Hendrickson & Co. at that time.

"The FHLBB created a climate of permissiveness, by, for example, allowing losses on loan portfolio sales to be deferred over a number of years. You couldn't take a cookbook approach to any issue because quantifying approaches to issues just brought their circumvention."

FASB Reversal

Nevertheless, the antecedents for the profession's breakdown on ADC loans preceded the Reagan era and may well have been the result of fears of increased regulation rather than deregulation.

And like the controversy over equity participation loans, the issue did not disappear when the FASB initially dealt with it, but instead, lingered for 17 years until the FASB reversed an earlier position with the issuance of FASB Statement No. 114, which superseded the earlier FASB Statement No. 15.

And like the AcSEC "Notice to Practitioners," had FASB Statement No. 114 been in force during the 1980s, lending institutions would have likely had to recognize loan losses earlier and in greater magnitude than was the case under FASB Statement No. 15 which preceded it.

The recognition of such losses may have forced regulators to face up to the crisis earlier, or at the least, forced a vigorous interinstitutional debate had the FHLBB promulgated regulations that vitiated GAAP.

FASB Statement No. 15, issued in June 1977, was the FASB's response to what it perceived was a "substantial increase" defaults and restructurings that resulted from the 1974-1975 recession.

COMPETITIVE *forces, the pursuit of self-interested solutions by industries, and the difficulty of foreseeing the impact of accounting rules assure imperfection.*

The statement defined "troubled debt restructurings" as a restructuring in which "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."

A key, controversial issue raised by the pronouncement was on what basis losses should determined and recognized. The FASB's discussion memorandum initially contained, among several alternatives, a proposal that the carrying amount of the debt be written down to a present value.

When the pronouncement was issued in final form, however, it required writedowns only if the "recorded investment in the receivable at the time of the restructuring . exceeds the total future cash receipts specified by the new terms."

In other words, if the restructuring agreement provided only for the repayment of loan principal and no interest, the lender would not be required to write down its loan asset.

Now, some 16 years later, the FASB has reversed itself and with the issuance of FASB Statement No. 114, GAAP currently provides that a "creditor should measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate," which is defined as "the rate of return implicit in the [original] loan."

Bankers' Opposition

Like the proposed changes to guidance for accounting for ADC loans, the changes to rules for troubled debt restructurings

CHANGES *to rules for troubled debt restructurings have been greeted by a relative silence.*

have been greeted by a relative silence given the history of the issue.

The American Bankers Association again led opposition to the change, but according to ABA official Donna Fisher, the effort was diffused by the organization's involvement in opposing FASB Statement 115 on debt and equity securities and its lobbying efforts in connection with the FDIC Improvement Act of 1991.

In 1976, however, when the FASB first considered the issue, the banking industry's response was highly organized and overwhelmingly negative. The FASB received some 850 written responses to a discussion memorandum, more than 700 of them reportedly from banks and bankers.

In four days of hearings on the issue, a procession of banking giants, including Walter Wriston of Citibank, David Rockefeller of Chase Manhattan, and chief executives from Chemical, Continental Illinois, Bankers Trust, Irving Trust, and Bowery Savings, testified against the proposed changes.

The primary thrust of the banking industry's opposition was the impact that writedowns would have on the financial condition of many institutions. Various executives raised the specter that some major banks would be unable to continue to pay dividends, write long-term, fixed rate loans, or report results of operations with any meaningful consistency.

'Intense' Pressure

A senior executive from Chemical Bank said the changes would adversely impact loans to disadvantaged borrowers, municipalities, emerging companies, and less-developed countries.

Despite supportive testimony for more stringent criteria from the accounting profession, the FASB adopted the banking industry's position and the present value of future payments concept included in the board's discussion memorandum was rejected in favor of the less troublesome future value provision which limited the requirements for write downs.

Like its restructured borrowers, the banking industry successfully bought itself time.

Recalls Mr. Wyatt, who became an FASB member in 1986: "The pressure from the industry was intense at a time when the FASB was newly formed. Public accounting was under great pressure from Congress and the banking industry and the Federal Reserve were entrenched interests which opposed the changes.

Influence Lost

In the end though, the changes to FASB Statement No. 15 and the accounting for ADC loans may have come not so much because of the persistence of the standard-setters, but because banks and thrifts, crippled by massive losses and in too many cases, riddled by scandal, have simply lost their once-considerable influence.

Competitive forces within the profession, the pursuit of self-interested solutions by impacted industries, and the difficulty of foreseeing the full impact of highly technical and often arcane accounting rules assure the continued imperfection of what has proven to be an imperfect process.

While actions taken by standard-setters have forestalled some reporting debacles, as with many institutions, on politically charged issues, it is, unfortunately, often the debacle itself that produces impetus for significant and timely change. □