



Federal Accounting Standards Advisory Board

**Technical Amendments to Accounting Standards
For Direct Loans and Loan Guarantees
In Statement of Federal Financial Accounting Standards No. 2**

Statement of Federal Financial Accounting Standards No. 19

March 2001

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THE FEDERAL ACCOUNTING STANDARDS ADVISORY BOARD

The Federal Accounting Standards Advisory Board (the FASAB or "the Board") was established by the Secretary of the Treasury, the Director of the Office of Management and Budget (OMB), and the Comptroller General in October 1990. It is responsible for promulgating accounting standards for the United States Government.

An accounting standard is typically formulated initially as a proposal after considering the financial and budgetary information needs of citizens (including the news media, state and local legislators, analysts from private firms, academe, and elsewhere), Congress, Federal executives, Federal program managers, and other users of Federal financial information. The proposed standard is published in an Exposure Draft for public comment. A public hearing is sometimes held to receive oral comments in addition to written comments. The Board considers comments and decides whether to adopt the proposed standard with or without modification. The Board publishes adopted standards in a Statement of Federal Financial Accounting Standards.

Additional background information is available from the FASAB:

"Memorandum of Understanding among the General Accounting Office, the Department of the Treasury, and the Office of Management and Budget, on Federal Government Accounting Standards and a Federal Accounting Standards Advisory Board," amended on October 1, 1999.

"Mission Statement of the Federal Accounting Standards Advisory Board."

Federal Accounting Standards Advisory Board

441 G Street, NW, Suite 6814

Washington, DC 20548

Telephone (202) 512-7350

Fax (202) 512-7366

www.financenet.gov/fasab.htm

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EXECUTIVE SUMMARY

- I. This Statement presents technical amendments to certain portions of Statement of Federal Financial Accounting Standards No. 2, *Accounting for Direct Loans and Loan Guarantees* (SFFAS No. 2), which was issued in August 1993. These amendments were proposed for public comment in an Exposure Draft titled *Credit Program Reconciliation and Technical Amendments to Accounting Standards for Direct Loans and Loan Guarantees in Statements of Federal Financial Accounting Standards No. 2 and No. 18*, issued in May 2000. (Hereinafter referred to as the May 2000 ED.)
- II. The technical amendments serve the following purposes:
 - (A) Clarify that the cash flow discount method used in the accounting standards prescribed in SFFAS No. 2 is consistent with the method required in the Federal Credit Reform Act of 1990, as amended in July 1997.
 - (B) Clarify that the effective interest rate of a cohort of direct loans or loan guarantees is the interest rate adjusted for the interest rate re-estimate, as defined in paragraph 9(A), SFFAS No. 18, *Amendments to Accounting Standards for Direct Loans and Loan Guarantees in SFFAS No. 2*. The adjusted interest rate is used for amortizing subsidy cost allowance, accruing and compounding interest on the liability for loan guarantees, determining the book value of modified direct loans and the book value of the liability for modified loan guarantees, and calculating the present value of assets acquired through foreclosure.
 - (C) Clarify the measurement principle for the default costs of direct loans and loan guarantees. Briefly, the default cost of direct loans is measured at the present value of projected deviations due to defaults by the borrowers from payment schedules for principal, interest, and fee payments in the loan contracts, minus projected net recoveries. However, the measurement of default costs does not include prepayments. The default cost of loan guarantees is measured at the present value of projected claim payments to lenders required by the guarantee, plus uncollected fees, minus interest supplements not paid as the result of the default, and minus projected net recoveries.
- III. In the May 2000 ED, the Board proposed that entities display a program-by-program reconciliation for major credit programs between the beginning and ending balances of subsidy cost allowance for direct loans

and the liability for loan guarantees. The Board decided not to adopt this proposal based on cost-benefit considerations.

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INTRODUCTION

Background and Purposes

1. In this Statement the Board adopts a number of technical amendments to certain portions of the Statement of Federal Financial Accounting Standards No. 2, *Accounting for Direct Loans and Loan Guarantees* (SFFAS No. 2), which was issued in August 1993. These amendments were proposed for public comment in an Exposure Draft (ED) issued in May 2000. The title of that ED is “*Credit Program Reconciliation and Technical Amendments to Accounting Standards for Direct Loans and Loan Guarantees in Statements of Federal Financial Accounting Standards No. 2 and No. 18.*” (Hereinafter the ED is referred to as the May 2000 ED.)
2. The technical amendments serve the following purposes:
 - (A) Clarify that the cash flow discount method used in the accounting standards prescribed in SFFAS No. 2 is consistent with the method required in the Federal Credit Reform Act of 1990, as amended in July 1997.
 - (B) Clarify that the effective interest rate of a cohort of direct loans or loan guarantees is the interest rate adjusted for the interest rate re-estimate, as defined in paragraph 9(A), SFFAS No. 18, *Amendments to Accounting Standards for Direct Loans and Loan Guarantees in SFFAS No. 2.*
 - (C) Clarify the measurement principle for the default costs of direct loans and loan guarantees.
3. The Board received nine responses to the ED. All of the respondents were in support for the technical amendments, except for two respondents who commented on the proposed technical amendments related to the measurement of default costs. Based on the comments, the Board made a minor modification to the proposed measurement of default costs for direct loans. This modification is discussed in this Statement’s Appendix A, Basis for Conclusions.
4. In addition to the technical amendments, the Board proposed a standard in the May 2000 ED, requiring that entities display a program-by-program reconciliation for major credit programs between the beginning and ending balances of subsidy cost allowance for direct loans and the liability

for loan guarantees. The Board decided not to adopt that proposal based on cost-benefit considerations.

Effective Date

5. The technical amendments adopted in this Statement are effective for periods beginning after September 30, 2002. Early implementation of the amendments is encouraged.

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TECHNICAL AMENDMENTS TO SFFAS NO. 2

Cash Flow Discount Method

6. The amendments in (a) and (b) below are made to clarify that the accounting standards in SFFAS No. 2 are consistent with the cash flow discount method required by the amendment enacted in July 1997 to the Federal Credit Reform Act of 1990. Sec. 502 (5)(E) of the Act, as amended, provides that “In estimating net present values, the discount rate shall be the average interest rate on marketable Treasury securities of similar maturity to the cash flows of the direct loan or loan guarantee for which the estimate is being made.”
 - (a) In paragraph 24, SFFAS No. 2, the phrase “with a similar maturity term” is changed to “with similar maturity to the cash flows.”
 - (b) In footnotes 3, 4, 6, and 7, SFFAS No. 2, the phrase “the remaining maturity” is replaced with the phrase “the remaining cash flows.”

Effective Interest Rate

7. The following amendments are made to clarify that the effective interest rate of a cohort of direct loans or loan guarantees is the interest rate adjusted for the interest rate re-estimate, as defined in paragraph 9(A), SFFAS No. 18. The adjusted rate should be used for amortizing subsidy cost allowance, accruing and compounding interest on the liability for loan guarantees, determining the book value of modified direct loans and the book value of the liability for modified loan guarantees, and calculating the present value of assets acquired through foreclosure.
 - (a) In paragraph 30, SFFAS No. 2, the first sentence is changed to:

“The subsidy cost allowance for direct loans is amortized by the interest method using the interest rate that was used to calculate the present value of the direct loans when the direct loans were disbursed, after adjusting for the interest rate re-estimate.”
 - (b) In paragraph 31, SFFAS No. 2, the first sentence is changed to:

“Interest is accrued and compounded on the liability for loan guarantees at the interest rate that was used to calculate the present value of the loan guarantee liabilities when the guaranteed loans were disbursed, after adjusting for the interest re-estimate.”

- (c) In paragraph 46, SFFAS No. 2, the phrase in the parentheses is changed to “the rate that was originally used to calculate the present value of the direct loans, when the direct loans were disbursed, after adjusting for the interest rate re-estimate.”
- (d) In paragraph 50, SFFAS No. 2, the phrase in the parentheses is changed to “the rate that was originally used to calculate the present value of the liability, when the guaranteed loans were disbursed, after adjusting for the interest rate re-estimate.”
- (e) In paragraphs 57 and 59, SFFAS No. 2, the words “adjusted for the interest rate re-estimate” are added immediately after the words “the original discount rate.”

Measuring Default Costs

- 8. Paragraph 27 in SFFAS No. 2 is replaced with the following two paragraphs:
 - (a) The default cost of direct loans results from projected deviations by the borrowers from the payment schedules for principal, interest, and fee payments in the loan contracts. However, the measurement of default costs does not include prepayments. The default cost is measured at the present value of projected payment deviations due to defaults minus projected net recoveries. Projected net recoveries include the amounts that would be collected from borrowers at a later date or the proceeds from the sales of acquired assets minus the costs of foreclosing, managing, and selling the assets.
 - (b) The default cost of loan guarantees results from paying lenders' claims upon default of the guaranteed loans. The default cost of loan guarantees is measured at the present value of projected payments to lenders required by the guarantee, plus uncollected fees, minus interest supplements not paid as the result of the default, and minus projected net recoveries as defined in paragraph 8(a).

APPENDIX A: BASIS FOR CONCLUSIONS

Program-by-Program Reconciliation

9. In the May 2000 ED, the Board proposed a standard requiring that entities display a program-by-program reconciliation for major credit programs between the beginning and ending balances of the subsidy cost allowance for direct loans and the liability for loan guarantees. Nine respondents to the ED commented on the proposal. Five of them supported the proposal and the remaining four were opposed to the proposed standard.
10. Those who supported the proposal believed that the display of a program-by-program reconciliation would enhance disclosure for program costs and performance. One of the respondents said that the program-by-program reconciliation would reveal actual program performance information, such as direct loans written off, default claims paid, fees received, and interest supplements paid. Reporting this kind of information on a program-by-program basis is not required by the existing standards. If the data were reported, they could be useful in analyzing a program's operating results and providing feedback to the program's budget expectations. Another respondent pointed out that when program data are aggregated, increases and decreases in program costs would offset each other. Thus, without a display of program-by-program reconciliation, entity-wide reconciliation alone would not disclose variations in program performance.
11. Among those who were opposed to the proposal, the Chief Financial Officer (CFO) of US Department of Agriculture (USDA) said that the proposed standard was unnecessary because USDA has reported subsidy costs by credit areas. The USDA CFO and several other respondents expressed their concern that the proposed display of program-by-program reconciliation would make the disclosure too lengthy and complex and thus reduce its information value to the users of general-purpose financial reports.
12. After considering the comments, the Board decided not to adopt the proposed standard. The Board concluded that SFFAS No. 2 and SFFAS No. 18 already require sufficient program information. Paragraph 32 in

SFFAS No. 2, as amended by SFFAS No. 18, requires that entities disclose each program's interest rate re-estimates and technical/default re-estimates. More extensive disclosure is required in SFFAS No. 18. Paragraph 11(a) in SFFAS No. 18, for example, requires that entities provide a description of the characteristics of the programs that they administer. It also requires disclosure of the amount of direct or guaranteed loans disbursed for each program during the reporting year as well as each program's subsidy expense, and subsidy re-estimates. Paragraph 11(b) requires disclosure of each program's subsidy rates for direct loans and loan guarantees in the current year's cohort. Furthermore, paragraph 11(c) requires that reporting entities disclose, discuss, and explain events and changes in economic conditions, other risk factors, legislation, credit policies, and subsidy estimation methodologies and assumptions, that have had a significant and measurable effect on subsidy rates, subsidy expense, and subsidy re-estimates. The Board believes that in the process of producing the program-based information required by paragraph 11(c), an entity will naturally describe important changes in the actual performance of its credit programs; e.g., default claims paid, loans written off, etc. Thus, the Board concluded that the program-based disclosure and discussion required by the existing standards should provide sufficient information about credit activities at the program level. In addition, although the incremental cost of producing the program-based reconciliation would be quite small for most agencies, the Board believes that requiring the display of program-based reconciliation would add length and complexity to the financial reports that are already detailed and complex. As a result of these benefit and cost considerations, the Board concluded that requiring the display of a program-by-program reconciliation was not justified.

Technical Amendments

13. The Board adopted three groups of technical amendments to SFFAS No. 2. The first group affects paragraph 24 and footnotes 3, 4, 6, and 7 of SFFAS No. 2. These amendments clarify that the accounting standards are consistent with the cash flow discount method required by the Federal Credit Reform Act of 1990, as amended in July 1997.¹ As required in Section 502 (5)(E) of the Act, the amended standards require using as

¹ Office of Management and Budget (OMB) has implemented the amendment in Circular A-11, Preparation and Submission of Budget Estimates, July 1999 and in its recent release of a new credit subsidy calculator.

the discount rate the average interest rate on Treasury securities of similar maturity to the cash flows of a direct loan or loan guarantee. None of the respondents to the ED objected to these amendments.

14. The second group of amendments affects paragraphs 30, 31, 46, 50, 57, and 59 of SFFAS No. 2. These amendments are related to interest rate re-estimates. The amendments clarify that the effective interest rate of a cohort of direct loans and loan guarantees is the interest rate adjusted by the interest rate re-estimate, as defined in paragraph 9(a), SFFAS No. 18. The adjusted rate should be used for amortizing subsidy cost allowance, accruing and compounding interest on the liability for loan guarantees, determining the book value of modified direct loans and the book value of the liability for modified loan guarantees, and calculating the present value of assets acquired through foreclosure. None of the respondents to the ED objected to these amendments.
15. The third group of amendments, proposed in ED paragraphs 10(A) and 10(B), concerns the measurement of default costs discussed in paragraph 27, SFFAS No. 2. ED paragraph 10(A) addressed the default costs of direct loans. The proposed amendment in that paragraph would include the effect of short-term delinquencies in the “other costs” category, rather than the “default costs” category.
16. The USDA CFO and IG objected to the exclusion of short-term delinquencies from default costs. They said that the Commodity Credit Corporation (an USDA unit) uses the Inter-Agency Country Risk Assessment System (ICRAS) to estimate default costs. The ICRAS, used for lending to foreign countries, includes short-term delinquencies in measuring default costs. Thus, the proposed amendment would create a difference from that practice.
17. The Board understands that practices differ among lending institutions in treating delinquencies. They may or may not regard a payment delay within a certain time frame as default. The Board is of the view that the variation would not distort the measurement of credit subsidy costs, if each practice is followed consistently. In this regard, it is better that the accounting standard leaves some leeway for the agencies that are responsible for developing subsidy estimate models and methodologies. Thus, the Board deleted the words related to “delinquencies” in paragraph 8(a) of this Statement on default costs of direct loans.

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18. Paragraph 8(b) of this Statement addressed the measurement of default costs for loan guarantees. The paragraph reads as follows:
- The default cost of loan guarantees results from paying lenders' claims upon default of the guaranteed loans. The default cost of loan guarantees is measured at the present value of projected payments to lenders required by the guarantee, plus uncollected fees, minus interest supplements not paid as the result of the default, and minus projected net recoveries as defined in paragraph 10(A).
19. The USDA CFO commented on the requirement for including uncollected fees and "interest supplements not paid" in measuring default costs. The USDA CFO stated that although those cash flow components are specified in the OMB credit subsidy calculator, OMB would give agencies flexibility in implementation with regard to those cash flow components. The USDA CFO pointed out that realigning those cash flow components might entail substantial changes in agencies' credit subsidy models. She also indicated problems with private lender restrictions and workload increases. She suggested that agencies be allowed flexibility to determine whether those cash flow components are to be included in default costs.
20. The Board believes the amended standard provides a sound methodology for measuring the default costs for loan guarantees. Uncollected fees are a direct result of default itself and therefore should be included in measuring the default costs. The interest supplements not paid are also a direct result of defaults. When a guaranteed loan is in default, the government pays the default claim to the lender and stops paying interest supplement for that loan. Thus, the interest supplements that are saved due to default should be subtracted from the default costs. The Board concluded that the categorization of these cash flow components should be uniform across the government so that they can be comparable among programs. However, as discussed in the following paragraph, the Board has decided to delay the implementation of the technical amendments for one year. This delay should help resolve some of the problems raised by the USDA CFO.

Effective Date

21. The proposed effective date for the technical amendments was for periods beginning after September 30, 2001, which means FY 2002. The Board realized that that the subsidy expenses to be reported for FY 2002

would be based on the budget submission for that year. However, there would not be sufficient time to implement the amendments for the FY 2002 budget. Therefore, the Board decided to make the effective date for periods beginning after September 30, 2002, and the Board encourages earlier implementation.

Board Approval

- 23 This Statement was approved by the Board with a vote of eight members in approval of its issuance. One member submitted a written dissent, which is available for inspection at the FASAB office.

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APPENDIX B: THE ACCOUNTING STANDARDS IN SFFAS No. 2

Presented in this Appendix are the standards originally prescribed in SFFAS No. 2. The paragraphs and their numbers reproduced in this Appendix are the same as those that appear in SFFAS No. 2, and are presented here for reference purposes only. The shaded words, paragraphs, and footnotes are those that have been amended by SFFAS No. 18² or by this Statement.

Explanation

21. These standards concern the recognition and measurement of direct loans, the liability associated with loan guarantees, and the cost of direct loans and loan guarantees. The standards apply to direct loans and loan guarantees on a group basis, such as a cohort or a risk category of loans and loan guarantees. Present value accounting does not apply to direct loans or loan guarantees on an individual basis, except for a direct loan or loan guarantee that constitutes a cohort or a risk category.

Accounting Standards

Post-1991 Direct Loans

22. Direct loans disbursed and outstanding are recognized as assets at the present value of their estimated net cash inflows. The difference between the outstanding principal of the loans and the present value of their net cash inflows is recognized as a subsidy cost allowance.

Post-1991 Loan Guarantees

23. For guaranteed loans outstanding, the present value of estimated net cash outflows of the loan guarantees is recognized as a liability. Disclosure is made of the face value of guaranteed loans outstanding and the amount guaranteed.

Subsidy Costs of Post-1991 Direct Loans and Loan Guarantees

24. For direct or guaranteed loans disbursed during a fiscal year, a subsidy expense is recognized. The amount of the subsidy expense equals the present value of estimated cash outflows over the life of the loans minus the present value of estimated cash inflows, discounted at the interest rate of marketable Treasury securities with a similar maturity term

² SFFAS NO. 18 amended paragraph 32 in SFFAS No. 2.

applicable to the period during which the loans are disbursed (hereinafter referred to as the applicable Treasury interest rate).

25. For the fiscal year during which new direct or guaranteed loans are disbursed, the components of the subsidy expense of those new direct loans and loan guarantees are recognized separately among interest subsidy costs, default costs, fees and other collections, and other subsidy costs.
26. The interest subsidy cost of direct loans is the excess of the amount of the loans disbursed over the present value of the interest and principal payments required by the loan contracts, discounted at the applicable Treasury rate. The interest subsidy cost of loan guarantees is the present value of estimated interest supplement payments.
27. The default cost of direct loans or loan guarantees results from any anticipated deviation, other than prepayments, by the borrowers from the payments schedule in the loan contracts. The deviations include delinquencies and omissions in interest and principal payments. The default cost is measured at the present value of the projected payment delinquencies and omissions minus net recoveries. Projected net recoveries include the amounts that would be collected from the borrowers at a later date or the proceeds from the sale of acquired assets minus the costs of foreclosing, managing, and selling those assets.
28. The present value of fees and other collections is recognized as a deduction from subsidy costs.
29. Other subsidy costs consist of cash flows that are not included in calculating the interest or default subsidy costs, or in fees and other collections. They include the effect of prepayments within contract terms.

Subsidy Amortization and Reestimation

30. The subsidy cost allowance for direct loans is amortized by the interest method using the interest rate that was originally used to calculate the present value of the direct loans when the direct loans were disbursed. The amortized amount is recognized as an increase or decrease in interest income.

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31. Interest is accrued and compounded on the liability of loan guarantees at the interest rate that was originally used to calculate the present value of the loan guarantee liabilities when the guaranteed loans were disbursed. The accrued interest is recognized as interest expense.
 32. The subsidy cost allowance for direct loans and the liability for loan guarantees are reestimated each year as of the date of the financial statements. Since the allowance or the liability represents the present value of the net cash outflows of the underlying direct loans or loan guarantees, the reestimation should take into account all factors that may have affected the estimate of each component of the cash flows, including prepayments, defaults, delinquencies, and recoveries. Any increase or decrease in the subsidy cost allowance or the loan guarantee liability resulting from the reestimates should be recognized as a subsidy expense (or a reduction in subsidy expense). Reporting the subsidy cost allowance of direct loans (or the liability of loan guarantees) and reestimates by component is not required.

Criteria for Default Cost Estimates

33. The criteria for default cost estimates provided in this and the following paragraphs apply to both initial estimates and subsequent reestimates. Default costs are estimated and reestimated for each program on the basis of separate cohorts and risk categories. The reestimates take into account the differences in past cash flows between the projected and realized amounts and changes in other factors that can be used to predict the future cash flows of each risk category.
34. In estimating default costs, the following risk factors are considered: (1) loan performance experience; (2) current and forecasted international, national, or regional economic conditions that may affect the performance of the loans; (3) financial and other relevant characteristics of borrowers; (4) the value of collateral to loan balance; (5) changes in recoverable value of collateral; (6) newly developed events that would affect the loans' performance; and (7) improvements in methods to reestimate defaults.
35. Each credit program should use a systematic methodology, such as an econometric model, to project default costs of each risk category. If individual accounts with significant amounts carry a high weight in risk exposure, an analysis of the individual accounts is warranted in making the default cost estimate for that category.

36. Actual historical experience of the performance of a risk category is a primary factor upon which an estimation of default cost is based. To document actual experience, a database should be maintained to provide historical information on actual payments, prepayments, late payments, defaults, recoveries, and amounts written off.

Revenues and Expenses

37. Interest accrued on direct loans, including amortized interest, is recognized as interest income. Interest accrued on the liability of loan guarantees is recognized as interest expense. Interest due from Treasury on uninvested funds is recognized as interest income. Interest accrued on debt to Treasury is recognized as interest expense.
38. Costs for administering credit activities, such as salaries, legal fees, and office costs, that are incurred for credit policy evaluation, loan and loan guarantee origination, closing, servicing, monitoring, maintaining accounting and computer systems, and other credit administrative purposes, are recognized as administrative expense. Administrative expenses are not included in calculating the subsidy costs of direct loans and loan guarantees.

Pre-1992 Direct Loans and Loan Guarantees

39. The losses and liabilities of direct loans obligated and loan guarantees committed before October 1, 1992, are recognized when it is more likely than not that the direct loans will not be totally collected or that the loan guarantees will require a future cash outflow to pay default claims. The allowance of the uncollectible amounts and the liability of loan guarantees should be reestimated each year as of the date of the financial statements. In estimating losses and liabilities, the risk factors discussed in the previous section should be considered. Disclosure is made of the face value of guaranteed loans outstanding and the amount guaranteed.
40. Restatement of pre-1992 direct loans and loan guarantees on a present value basis is permitted but not required.

Modification of Direct Loans and Loan Guarantees

41. The term modification means a federal government action, including new legislation or administrative action, that directly or indirectly alters the

estimated subsidy cost and the present value of outstanding direct loans, or the liability of loan guarantees.

42. Direct modifications are actions that change the subsidy cost by altering the terms of existing contracts or by selling loan assets. Existing contracts may be altered through such means as forbearance, forgiveness, reductions in interest rates, extensions of maturity, and prepayments without penalty. Such actions are modifications unless they are considered reestimates, or workouts as defined below, or are permitted under the terms of existing contracts.
43. Indirect modifications are actions that change the subsidy cost by legislation that alters the way in which an outstanding portfolio of direct loans or loan guarantees is administered. Examples include a new method of debt collection prescribed by law or a statutory restriction on debt collection.
44. The term modification does not include subsidy cost reestimates, the routine administrative workouts of troubled loans, and actions that are permitted within the existing contract terms. Workouts are actions taken to maximize repayments of existing direct loans or minimize claims under existing loan guarantees. The expected effects of workouts on cash flows are included in the original estimate of subsidy costs and subsequent reestimates.

A. Modification of Direct Loans

45. With respect to a direct or indirect modification of pre-1992 or post-1991 direct loans, the cost of modification is the excess of the pre-modification value³ of the loans over their post-modification value⁴. The amount of the modification cost is recognized as a modification expense when the loans are modified.

³ The term "pre-modification value" is the present value of the net cash inflows of direct loans estimated at the time of modification under pre-modification terms and discounted at the interest rate applicable to the time when the modification occurs on marketable Treasury securities that have a comparable maturity to **the remaining maturity** of the direct loans under pre-modification terms (simply stated, the pre-modification terms at the current rate).

⁴ The term "post-modification value" is the present value of the net cash inflows of direct loans estimated at the time of modification under post-modification terms and discounted at the interest rate applicable to the time when the modification occurs on marketable Treasury securities that have a comparable maturity to **the remaining maturity** of the direct loans under post-modification terms (simply stated, the post-modification terms at the current rate).

46. When post-1991 direct loans are modified, their existing book value is changed to an amount equal to the present value of the loans' net cash inflows projected under the modified terms from the time of modification to the loans' maturity and discounted at the original discount rate (the rate that was originally used to calculate the present value of the direct loans, when the direct loans were disbursed).
47. When pre-1992 direct loans are directly modified, they are transferred to a financing account and their book value is changed to an amount equal to their post-modification value. Any subsequent modification is treated as a modification of post-1991 loans. When pre-1992 direct loans are indirectly modified, they are kept in a liquidating account. Their bad debt allowance is reassessed and adjusted to reflect amounts that would not be collected due to the modification.
48. The change in book value of both pre-1992 and post-1991 direct loans resulting from a direct or indirect modification and the cost of modification will normally differ, due to the use of different discount rates or the use of different measurement methods. Any difference between the change in book value and the cost of modification is recognized as a gain or loss. For post-1991 direct loans, the modification adjustment transfer⁵ paid or received to offset the gain or loss is recognized as a financing source (or a reduction in financing source).

B. Modification of Loan Guarantees

49. With respect to a direct or indirect modification of pre-1992 or post-1991 loan guarantees, the cost of modification is the excess of the post-modification liability⁶ of the loan guarantees over their

⁵ OMB instructions provide that if the decrease in book value exceeds the cost of modification, the reporting entity receives from the Treasury an amount of "modification adjustment transfer" equal to the excess; and that if the cost of modification exceeds the decrease in book value, the reporting entity pays to the Treasury an amount of "modification adjustment transfer" to offset the excess. (See OMB Circular A-11.)

⁶ The term "post-modification liability" is the present value of the net cash outflows of the loan guarantees estimated at the time of modification under the post-modification terms, and discounted at the interest rate applicable to the time when the modification occurs on marketable Treasury securities that have a comparable maturity to the remaining maturity of the guaranteed loans under post-modification terms (simply stated, the post-modification terms at the current rate).

pre-modification liability⁷. The modification cost is recognized as modification expense when the loan guarantees are modified.

50. The existing book value of the liability of modified post-1991 loan guarantees is changed to an amount equal to the present value of net cash outflows projected under the modified terms from the time of modification to the loans' maturity, and discounted at the original discount rate (the rate that was originally used to calculate the present value of the liability when the guaranteed loans were disbursed).
51. When pre-1992 loan guarantees are directly modified, they are transferred to a financing account and the existing book value of the liability of the modified loan guarantees is changed to an amount equal to their post-modification liability. Any subsequent modification is treated as a modification of post-1991 loan guarantees. When pre-1992 direct loan guarantees are indirectly modified, they are kept in a liquidating account. The liability of those loan guarantees is reassessed and adjusted to reflect any change in the liability resulting from the modification.
52. The change in the amount of liability of both pre-1992 and post-1991 loan guarantees resulting from a direct or indirect modification and the cost of modification will normally differ, due to the use of different discount rates or the use of different measurement methods. The difference between the change in liability and the cost of modification is recognized as a gain or loss. For post-1991 loan guarantees, the modification adjustment transfer⁸ paid or received to offset the gain or loss is recognized as a financing source (or a reduction in financing source).

C. Sale of Loans

⁷ The term "pre-modification liability" is the present value of the net cash outflows of loan guarantees estimated at the time of modification under the pre-modification terms and discounted at the interest rate applicable to the time when the modification occurs on marketable Treasury securities that have a comparable maturity to the remaining maturity of the guaranteed loans under pre-modification terms (simply stated, the pre-modification terms at the current rate).

⁸ OMB instructions provide that if the increase in liability exceeds the cost of modification, the reporting entity receives from the Treasury an amount of "modification adjustment transfer" equal to the excess; and that if the cost of modification exceeds the increase in liability, the reporting entity pays to the Treasury an amount of "modification adjustment transfer" to offset the excess. (See OMB Circular A-11.)

53. The sale of post-1991 and pre-1992 direct loans is a direct modification. The cost of modification is determined on the basis of the pre-modification value of the loans sold. If the pre-modification value of the loans sold exceeds the net proceeds from the sale, the excess is the cost of modification, which is recognized as modification expense.
54. For a loan sale with recourse, potential losses under the recourse or guarantee obligations are estimated, and the present value of the estimated losses from the recourse is recognized as subsidy expense when the sale is made and as a loan guarantee liability.
55. The book value loss (or gain) on a sale of direct loans equals the existing book value of the loans sold minus the net proceeds from the sale. Since the book value loss (or gain) and the cost of modification are calculated on different bases, they will normally differ. Any difference between the book value loss (or gain) and the cost of modification is recognized as a gain or loss.⁹ For sales of post-1991 direct loans, the modification adjustment transfer¹⁰ paid or received to offset the gain or loss is recognized as a financing source (or a reduction in financing source).

D. Disclosure

56. Disclosure is made in notes to financial statements to explain the nature of the modification of direct loans or loan guarantees, the discount rate used in calculating the modification expense, and the basis for recognizing a gain or loss related to the modification.

Foreclosure of Post-1991 Direct and Guaranteed Loans

57. When property is transferred from borrowers to a federal credit program, through foreclosure or other means, in partial or full settlement of post-1991 direct loans or as a compensation for losses that the government sustained under post-1991 loan guarantees, the foreclosed property is recognized as an asset at the present value of its estimated future net cash inflows discounted **at the original discount rate**.

⁹ If there is a book value gain, the gain to be recognized equals the book value gain plus the cost of modification.

¹⁰ See footnote No. 7 for an explanation for "modification adjustment transfer".

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58. If a legitimate claim exists by a third party or by the borrower to a part of the recognized value of the foreclosed assets, the estimated amount of the claim is recognized as a special contra valuation allowance.
 59. At a foreclosure of guaranteed loans, a federal guarantor may acquire the loans involved. The acquired loans are recognized at the present value of their estimated net cash inflows from selling the loans or from collecting payments from the borrowers, discounted **at the original discount rate**.
 60. When assets are acquired in full or partial settlement of post-1991 direct loans or guaranteed loans, the present value of the government's claim against the borrowers is reduced by the amount settled as a result of the foreclosure.

Write-off of Direct Loans

61. When post-1991 direct loans are written off, the unpaid principal of the loans is removed from the gross amount of loans receivable. Concurrently, the same amount is charged to the allowance for subsidy costs. Prior to the write-off, the uncollectible amounts should have been fully provided for in the subsidy cost allowance through the subsidy cost estimate or reestimates. Therefore, the write-off would have no effect on expenses.

FASAB Board Members

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Robert N. Reid
Nelson Toye
Kenneth J. Winter

*Term expired in December 2000.

FASAB Staff

Wendy M. Comes, Executive Director

Project Staff:
Richard Mayo
Lucy Lomax

Federal Accounting Standards Advisory Board

441 G Street NW
Suite 6814
Washington, DC 20548
Telephone (202) 512-7350
FAX (202) 512-7366

www.financenet.gov/fasab.htm

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