

<p>HORNE BANKERS' FORUM 2011</p>	
	<p>Accounting Hot Topics A Focus on Troubled Debt Restructurings</p> <p>HANS C. PETTIT, CPA/ Partner</p>

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Troubled Debt Restructurings

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Troubled Debt Restructurings

- **FASB Accounting Standards Update (ASU) 2011-02:**
 - “Receivables (Topic 310) – A creditor’s Determination of Whether a Restructuring is a Troubled Debt Restructuring”
- **Does not change basic criteria for a TDR.** A loan renewal, extension or other modification is a TDR when two conditions are present:
 - Borrower is experiencing **financial difficulty**
 - Creditor grants a **concession** it would not otherwise consider but for the borrower’s financial difficulties.

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Troubled Debt Restructurings

The Criteria: Financial Difficulty?

- Currently in default on any debt.
 - Creditor must evaluate probability that debtor would be in payment default on any of its debt in the foreseeable future without the modification.
 - Declared or in process of declaring bankruptcy.
 - Substantial doubt about borrower as a going concern.
 - Delisted, or in process of being delisted.
 - Unable to service debt in accordance with the contractual terms in the foreseeable future.
 - Borrower unable to secure financing from other lenders at a market rate.

Troubled Debt Restructurings

The Criteria: Concession Granted?

- Many had used effective borrowing rate to determine whether a concession had been granted. BUT....
 - A creditor is precluded from using borrower's effective rate test in paragraph 470-60-55-10 in its evaluation.
- A creditor has granted a concession when it **does not expect to collect all amounts due**, including interest accrued at **original contract rate**.
 - If collection is collateral dependent, consider current value of that collateral in determining whether principal will be paid.
- Additional collateral or guarantees from the debtor.
 - Concession granted when amount of what is offered does not serve as **adequate compensation**.
 - Must evaluate both a guarantor's **ability and willingness** to pay.

Troubled Debt Restructurings

The Criteria: Concession Granted? (cont'd)

- If a **debtor cannot get the same loan (rate and terms) elsewhere** or the bank would not normally make this loan to a new customer, this generally indicates the creditor has granted a concession.
- A temporary or permanent increase in the conceptual interest rate does not preclude the restructuring from being considered a concession.
 - Does the higher rate compensate for the change in the risk profile?
 - Would you make this loan to another borrower off the street?

Troubled Debt Restructurings

The Criteria: Concession Granted? (cont'd)

- A delay in payment that is insignificant is not a concession.
Examples:
 - The amount of restructured payments subject to delay is **insignificant relative to unpaid principal or collateral value** of the debt and will result in an insignificant shortfall in contractual amount due.
 - The delay in timing of restructured payment period is insignificant relative to any one of the following:
 - The frequency of payments due under the debt.
 - The debt's original contractual maturity.
 - The debt's original expected duration.
 - If the debt was previously restructured, **consider the cumulative effects**.

Troubled Debt Restructurings

Effective Date & Transition

- For Public Entities
 - Effective for **first interim or annual period beginning on or after June 15, 2011**, and should be **applied retrospectively** to the beginning of annual period of adoption.
 - For purposes of **measuring impairment** of those receivables, an entity should apply amendments **prospectively** for first interim or annual period beginning on or after June 15, 2011.
 - Disclosures about TDRs are effective for interim and annual periods ending on or after June 15, 2011, consistent with the requirements of ASU 2010-20.

Troubled Debt Restructurings

Effective Date & Transition (cont'd)

- For Nonpublic Entities
 - Effective for **annual periods ending on or after December 15, 2012, including interim periods within those annual periods.**
- Early Adoption
 - Early adoption is permitted for public and nonpublic entities. A nonpublic entity may early adopt amendments for any interim period of fiscal year of adoption. A nonpublic entity that elects early adoption should apply provisions of this update retrospectively to restructurings occurring on or after beginning of the fiscal year of adoption.

Troubled Debt Restructurings - Example

Owner Occupied Manufacturing Facility

Loan Summary

- In 2009 the bank loaned \$2,500,000 to ABC Manufacturing to acquire a building with a beautiful view of the Mississippi River to house its manufacturing operation.
- The loan was structured on a 25-year amortization with a three-year call provision during which time it was anticipated that the firm would develop the financial history necessary to tap into the commercial mortgage market at more favorable terms.
- The loan had a P+2 rate adjusted annually. The debt service coverage ratio was 1.15X, but the enhanced efficiency associated with the new facility was expected to improve this ratio and allow for a refinance.

Troubled Debt Restructurings - Example

Owner Occupied Manufacturing Facility (cont'd)

Difficulties Encountered

- In 2011 extraordinary weather conditions caused flooding in the area. Although the building was not damaged a number of local suppliers experience damage and all businesses in the area, customers as well as suppliers, suffered.
- Production suffered, inventory built up waiting for customer business resumption, and accounts receivable collection from local customers slowed.
- Mississippi Manufacturing requested a forbearance in the mortgage payments to allow them to conserve cash until normal business operations resumed.

Troubled Debt Restructurings - Example

Owner Occupied Manufacturing Facility (cont'd)

Alternative to TDR

- Call the loan and foreclose on the property.
- Do nothing and let the loan be past due with the customer making payments as it can and catch up as business gets back to normal. Normality was expected to take one year to 18 months.

Troubled Debt Restructurings - Example

Owner Occupied Manufacturing Facility (cont'd)

Debt Restructure

- The bank agreed to cease and capitalize interest payments for three months.
- After the three-month period the company would make interest only payments at 3% but the loan would accrue at the contract rate for nine months.
- At the end of the year the bank would begin amortization on the new loan balance consistent with the original maturity. That balance is the total of old principal plus capitalized interest.

Troubled Debt Restructurings - Example

Owner Occupied Manufacturing Facility (cont'd)

Is this a Troubled Debt Restructuring?

- Financial Distress?
 - Requested a forbearance of mortgage payments
- Concessions?
 - Deferral of a portion of interest payment although the loan continues to accrue at original contract rate
 - Period of interest only
 - Capitalize interest for three months
- No, not TDR
 - Resulting delay in payment is insignificant and payments will be collected over original terms.

Troubled Debt Restructurings - Example

Operating Company

Loan Summary

- Widgets LLC manufactures and installs exhaust fans for high temperature applications such as restaurant grills and commercial boilers.
- The company manufactures domestically and imports a portion of its product.

Troubled Debt Restructurings - Example

Operating Company (cont'd)

Loan Summary (cont'd)

- The bank provided two credit facilities on the following terms in 2007:
 - A \$750,000 revolving line of credit to support its accounts receivable. The line is administered via accounts receivable aging and an availability calculation with the usual definition of eligible accounts receivable and a 75% advance rate.
 - A \$250,000 term loan on a 10-year amortization used to finance equipment and facilities enhancement.
 - The loans are cross collateralized with all assets of the company and the personal guaranty of the owners. Financial covenants are in place for liquidity, leverage and profitability. Monthly reporting is required with a year-end audit.

Troubled Debt Restructurings - Example

Operating Company (cont'd)

Difficulties Encountered

- The company's largest customers are fast food franchise operations and hospitals who canceled all elective expansion and capital expenditure programs in the face of the economic downturn. Revenues dropped 30% as a result.
- The value of the dollar dropped against the currency of one of the major suppliers. The resulting increase in COGS could not be passed on to customers. The firm's gross margin dropped.
- The level of accounts receivable declined and several major accounts aged severely. The company soon became unable to stay in formula on its accounts receivable advance calculation.
- The firm defaulted on its financial and liquidity covenants.

Troubled Debt Restructurings - Example

Operating Company (cont'd)

Alternative to TDR

- Shut down line of credit, which would throw company into bankruptcy and jeopardize jobs of 35 people. Bankruptcy would also send a signal to firm's strongest accounts that it was no longer a reliable supplier.
- Refer company to an asset-based lender who would provide a smaller line with tighter reporting and control of cash. The interest rate on the line would increase significantly. The bank would still have the term loan and over-advance outstanding.

Troubled Debt Restructurings - Example

Operating Company (cont'd)

Debt Restructure

- The bank concluded company was still viable, principals were of good character and relationship could be salvaged with a restructure.
- The line of credit was reduced to \$600,000. The rate was lowered from P+1 to Prime Floating. Reporting requirements were revised to require weekly rather than monthly reports.
- The term loan was increased \$125,000 with owners pledging a \$50,000 certificate of deposit and allowing a second lien to be placed on a home they owned. The maturity was shortened to one year, but the amortization was increased from remaining six years to 15 years. The interest rate was lowered from P+2 to P+1/2.
- A less constraining financial covenant package was put in place.

Troubled Debt Restructurings - Example

Operating Company (cont'd)

Is this a Troubled Debt Restructuring?

- Financial Distress?
 - Default on covenants
 - Absent a restructure payment default was probable
- Concessions?
 - Below market interest rate
 - Significantly increased the amortization terms on amortizing note
 - Borrowers concessions not sufficient to offset the concession made by the bank.
- Yes, TDR

Troubled Debt Restructuring

Credit Quality Disclosures (previously deferred)

- Creditors must disaggregate portfolio by:
 - **Class:** Based on initial measurement attribute (e.g. amortized cost or purchased credit impaired) and further **disaggregated to the level that an entity uses when assessing and monitoring the risk and performance**
 - **Portfolio segment:** Level at which an entity develops and documents a systematic **methodology to determine its allowance for credit losses.**

Troubled Debt Restructuring

Credit Quality Disclosures (previously deferred)

Requirement	By Class	By Portfolio Segment
For each income statement presented, disclosures about troubled debt restructurings of loans that occurred during the period	Qualitative and quantitative information about the nature of modifications and the impact the modifications had on the allowance for credit losses	Qualitative information about how such modifications are factored into the determination of the allowance for credit losses
For each income statement presented, disclosures about loans modified as troubled debt restructurings within the previous 12 months for which there was a payment default during the current period	Qualitative and quantitative information about the type of loans that defaulted during the current period and the amount of loans that defaulted during the current period	Qualitative information about how such defaults are factored into the determination of the allowance for credit losses

Troubled Debt Restructuring

Example – Modification by Class Disclosure

		Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings	Number of Contracts		
Residential – prime	XXX	\$XX,XXX	\$XX,XXX
Residential – subprime	XXX	XX,XXX	XX,XXX
Consumer – other	XXX	XX,XXX	XX,XXX
Finance Leases	XXX	XX,XXX	XX,XXX
Troubled Debt Restructurings that Subsequently Defaulted	Number of Contracts	Recorded Investment	
Residential – prime	XXX	\$XX,XXX	
Residential – subprime	XXX	XX,XXX	
Consumer – other	XXX	XX,XXX	
Finance Leases	XXX	XX,XXX	

Troubled Debt Restructuring

Regulatory Considerations

- Call Report changes – Effective March 31, 2011
 - Reporting of TDRs by loan category
 - Consumer loans that have undergone TDRs, required to be reported
- Until a loan that is a TDR is paid in full or otherwise settled, sold, or charged off, the loan must be reported in the appropriate loan category in Schedule RC-C, part I, items 1 through 9, and in the appropriate loan category in:
 - Schedule RC-C, part I, Memorandum item 1, if it is in compliance with its modified terms
 - Schedule RC-N, Memorandum item 1, if it is not in compliance with its modified terms

Troubled Debt Restructuring

Regulatory Considerations (cont'd)

- A loan that is a TDR that **yields a market rate of interest at the time of restructuring and is in compliance with its modified terms** need not continue to be reported as a TDR in Schedule RC-C in calendar years after the year in which the restructuring took place
- To be considered in compliance with its modified terms, a loan:
 - Must not be in nonaccrual status
 - Must be current or less than 30 days past due on its contractual principal and interest payments under the modified terms

Troubled Debt Restructuring

Regulator Observations

- **Do not anticipate significant impact** as they believe it is generally consistent with previous interagency interpretations.
- Do **expect updates to policies, additional analysis or documentation** in light of new guidance, particularly on the insignificant delay criteria.
- There are **no bright lines on insignificant delays**; must do the analysis.
- Ensure that disclosures **clearly indicate that risk ratings** (regardless of rating method) are those **assigned by management**.
- Ensure **no disclosure of confidential examination information**.
- **Do not include** language stating or **implying examiners agreement** with assigned risk ratings.

Troubled Debt Restructuring

Application Considerations

- **Processes and Controls**
 - Procedures and controls in place to timely identify TDRs considering ASU clarifications
 - Ensuring tracking and reporting processes in place to address new disclosures required
 - SOX documentation surrounding new processes and related controls, testing, signoff procedures
 - Adoption required for calendar year-end public companies for 3rd quarter 2011

Troubled Debt Restructuring

Comment Letter Trends

- **Modifications/Troubled Debt Restructurings**
 - Discuss success rates with modifications and describe workout programs
 - Quantify concessions made (e.g., reduction in interest rate, payment extensions, forgiveness of principal)
 - Provide disaggregation on accruing and non-accruing loans that have been restructured
 - Disclose information on commercial real estate workouts where an existing loan is restructured into multiple loans (A-note/B-note structures)

Troubled Debt Restructurings

Question for the Future

With improved credit quality disclosures, are TDR designations still helpful?

Other Accounting Developments

The Good

- Goodwill Impairment Testing (effective beginning 2012, early adoption permitted)
- Credit Quality Disclosures (effective for private companies 2011)

The Bad

- Leases (2nd exposure draft in 4th quarter 2011)
- Allowance for Loan Losses (three bucket approach in redeliberations)

The Ugly

- Financial Instruments (redeliberations and considering 2nd exposure draft)
- Financial Statement Presentation (still in discussion and research)
- Revenue Recognition (loyalty point programs & asset management fees)

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Hans serves as a partner in the financial institutions practice for HORNE and has more than 10 years of comprehensive accounting experience in financial reporting, business processes, internal controls and GAAP compliance. His career involves financial executive experience with a top 50 commercial bank and a Big Four accounting firm. Hans has extensive experience with both public and private companies.

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