FASAB

Federal Accounting Standards Advisory Board

# 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. 18

*May 2000*

## 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 and executives, analysts from private firms, academe, and other organizations), Congress, executive branch agencies, 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."

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## EXECUTIVE SUMMARY

I. This Statement presents 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. The objective of these amendments is to improve financial reporting for subsidy costs and performance of Federal credit programs.

II. During 1998 and early 1999, the Board discussed issues related to reporting the credit subsidy expense and credit subsidy reestimates in general. The Board concluded that certain portions of SFFAS No. 2 should be amended so that more useful information on credit programs' subsidy costs and performance will be provided to citizens, Congress, program managers, and other users of Federal financial information. The amendments were proposed for public comment in an Exposure Draft published in March 1999. After considering comments, the Board decided to adopt the following amendments:

a. **Report subsidy reestimates in two distinct components: the interest rate reestimate and the technical/default reestimate.**

The former is a reestimate due to a change in interest rates from the rate assumed in budget preparation and used in calculating the subsidy expense to the rates that are prevailing at the time the direct or guaranteed loans are disbursed. The latter is a reestimate due to changes made in projected cash flows under the terms of the direct loans or loan guarantees after reevaluating all the risk factors as of the financial statement date, except for the effect of interest rate reestimates.

b. **Display a reconciliation between the beginning and the ending balances of the subsidy cost allowance for direct loans and the liability for loan guarantees, reported in an entity's balance sheet.**

The reconciliation displays activities that affect the subsidy cost allowance or the loan guarantee liability, such as the subsidy expense for direct or guaranteed loans disbursed during the reporting period, subsidy reestimates, fees received, interest supplements paid, loans written off, claim payments made to lenders, recoveries obtained, and other adjustments.

c. **Provide a description of program characteristics and disclose: (i) the amounts of direct or guaranteed loans disbursed in each program during the reporting year, (ii) the estimated subsidy rates for the total subsidy and**

**the subsidy components at the program level in the current year's budget for the current year's cohorts, (iii) 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 reestimates, and (iv) events and changes in conditions that have occurred and are more likely than not to have a significant impact but the effects of which are not measurable at the reporting date.**

Reporting entities should discuss how those events and changes have affected or would affect credit programs' subsidy costs, subsidy reestimates, and the subsidy rates estimated in the budget.

III. In addition to requiring reconciliation for the balances of direct loan allowance and loan guarantee liability on an entity-wide basis as prescribed in this statement, the Board recognizes that reconciliation on a program-by-program basis can better reveal information relevant to program performance. Since the program-by-program reconciliation was not proposed for public comment in the March 1999 ED, the Board has not received input on this option. Because the proposal appears to have merit, the Board has decided to issue an exposure draft to propose program-by-program reconciliation for major programs in addition to the entity-wide reconciliation.

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# INTRODUCTION

## PURPOSE

1. The purpose of this Statement is to amend accounting standards for direct loans and loan guarantees by adding the following requirements: (a) report subsidy reestimates in two components: interest rate reestimates and technical/default reestimates, (b) display in a note to financial statements a reconciliation between the beginning and ending balances of loan guarantee liability and the subsidy cost allowance for direct loans, and (c) provide disclosure and discussion for changes in program subsidy rates, subsidy expense, and subsidy reestimates.

## BACKGROUND

2. During 1998 and 1999, the Board held discussions on what improvements could be made to financial reporting for credit subsidy rates, subsidy expense, and subsidy reestimates.[3] During the discussions, the Board directed its staff to conduct a survey in two issue areas: (a) How difficult is it for agencies to prepare and report subsidy data, and (b) What subsidy data are useful to users of Federal agency financial reports.

3. In June 1998, representatives of the Small Business Administration and the Department of Education made presentations to the Board on their experience and capabilities for preparing subsidy cost data for direct loans and loan guarantees. The presentations indicated that to meet the budgeting requirements, agencies must have systems and procedures to estimate for each cohort of direct loans or loan guarantees the subsidy rates, subsidy expense, and subsidy reestimates in components as currently required in preparing the budget. The presentations indicated that if a sound system is in place, the information on subsidy rates, subsidy expense, and subsidy reestimates could be retrieved and aggregated on a program or entity basis to meet the financial reporting requirements.

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[3] The discussions were initiated by the Credit Reform Task Force of the Accounting and Auditing Policy Committee (AAPC) which proposed that paragraph 25 in SFFAS No. 2 be amended to require disclosure of subsidy rates estimated in the budget for the current year cohorts in lieu of reporting the dollar amounts of the subsidy components. That proposal was discussed in the March 1999 ED. The Board accepted the Task Force proposal for disclosing subsidy rates, but did not remove the requirement for reporting the dollar amounts of subsidy expense components.

4. A questionnaire on data usefulness was sent to congressional staff members who had been involved in Federal credit programs. Oral and written responses were received from a number of the staff members and were presented to the Board at its October 1998 meeting. All of those who responded indicated that for appropriation and oversight purposes, they needed more rather than less detailed data on subsidy costs for direct loans and loan guarantees. They preferred that subsidy data be reported by component in both rates and dollar amounts. Furthermore, they said that they would like to compare initial budget expectations with current reestimates and to know causes that explain changes in subsidy rates.

5. The Board agreed that the subsidy cost information reported by Federal credit agencies could be improved by adopting the following requirements: (a) report subsidy reestimates by component, (b) display in a note to financial statements a reconciliation between the beginning and ending balances of the subsidy cost allowance for direct loans and the liability for loan guarantees, and (c) provide disclosure and discussion that would help the reader understand the changes in Federal credit programs' subsidy costs and performance. These requirements were proposed in the Exposure Draft issued in March 1999 (the March 1999 ED).

6. The Board received comments from twelve respondents. Of those respondents, ten were from Federal agencies (including the CFO Council of the Federal Government), and two were from the private sector. They were generally in favor of the Board's proposals to improve financial reporting for credit programs' subsidy costs and performance. However, some of them expressed different views on some of the proposals, which are addressed in Appendix A, Basis for Conclusions. After considering the comments, the Board decided to issue in this final statement all of the amendments proposed in the March 1999 ED.

7. The Board considered and agreed with the view that reconciliations for direct loan allowance and loan guarantee liability on a program-by-program basis can better reveal variations in program characteristics and performance. Since the program-by-program reconciliation was not proposed for public comment in the March 1999 ED, the Board has not received input on this option. Because the proposal appears to have merit, the Board will issue an exposure Draft to propose reconciliation for major programs in addition to the entity-wide reconciliation prescribed in

this statement.

## EFFECTIVE DATE

8. The accounting standards prescribed in this statement are effective for periods beginning after September 30, 2000. Earlier implementation is encouraged.

# ACCOUNTING STANDARDS
## FOR DIRECT LOANS AND LOAN GUARANTEES

### SUBSIDY REESTIMATES - AN AMENDMENT TO SFFAS No. 2

9. Paragraph 32 in SFFAS No. 2 is amended to read:

Credit programs should reestimate the subsidy cost allowance for outstanding direct loans and the liability for outstanding loan guarantees as required in this standard. There are two kinds of reestimates: (a) interest rate reestimates, and (b) technical/default reestimates [4]. Entities should measure and disclose each program s reestimates in these two components separately. An increase or decrease in the subsidy cost allowance or loan guarantee liability resulting from the reestimates is recognized as an increase or decrease in subsidy expense for the current reporting period.

(A) An interest rate reestimate is a reestimate due to a change in interest rates <u>from</u> the interest rates that were assumed in budget preparation and used in calculating the subsidy expense <u>to</u> the interest rates that are prevailing during the time periods in which the direct or guaranteed loans are disbursed. Credit programs may need to make an interest rate reestimate for cohorts from which direct or guaranteed loans are disbursed during the reporting year. If the assumed interest rates that were used in calculating the subsidy expense for those cohorts differ from the interest rates that are prevailing at the time of loan disbursement, an interest rate reestimate for those cohorts should be made as of the date of the financial statements.

(B) A technical/default reestimate is a reestimate due to changes in projected cash flows of outstanding direct loans and loan guarantees after reevaluating the underlying assumptions and other factors that affect cash flow projections as of the financial statement date, except for any effect of the interest rate reestimates explained in (a) above. In making technical/default

[4] The term “technical/default reestimate” used in this statement is identical in meaning to the term “technical reestimate” used in OMB Circular A-11, as revised in July 1999.

reestimates, reporting entities should take into consideration all factors that may have affected various components of the projected cash flows, including defaults, delinquencies, recoveries, and prepayments. The technical/default reestimate should be made each year as of the date of the financial statements.

## RECONCILIATION

10. In a note to the financial statements, reporting entities should display a reconciliation between the beginning and ending balances of the subsidy cost allowance for outstanding direct loans and the liability for outstanding loan guarantees reported in the entities' balance sheet. The reconciliation is accomplished by adding to or subtracting from the beginning balance the dollar amounts of the following items: (a) the subsidy expense recognized in the four components as defined in paragraphs 25 through 29 for direct or guaranteed loans disbursed during the reporting year, (b) the two types of subsidy reestimates as defined in paragraph 32, and (c) other adjustments. For direct loans, the other adjustments include loan modifications, fees received, loans written off, foreclosed property or other recoveries acquired, and subsidy allowance amortization. For loan guarantees, the other adjustments include loan guarantee modifications, fees received, interest supplements paid, claim payments made to lenders, foreclosed property or other recoveries acquired, and interest accumulated on the loan guarantee liability. The requirement to display reconciliation applies to direct loans and loan guarantees obligated or committed on or after October 1, 1991, the effective date of the Federal Credit Reform Act of 1990. Reporting entities are encouraged but not required to display reconciliations for direct loans and loan guarantees obligated or committed prior to October 1, 1991, in schedules separate from the direct loans and loan guarantees obligated or committed after September 30, 1991.

## DISCLOSURE AND DISCUSSION

11. The disclosure and discussion requirements are prescribed in paragraphs 11(A) through 11(C):

(A) Reporting entities should provide a description of the characteristics of the programs that they administer, and should disclose for each program: (a) the total amount of direct or guaranteed loans disbursed for the current reporting year and the preceding reporting year, (b) the subsidy expense by components as defined in paragraphs 25 through 29, recognized for the direct or guaranteed loans disbursed in those years, and (c) the subsidy reestimates by components as defined in paragraph 32 for those years.

(B) Reporting entities should also disclose, at the program level, the subsidy rates for the total subsidy cost and its components for the interest subsidy costs, default costs (net of recoveries), fees and other collections, and other costs, estimated for direct loans and loan guarantees in the current year's budget for the current year's cohorts. Each subsidy rate is the dollar amount of the total subsidy or a subsidy component as a percentage of the direct or guaranteed loans obligated in the cohort. Entities may use trend data to display significant fluctuations in subsidy rates. Such trend data, if used, should be accompanied with analysis to explain the underlying causes for the fluctuations.

(C) Reporting entities should 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 reestimates. The disclosure and discussion should also include events and changes that have occurred and are more likely than not to have a significant impact but the effects of which are not measurable at the reporting date. Changes in legislation or credit policies include, for example, changes in borrowers' eligibility, the levels of fees or interest rates charged to borrowers, the maturity terms of loans, and the percentage of a private loan that is guaranteed.

# APPENDIX A: BASIS FOR CONCLUSIONS

## SUBSIDY REESTIMATES

12. Paragraph 32 in SFFAS No. 2, as amended, requires that entities measure and disclose reestimates in two components separately; namely, the interest rate reestimate and the technical/default reestimate. The former is a reestimate made for differences between interest rate assumptions at the time of budget formulation (the same assumption is used at the time of obligation or commitment) and the actual interest rates for the years of disbursement.[5] The later is a reestimate due to changes in projected cash flows as reflected in the direct loan allowance and loan guarantee liabilities at the beginning of each fiscal year, after reevaluating the underlying assumptions and other factors that affect cash flow projections as of the financial statement date, except for any effect of interest rate reestimates.

13. As explained in the March 1999 ED, the rationale for separating the two reestimate components lies in the fact that interest rate reestimates and technical/default reestimates differ in nature. The interest rate reestimate depends on how close the assumed interest rate, which is initially used in the budget, is to the actual interest rates prevailing at the time of loan disbursement. The interest rate reestimate does not in itself indicate changes in the quality of loan assets or the overall risk of loan guarantees, nor does it have any implication for the quality of the agency's subsidy estimation process. The technical/default reestimate, on the other hand, reflects the latest developments in risk and program characteristics and thus it indicates changes in the quality of loan portfolio or the overall risk of loan guarantees. In some instances, a large technical/default reestimate may indicate that the credit program management should find ways to improve its subsidy estimation process and/or its portfolio management. Because of the difference in the nature of the two components, separate reporting would provide better information to users of the financial reports.

14. All of the 12 respondents to the March 1999 ED agreed with the Board’s proposal for reporting subsidy reestimates in those two components. The

[5] See OMB Circular A-11, sec. 85.5 (a), revised in July 1999. The interest rate reestimate does not involve any change in original assumptions other than the interest rates.

respondents believe that reporting the two reestimate components separately will provide information to reveal the causes of the reestimates. They believe that such information can help program managers improve credit program performance and subsidy estimation methodology.

15. Although in support for the proposal, one respondent commented on the controllability argument. Since it was discussed in the March 1999 ED that the magnitude of an interest rate reestimate is beyond agencies' control, the respondent pointed out that some default factors, such as changes in economic conditions and natural disasters, are also beyond the control of credit programs. While it was stated in the March 1999 ED that "the assumed rate is determined by the Administration and is beyond the control of the agency," that statement does not imply that credit programs can control changes in economic conditions or all of the other events that would impact default rates. However, the Board believes that a reliable assessment of the economic changes and other risk factors in making default subsidy reestimates, whether or not controllable by the agency, can help credit programs better manage program costs and performance.

16. Another respondent stated that analyses performed by his agency indicated that in past years, changes in interest rates produced relatively minor changes in that agency's overall subsidy rates. Thus, the respondent suggested that the Board consider whether it is cost-beneficial to separate out the interest rate reestimates.

17. The interest rate reestimates vary in magnitude from year to year. For some years, the assumed and the actual rates may be fairly close, whereas in other years they differ significantly and could produce a material effect on the overall subsidy rate. For example, the subsidy reestimate data provided USDA Rural Development Water and Waste Direct Loan program indicated that for fiscal years 1992 through 1994, the amounts of interest rate reestimates exceeded the amounts of technical/default reestimates. In 1995, the interest rate reestimate accounted for 84 percent of the total subsidy reestimate. In more recent years, the impact of interest rate reestimates was relatively small. In any case, we do not believe one can rely on the past experience for any particular year to make a conclusion about interest variations in future years.

**RECONCILIATION**

18. It is prescribed as an accounting standard in this statement that reporting entities display in a note to financial statements a reconciliation between the beginning and ending balances of the subsidy cost allowance for outstanding direct loans and the liability for outstanding loan guarantees reported in the entities' balance sheet.

19. During its discussions about the subsidy expense and subsidy reestimates, the Board held the view that it is not adequate or desirable to report annual subsidy expense and reestimates in an isolated fashion. The Board concluded that additional information is needed to provide a full picture about a credit program's performance. The Board believes that the reconciliation can be used as an effective vehicle to provide such information.

20. As explained in the March 1999 ED, an advantage of displaying the reconciliation is to show in one place the activities that affect the subsidy cost allowance or the loan guarantee liability. In addition to the subsidy expense and reestimates, which are based on projections of future cash flows, the reconciliation schedule also displays data on actual performance, such as fees received, loans written off, claim payments made to lenders, and foreclosed property, loans receivable, or other recoveries acquired during the reporting year. These actual performance data and the data on subsidy cost estimates would be a useful tool to begin assessing the actual performance of a reporting entity's lending or loan guarantee activities against its budget expectations.

21. The Board noted as another advantage that the reconciliation process would enhance credit agencies' internal control. To comply with the requirement, entities must make the subsidy data elements consistent, accurate, and thus reconcilable. In conjunction with credit agencies' loan monitoring systems, the reconciliation process can serve as a tool to foster a discipline in organizing data related to subsidy costs and performance in a systematic manner.

22. A majority of the respondents supported the Board's proposal for displaying the reconciliation. They believed that the reconciliation will provide useful information to Congress, program managers, and other users of financial statements. One respondent stated that once required as a part of the financial statements, the reconciliation will be subject to validation through audit and thus will become a reliable source of

information for those who make decisions and evaluate results for credit activities.

23. Several respondents, however, expressed disagreements or reservations about the proposed reconciliation. Some of them commented that compiling the reconciliation data would be a burdensome process. We believe that performing the reconciliation would initially require some staff training and computer programming. However, the effort will be worthwhile because the process will help agencies organize the necessary data in an orderly manner. When properly programmed, the reconciliation process can become a routine and systematic process. In fact the reconciliation requires no more data than those that are necessary in deriving the ending balances of the subsidy cost allowance and loan guarantee liability from their beginning balances of a reporting period. Thus, all the data necessary for the reconciliation should be available and verifiable if the ending balances are accurate.

24. It should be noted that it is not unusual to require reconciliation in credit activities. In its Industry Guide No. 3, the Securities and Exchange Commission (SEC) requires bank holding companies to provide an analysis of the allowance of loan losses in their financial statements.[6] The analysis is equivalent to the reconciliation of the subsidy cost allowance required in this statement. The SEC Guide requires that the beginning and ending balances of the allowance be reconciled with charge-offs (loans written off), recoveries, and additions charged to operations (equivalent to subsidy reestimates). The charges-offs and recoveries are displayed by type of loans (such as consumer installments, commercial, real estate, and lease financing, as so forth). A similar requirement is prescribed by the Financial Accounting Standards Board (FASB) in paragraph 20, FAS No. 114, as amended by FAS 118, for impaired loans accounted for on a present value basis:

> For each period for which results of operations are presented, a creditor also shall disclose the activity in the total allowance for credit losses related to loans, including the balance in the allowance at the beginning and end of each period, additions charged to operations, direct write-downs

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[6] SEC Accounting Rules, & 8303, 1984 Commerce Clearing House, Inc. [Additional reference: Securities Act Guide 3 adopted in Release No. 34-12784, amended by Release Nos. 33-6221, 33-6383, FR-11, FR-13 and FR-27]

> charged against the allowance, and recoveries of amounts previously charged off. The total allowance for credit losses related to loans includes those amounts that have been determined in accordance with FASB Statement No. 5, Accounting for Contingencies, and with this Statement.

25. Some of those who disagreed with the reconciliation proposal recognized merits in reconciling subsidy cost allowance for direct loans and liability for loan guarantees, but doubted whether the reconciliation on an entity basis would provide useful information. They pointed out that the programs their agencies administer vary in characteristics and subsidy rates, and that the reconciliation at the entity level will aggregate the program data and, as a result, will not reveal the characteristics and operating results of individual programs.

26. The Board was aware that programs administered by an agency often differ in characteristics and subsidy rates. The Board agrees with the view that the entity-wide reconciliation in itself would not reveal variations in program performance. The Board thus decided to issue an exposure draft, soon after issuing this statement, to propose a display of a program-by-program reconciliation for major programs. Nevertheless the Board sees value in the entity-wide reconciliation itself. With respect to the subsidy cost allowance and the loan guarantee liability reported on an entity's balance sheet, the entity-wide reconciliation shows changes in those balances. Those changes indicate the entity's aggregate performance results for all the credit activities under the entity's management.

27. The Board considered two primary reasons for adopting the entity-wide reconciliation in this statement, rather than postpone it until the program-by-program reconciliation is proposed and considered. First, by making the entity-wide reconciliation effective as early as possible, agencies can begin to get their personnel and systems resources ready for implementing the requirement without further delay. Second, by requiring the display of the entity-wide reconciliation, it is likely that program-by-program reconciliation data would be available for users. This is based on the rationale that in order to display the entity level reconciliation, the reporting entity would normally first reconcile the balances of individual programs. If they do so, program managers as well as auditors will have access to the program reconciliation data to validate the entity-wide reconciliation and to use the program-based data in program analysis and evaluation. If requested by Congress, special reports for any particular

program can also be made available to Congress.

28. One respondent pointed out that loan guarantee programs sometimes acquire guaranteed loans for direct collection upon paying default claims for those loans. He asked whether the subsidy cost allowance of those loans should be reconciled in a separate schedule. Under credit reform accounting, guaranteed loans acquired by the loan guarantee program upon paying default claims are carried at their present value and the present value is reestimated annually before the loans are collected or written off. The amount of those loans and their allowance are reported in Note 7 in OMB Bulletin 97-01, Form and Content of Agency Financial Statements. Since the acquired loans do not represent a primary line of business for loan guarantee programs, the Board does not believe that a display of reconciliation for those acquired loans should be required.

29. One respondent asked whether the reconciliation requirement applies to pre-credit reform direct loans and loan guarantees as well as post-credit reform direct loans and loan guarantees. The Board considered the issue and concluded that the reconciliation requirement applies only to post-credit reform direct loans and loan guarantees, i.e., direct loan and loan guarantees obligated or committed after September 30, 1991. One of the principal objectives for the reconciliation requirement is to provide information that can be used to compare initial budget expectations with operating results. This is achievable with direct loans and loan guarantees that were obligated or committed after September 30, 1991, because under credit reform, budgeting and financial reporting for credit activities are performed on the same present value basis. This is not the case with pre-credit reform direct loans and loan guarantees.

30. However, aside from the basic objective discussed above, the other advantages of the reconciliation are valid for both pre and post- credit reform direct loans and loan guarantees. Those advantages include: (a) revealing information on activities that affect the balances, and (b) enhancing accounting integrity and internal control. Agencies are encouraged, but not required, to reconcile the direct loan allowance and loan guarantee liability balances for direct loans and loan guarantees obligated or committed prior to October 1, 1991. Since the measurement bases differ between pre and post-credit reform direct loans and loan guarantees, agencies should use separate reconciliation schedules for pre and post-credit reform direct loans and loan guarantees.

## DISCLOSING SUBSIDY RATES

31. A disclosure provision has been prescribed in this statement to require that reporting entities disclose, at the program level, the rates for the total estimated subsidy cost and the subsidy cost components in the current year's budget for the current year's cohorts. Each rate equals the amount of the total subsidy or a subsidy component divided by the amount of direct or guaranteed loans obligated in the cohort for the reporting year. The Board members believed that the budget subsidy rates for the reporting year are highly important because they represent budget expectations that reflect the most recent program characteristics.

32. The standard provides that reporting entities may use trend data to display significant fluctuations in a program's subsidy rates. To avoid excessive and purposeless presentation of historical data, the use of trend data should be limited to the subsidy rate for the total subsidy or for a subsidy component of a particular program that has experienced significant fluctuations in recent years. The presentation of trend data should be accompanied by analysis to explain causes of the fluctuations.

33. A majority of the respondents supported the proposal for disclosing the estimated subsidy rates for cohorts of the current year. The arguments for the proposal they presented include: (a) those subsidy rates estimated in the current year's budget "give the reader the most up-to-date information on cohorts as established by appropriation law," (b) those rates reflect the most recent program characteristics, and (c) the subsidy rates reported for a number of recent years can form a trend for comparison and analysis.

34. One respondent requested clarification for the phrase "in the current year's budget for the current year's cohorts." The required disclosure is for budget subsidy rates for the cohorts of the current reporting year, i.e., the year for which the financial reports are published. For example, in the financial reports for the 2001 fiscal year, the budget subsidy rates in the FY 2001 budget for the FY 2001 cohorts should be complied and disclosed at the program level. The standard does not require disclosure of subsidy rates for cohorts of previous years, although some of the cohorts may continue to disburse loans during the current reporting year. However, as provided in the standard, entities may use trend data to display significant fluctuations in subsidy rates over a number of the most recent years.

35. Those who were opposed to the disclosure for subsidy rates presented the following arguments: (a) budget subsidy rates for all credit programs are published in the Federal Credit Supplement to the Budget of the U.S. Government, and it is unnecessary to duplicate the same data in financial reports, (b) the inclusion of budget subsidy rates in financial reports would appear to invite calculation of subsidy costs by applying the subsidy rates to disbursements, and such calculation could produce confusing results, and (c) the subsidy rates in the budget are estimated before all the data concerning the reporting year are available, and are subject to changes.

36. The Board was aware that the budget subsidy rates are published in the Federal Credit Supplement to the Budget of the U.S. Government. However, the inclusion of those subsidy rates in the financial reports will provide the reader of the financial statements with an easy access to the budget data. The Board was also aware that one cannot calculate the subsidy expense for the current year by applying the estimated subsidy rates of the current year cohorts to the amount of direct or guaranteed loans disbursed during the current year. Such calculation may give erroneous results because some of the loans disbursed during the current year may belong to previous years' cohorts. The disclosure of budget subsidy rates was initially proposed by the AAPC Credit Reform Accounting Task Force. When proposing the disclosure, the AAPC Credit Reform Accounting Task Force suggested that the disclosure be accompanied by a narrative explaining in conceptual terms how the total subsidy rate differs from the total subsidy expense recognized in the financial statements. The Board believes that it is necessary to have such a narrative to avoid confusion between the subsidy rates of the current year cohorts and the subsidy expense recognized for the current reporting year.

37. It is true that the estimated subsidy rates for a program in the current year's budget reflect budget expectations for that program, and do not reflect the program's operating results for the current reporting year. The actual performance of a program can be viewed from such data as subsidy reestimates, loans written off, default claims paid, and fees received. One of the purposes for the disclosure of the budget subsidy rates is to provide an indication of budget expectations of the most recent cohorts.

38. The Board believes that the disclosure for the subsidy rates for the

cohorts of the current reporting year will prove beneficial as they are important indicators for management's latest expectations reflecting the programs' current characteristics. The disclosure requirement is adopted because the advantages of the disclosure outweigh its disadvantages.

## DISCLOSURE AND DISCUSSION

39. The Board holds the view that merely reporting the figures for the subsidy expense and subsidy reestimates would not provide complete and understandable information to users of Federal agency financial reports. The Board believes that to make the figures meaningful, significant events and changes in assumptions underlying the cost estimates should be disclosed and their impact should be discussed. The disclosure and discussion should help explain the subsidy cost data. In other words, the Board believes that it is necessary to tell the stories behind the figures.

40. Reporting entities are required to provide a description of the programs that they administer and disclose at the program level the amounts of direct or guaranteed loans disbursed during the reporting year. This information would provide the reader with an indication of the programs' characteristics and the magnitude of their credit activities. With the information on amounts disbursed, analysts can calculate the subsidy expense, or one of its components, as a ratio to the amount of the loans disbursed and can compare the ratios among programs or over time.

41. Reporting entities are required to disclose events and changes that have had a significant and measurable effect on subsidy costs. These would include changes in economic conditions and risk factors, changes in legislation and policies regarding direct loans or loan guarantees, and changes in methodologies and assumptions used in making subsidy estimates and reestimates. Credit agencies are also required to disclose and discuss events and changes that have occurred and are more likely than not to have a significant impact on subsidy rates, subsidy expense, and subsidy reestimates but the effects of which are not measurable at the reporting date. These include events and changes that have occurred after the reestimation cut off date and will be taken into consideration in making reestimates for the following year. Reporting entities should discuss how those events and changes have or would have impacted the various components of subsidy expense, subsidy rates, and subsidy reestimates.

42. The Board noted in particular that changes in legislation and credit policies could significantly alter a program's characteristics and thus affect its subsidy rates. These changes include, for example, changes in borrowers' eligibility, the level of fees or interest rates charged borrowers, the maturity terms of loans, and the percentage of a private loan that is guaranteed. If such a change occurs during a reporting year, the reporting entity should disclose and explain the nature of the change and discuss its impact on program characteristics and its estimated subsidy rates.

43. Most respondents supported the Board proposal. They believed that to make the reported financial figures meaningful, significant events and changes in assumptions underlying those figures should be disclosed and their effect should be discussed. Some of the respondents provided examples of events that can affect default rates. For example, drought, flood, tornadoes, and other natural disasters may affect some regions or some sectors of the economy, and consequently, affect borrowers' ability to make loan payments. Those respondents also noted that changes in economic conditions, such as interest and employment rates, could an also have a significant impact on credit risks and performance. Some of them stated that legislative and policy changes could have a direct impact on the costs and performance of certain affected programs. They contend that without disclosing those events and changes and discussing their impact, the reader cannot fully understand the financial figures, such as subsidy rates, expenses, and reestimates.

44. One respondent noted that the same type of disclosure and discussion that is now required for credit subsidies is not usually required for many other operating costs, such as employees salary, rent, and computer service costs. The respondent questioned why the disclosure and discussion for credit activities are more critical than other costs reported in the statement of net cost. To address this issue, we can provide at least two reasons for this difference. First, unlike salary, rent, or the costs of other services, the credit subsidy costs are under a greater degree of uncertainty, as they are exposed to many risk factors external to the government. Many factors discussed in the March 1999 ED and by other respondents, such as changes in interest and employment rates and disastrous events, would cause the subsidy costs to vary from their estimates in the budget. Second, unlike most other cost items, the credit subsidy costs are reported in present values of future cash flows projected over the life of the underlying direct loans and loan guarantees. To a large extent, the reliability of the subsidy cost information depends on

the factors considered in making the cash flow projections. The reliability is also affected by the quality of the agency's data and its estimation methodology. The narrative disclosure and discussion would help the user to understand the factors that cause significant changes in the subsidy costs during the reporting year, which do not usually occur in salary, rent, or other operating costs.

45. Two respondents, however, were opposed to the narrative disclosure and discussion requirement on the grounds that it would be burdensome for entities with varied programs to present the required information. These respondents may have come under a mis-perception about the disclosure and discussion requirement. They may have perceived that the standard would require an excessively detailed description of all the technical aspects of the subsidy estimation methodologies and assumptions, and an extensive analysis of all risk factors in the programs and even sub-programs administered by the reporting entity. Thus, they concluded the requirement is extremely burdensome. However, such detailed disclosure and discussion were not intended. It was stated in paragraph 50 of the March 1999 ED:

> While the Board members believe that the proposed disclosure and discussion are necessary, they prefer that entity financial reports would not be overwhelmed with detailed numbers and ratios that may overburden the reader of the financial reports. The Board members believe that to the extent possible, the narrative discussion should be written in non-technical language so that the average reader can understand the data and the explanations.

46. The primary emphasis of the disclosure and discussion requirement is on significant changes in subsidy rates and reestimates. The disclosure and discussion should be focused on events that have occurred and have caused those significant changes. In addition, the disclosure and discussion should also include events that have occurred and are more likely than not to have a significant impact on subsidy rates and reestimates but the effects for which are not measurable at the reporting date.

47. Some respondents believed that the narrative disclosure and discussion should more appropriately belong to the Management Discussion and Analysis (MD&A) section of financial reports. The Board disagrees with this view. The narrative disclosure and discussion required in this statement should be specifically tailored to address credit subsidy

activities. As such, it differs from the MD&A requirements in breadth, depth, and detail. The Board believes that the disclosure and discussion required in this statement belong in a note to financial statements, such as Note 7 in OMB Bulletin 97-01, the Form and Content of Agency Financial Statements, in which all the data on direct loan assets, loan guarantee liabilities, subsidy rates, subsidy expenses, and reestimates are reported. By including the narrative disclosure and discussion in the same note, the reader would find all the information in one place. However, this does not preclude entity management from including a discussion and analysis to highlight credit activities in MD&A, so long as entity management determines that such a discussion and analysis meets the MD&A requirements in SFFAS 15.

48. Audit efforts for information provided in a footnote to financial statements differ from those for information provided in MD&A. MD&A is regarded as required supplementary information (RSI) and is subject to less stringent audit than basic financial statements and their notes.[7] The Board believes that program subsidy data should be reported in a note to agency financial statements because they are directly related to information reported in the financial statements. Those program subsidy data should be audited as basic financial information. Based on the preceding paragraph, it might appear that including the narrative disclosure and discussion in the same footnote with the subsidy data (instead of in MD&A) would expand the audit burden associated with credit subsidies. However, since the auditor already needs to test the reliability of the estimates and reestimates in the context of auditing the basic program subsidy data[8], the Board believes that there would be no substantial increase in audit burden from including the narrative disclosure and discussion in a footnote instead of in MD&A. In fact, the process of generating the required disclosure and discussion for the footnote should provide information on risk factors underlying the subsidy estimates and reestimates and thus should facilitate the audit of the basic subsidy data.

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[7] See Statement of Recommended Accounting Standards No. 15, Management Discussion and Analysis, (April 1999) par. 18.

[8] For example, *Federal Financial Accounting and Auditing Technical Release No. 3*, Preparing and Auditing Direct Loan and Loan Guarantee Subsidies under the Federal Credit Reform Act (July 1999), requires auditors to identify significant external and internal factors that may affect the credit subsidy estimates and reestimates. External factors include economic conditions, current political climate, and relevant legislation. Internal factors include the size of the agency's budget and accounting staff qualifications of key personnel, turnover of key personnel, and system capabilities.

49. One respondent commented that there may not be a basis to audit future events and their effect disclosed in the narrative. The required disclosure is for events that have occurred, but does not include events that are anticipated to occur. Also, the provision does not require quantifying the effect of an event that has occurred but whose effects cannot be measured at the reporting date.

**THE EFFECTIVE DATE**

50. In the March 1999 ED, it was proposed that the amendments be made effective for periods beginning after September 30, 1999. Two respondents requested that the effective date be made for periods beginning after September 30, 2000. They argued that many agencies were still having difficulties in implementing existing credit reform requirements and that the new requirements would require revisions in accounting procedures and systems. The CFO Council stated that many agencies are busy with resolving Y2K problems, and would not be able to initiate new systems changes until some time in year 2000.

51. There were arguments against postponing the effective date. First, the requirements prescribed in this statement do not require any new data. For example, the data needed for the reconciliation schedules should be in the system. Without that data, agencies could not report the ending balances of the subsidy cost allowance and the loan guarantee liability at the end of each fiscal year. Second, the proposed effective date, beginning with fiscal year 2000, provides adequate time because financial statements for that year will be issued in early calendar year 2001.

52. On the other hand, the Board recognizes that staff training and computer re-programming may be necessary to implement the new requirements. Therefore, the Board considered and granted a delay for the effective date to periods beginning after September 30, 2000. However, the Board emphasizes that this should not be considered a precedent for postponing implementation of adopted accounting standards. The Board encourages early implementation of the standards.

**VOTE FOR APPROVAL**

53. The accounting standards prescribed in this statement are approved by the Board unanimously.

# APPENDIX B: ILLUSTRATIVE REPORTING FORMATS

The following two schedules illustrate the reconciliation between beginning and ending balances of the subsidy cost allowance for direct loans and the liability for loan guarantees.

## A: Schedule for Reconciling Subsidy Cost Allowance Balances

In thousands of dollars

| **Beginning Balance, Changes, and Ending Balance** | **FY 2000** | **FY 2001** |
|---|---|---|
| Beginning balance of the subsidy cost allowance | $ | $ |
| Add: subsidy expense for direct loans disbursed during the reporting years by component: | | |
| (a) Interest subsidy costs | | |
| (b) Default costs (net of recoveries) | | |
| (c) Fees and other collections | | |
| (d) Other subsidy costs | | |
| Total of the above subsidy expense components | | |
| Adjustments: | | |
| (a) Loan modifications | | |
| (b) Fees received | | |
| (c) Foreclosed property acquired | | |
| (d) Loans written off | | |
| (e) Subsidy allowance amortization | | |
| (f) Other | | |
| Ending balance of the subsidy cost allowance before reestimates | | |
| Add or subtract subsidy reestimates by component | | |
| (a) Interest rate reestimate | | |
| (b) Technical/default reestimate | | |
| Total of the above reestimate components | | |
| Ending balance of the subsidy cost allowance | | |

## B: Schedule for Reconciling Loan Guarantee Liability Balances

In Thousands of dollars

| Beginning Balance, Changes, and Ending balance | FY 2000 | FY 2001 |
|---|---|---|
| Beginning balance of the loan guarantee liability | $ | $ |
| Add: subsidy expense for guaranteed loans disbursed during the reporting years by component: | | |
| (a) Interest subsidy costs | | |
| (b) Default costs (net of recoveries) | | |
| (c) Fees and other collections | | |
| (d) Other subsidy costs | | |
| Total of the above subsidy expense components | | |
| Adjustments: | | |
| (a) Loan guarantee modifications | | |
| (b) Fees received | | |
| (c) Interest supplements paid | | |
| (d) Foreclosed property and loans acquired | | |
| (e) Claim payments to lenders | | |
| (f) Interest accumulation on the liability balance | | |
| (g) Other | | |
| Ending balance of the loan guarantee liability before reestimates | | |
| Add or subtract subsidy reestimates by component: | | |
| (a) Interest rate reestimate | | |
| (b) Technical/default reestimate | | |
| Total of the above reestimate components | | |
| Ending balance of the loan guarantee liability | | |

Note: The schedules provided in this Appendix are for illustration only. These schedules, with their format and content, are not a part of the accounting standards.

# APPENDIX C: THE ACCOUNTING STANDARDS IN SFFAS No. 2

The following standards are prescribed in SFFAS No. 2. The texts of the paragraphs, and paragraph numbers reproduced in this Appendix are the same as those that appear in SFFAS No. 2. (The original footnote numbers are indicated in the footnotes) The shaded paragraph is affected by SFFAS No. 18.

**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 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.

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 data base 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 work-outs 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

value[9] of the loans over their post-modification value[10]. The amount of the modification cost is recognized as a modification expense when the loans are modified.

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 is 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 transfer[11] paid or

9(Original Footnote No. 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).

10 (Original footnote No. 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).

11(Original footnote No. 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.)

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 liability[12] of the loan guarantees over their pre-modification liability[13]. 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 is 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

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[12] (Original footnote 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).

[13] (Original footnote NO. 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).

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 transfer[14] 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

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.[15] For sales of post-1991 direct loans, the modification adjustment transfer[16] paid or received to offset the gain or loss is recognized as a financing source (or a reduction in financing source).

D. Disclosure

[14](Original footnote 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.)

[15](Original footnote No. 9) If there is a book value gain, the gain to be recognized equals the book value gain plus the cost of modification.

[16](Original footnote No. 19) See footnote No. 7 for an explanation for "modification adjustment transfer".

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 lose 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.

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.

## GLOSSARY

Included in this Glossary are terms that are used in this Statement. Most of the terms were also defined in the Glossary of SFFAS No. 2, but some of them have been updated based on the recent version of OMB Circular A-11. Readers are advised to rely on the latest OMB Circulars A-11 and A-34 for proper usage of federal budgetary terms and their definitions.

**Book value** - The net amount at which an asset or liability is carried on the books of account (also referred to as carrying value or amount). It equals the gross or nominal amount of any asset or liability minus any allowance or valuation amount.

**Cohort** - A budget term which refers to all direct loans or loan guarantees of a program for which a subsidy appropriation is provided for a given fiscal year, even if disbursements occur in subsequent years. For direct loans and loan guarantees for which a subsidy appropriation is provided for one fiscal year, the cohort will be defined for that fiscal year. For direct loans and loan guarantees for which multiple year or no-year appropriations are provided, the cohort is defined by the year of obligation.

**Credit program** - For the purpose of this Statement, a federal program that makes loans and/or loan guarantees to nonfederal borrowers.

**Direct loan** - A disbursement of funds by the government to a nonfederal borrower under a contract that requires the repayment of such funds with or without interest. The term includes the purchase of, or participation in, a loan made by a non-Federal lender.

**Direct loan obligation** - A binding agreement by a Federal agency to make a direct loan when specified conditions are fulfilled by the borrower.

**Econometric model** - An equation or a set of related equations used to analyze economic data through mathematical and statistical techniques. Such models may be devised in order to depict the essential quantitative impact of alternative assumptions or government policies. (Dictionary of Banking and Finance, Jerry M. Rosenberg, Ph.D., Wiley & Sons, New York, 1982, hereafter cited as Rosenberg's Dictionary)

**Foreclosure** - A method of enforcing payment of a debt secured by a mortgage by seizing the mortgaged property. Foreclosure terminates all rights that the mortgagor has in the mortgaged property upon completion of due process through the courts. (Treasury Financial Manual Supplement)

**Interest method** - A method used to amortize the premium or discount of an investment in bonds, or, as used in this Statement, to amortize the subsidy cost allowance of direct loans. Under this method, the amortization amount of the subsidy cost allowance equals the effective interest minus the nominal interest of the direct loans. The effective interest equals the present value of the direct loans times the effective interest rate (the discount rate). The nominal interest equals the nominal amount (face amount) of the direct loans times the stated interest rate (the rate stated in the loan agreements).

**Interest rate reestimate** - A reestimate for the subsidy cost of direct loans or loan guarantees due to a change in the interest rates used in present value calculations from the assumed interest rates used in budget preparations to the interest rates that are applicable to the periods in which the direct or guaranteed loans are disbursed.

**Loan guarantee** - Any guarantee, insurance, or other pledge with respect to the payment of all or part of the principal or interest on any debt obligation of a nonfederal borrower to a nonfederal lender, except for the insurance of deposits, shares, or other withdrawable accounts in financial institutions.

**Loan guarantee commitment** - A binding agreement by a federal agency to make a loan guarantee when specified conditions are fulfilled by the borrower, the lender, or any other party to the guarantee agreement.

**Modification -** 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 direct loan obligations), or the liability of loan guarantees (or loan guarantee commitments). Direct modifications are such actions that change the subsidy cost by altering the terms of existing contracts, selling loan assets, and purchasing loans under guarantee from a private lender. Indirect modifications change the subsidy cost by legislation that alters the way in which an outstanding portfolio of direct loans or loan guarantees is administered. (According to OMB Circular A-11, the term modification does not include a Government action that is assumed in the baseline cost estimate, as long as the assumption is documented and has been approved by OMB. For example, modification does not include routine administrative workouts of troubled loans or loans in imminent default, and the borrower's or the Government's exercise of an option that is permitted within the terms of an existing contract, such as prepaying the loan. OMB Circular A-11, sec. 85.3 (n) July 1999)

**Modification adjustment transfer** - A non-expenditure transfer from a credit program to the Treasury, or vice versa, to offset the difference between the amount appropriated for the cost of modification of direct loans (or loan guarantees) and the change in the book value of direct loans (or loan guarantee liabilities).

**Nominal (or face or par) value or amount** - The amount of a bond, note, mortgage, or other security as stated in the instrument itself, exclusive of interest or dividend accumulations. The nominal amount may or may not coincide with the price at which the instrument was first sold, its present market value, or its redemption price. Often referred to as the stated value. (Adapted from Kohler's Dictionary for Accountants, 6th ed., hereafter cited as Kohler's Dictionary)

**Present value (PV)** - The value of future cash flows discounted to the present at a certain interest rate (such as the reporting entity's cost of capital), assuming compound interest. (Adapted from Kieso and Weygandt, Intermediate Accounting, 7th ed., p. 264.)

**Recourse** - The rights of a holder in due course of a financial instrument (such as a loan) to force the endorser on the instrument to meet his or her legal obligations for making good the payment of the instrument if dishonored by the maker or acceptor. The holder in due course must have met the legal requirements of presentation and delivery of the instrument to the maker of a note or acceptor of a draft and must have found that this legal entity has refused to pay for or defaulted in payment of the instrument. (Rosenberg's Dictionary)

**Reestimate** - Revisions of the subsidy cost allowance for outstanding direct loans or the liability of outstanding loan guarantees, through reestimating the subsidy costs of those direct loans and loan guarantees. See “interest rate reestimate” and “technical/default reestimate.”

**Restatement (of direct loans or loan guarantees)** - For the purposes of this Statement, refers to establishing a new book value of a direct loan or the liability of a loan guarantee.

**Risk category** - Subdivisions of a cohort of direct loans or loan guarantees into groups of loans that are relatively homogeneous in cost, given the facts known at the time of obligation or commitment. Risk categories will group all direct loans or loan guarantees within a cohort that share characteristics predictive of defaults and other costs.

**Subsidy cost** - The cost of a grant of financial aid, usually by a governmental body, to some person or institution for particular purposes. (Kohler's Dictionary)

> **Credit subsidy cost** is the estimated long-term cost to the government of direct loans or loan guarantees calculated on a net present value basis, excluding administrative costs.
>
> **Direct loan subsidy cost** is the estimated long-term cost to the government of direct loans, calculated on a present value basis, excluding administrative costs. The cost is the net present value of estimated cash flows at the time the direct loans are disbursed. The discount rate used for the calculation is the average interest rate (yield) on marketable Treasury securities of similar maturity to the loans’ cash flows, applicable to the time when the loans are disbursed.

**Loan guarantee subsidy cost** - The estimated long-term cost to the government of loan guarantees calculated on a present value basis, excluding administrative costs. The cost is the net present value of estimated cash flows at the time the guaranteed loans are disbursed by the lender. The discount rate used for the calculation is the average interest rate (yield) on marketable Treasury securities of similar maturity to the cash flows projected under the terms of the loan guarantees, applicable to the time when the guaranteed loans are disbursed.

**Technical/default reestimate** - A reestimate of the subsidy cost of direct loans or loan guarantees based the latest projections on defaults, delinquencies, recoveries, and prepayments, and other cash flow components.

**Write-off** - An action to remove an amount from an entity's assets. A write-off of a loan occurs when an agency official determines that the loan will not be collected or, after all appropriate collection tools have been used, that the loan is uncollectible. Active collection on an account ceases, and the account is removed from an entity's receivables. (Treasury Financial Manual Supplement)

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