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Report to Congressional Requesters

May 1994

GOVERNMENT SPONSORED ENTERPRISES

Freddie Mac's and Fannie Mae's Accounting for Costs of Foreclosed Property

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Accounting and Information
Management Division

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May 27, 1994

The Honorable Donald W. Riegle, Jr.
Chairman, Committee on Banking, Housing,
and Urban Affairs
United States Senate

The Honorable Paul S. Sarbanes
Chairman, Subcommittee on Housing
and Urban Affairs
Committee on Banking, Housing, and
Urban Affairs
United States Senate

In accordance with your March 16, 1993, request and based on discussions with your offices, this report provides information on the accounting changes made by two government-sponsored enterprises (GSEs), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal National Mortgage Association (Fannie Mae), to adopt the American Institute of Certified Public Accountants' (AICPA) Statement of Position 92-3, Accounting for Foreclosed Assets (SOP 92-3). SOP 92-3 was issued in April 1992 and was effective for the GSEs as of December 31, 1992.

Freddie Mac and Fannie Mae are federally chartered, privately owned, for-profit corporations created by the Congress to ensure continuous nationwide availability of reasonably priced loans to home buyers. Our objectives were to (1) assess whether the accounting changes made by the GSEs in adopting SOP 92-3 were in accordance with generally accepted accounting principles (GAAP), (2) estimate the changes' effects on their respective loan loss reserves, and (3) estimate the changes' effects on compliance with minimum capital requirements established by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992. In addition, we considered the potential effects of accounting guidance issued by the Financial Accounting Standards Board (FASB) in May 1993 that partially conflicts with SOP 92-3 relative to recognizing selling costs. This new guidance, which was issued subsequent to the GSEs' adoption of new accounting policies under SOP 92-3, is effective for the GSEs beginning in January 1995.

Results in Brief

The accounting changes made by the GSEs to recognize selling and other costs for foreclosed property as expenses after foreclosure instead of

including such costs as part of provisions for loan losses are supportable under SOP 92-3 and were in accordance with GAAP.

Due to the changes in accounting policy, the GSEs' loan loss reserves are now available to cover losses of loan principal[1] only, whereas, before the changes, reserves were intended to be adequate to also cover selling and other costs. As of December 31, 1992, estimated accumulated selling and other costs of approximately $251 million at Freddie Mac and $425 million at Fannie Mae were included in loan loss reserves. The GSEs chose to retain these amounts in the reserves upon the adoption of SOP 92-3, thus increasing the reserve amounts available to offset principal losses. If the GSEs determine that loan loss reserves exceed the amounts needed for principal losses, the GSEs could reduce the level of loan loss reserves. However, due to the flexibility of GAAP in the area of determining loan loss reserves, the future effects of the accounting changes on these reserves cannot be reliably determined.

Because the GSEs did not reduce loan loss reserves upon adoption of SOP 92-3, their ability to comply with the act's minimum capital requirements was not affected. Fluctuations in loan loss reserves can affect net income and, therefore, the capital available to comply with minimum capital requirements. However, even if the GSEs decreased their current reserve levels by the maximum amount that could theoretically be justified by the accounting changes, their ability to comply with the minimum capital requirements would not increase significantly based on the available capital levels as of December 31, 1992 and 1993.

The AICPA is now considering questions that have arisen relating to conflicts between SOP 92-3 and other guidance recently issued by FASB concerning the timing of recognizing selling costs on financial statements. The new accounting guidance requires creditors to recognize selling costs as part of loan loss reserves for certain types of loans and, therefore, could require at least a partial change back to the GSEs' previous accounting policy of recognizing selling costs when estimating loan loss reserves. This change could result in inconsistent accounting for selling costs since certain types of loans guaranteed by the GSEs are not subject to the new accounting guidance. We are making recommendations to the AICPA and FASB to address this potential inconsistency in the accounting guidance.

[1]For purposes of this report, the term losses of loan principal also includes any related accrued interest.

Background

Generally, Freddie Mac and Fannie Mae promote financing for homes by purchasing and/or securitizing[2] mortgages from lenders, thus replenishing the lenders' funds for making additional loans. These GSEs issue debt and equity securities as well as mortgage-backed securities for which they guarantee the payment of principal and interest. These operations provide a secondary market for the purchase and sale of mortgage loans.

Like any private financial firm, the GSEs are subject to financial risks. These risks include losses arising from borrowers failing to repay their loans, losses from changes in interest rates, and losses from poor management decisions and unfavorable business conditions. Unlike federally insured financial institutions, the federal government does not guarantee payment of any of the GSEs' liabilities. We concluded in a previous report that government supervision of the GSEs' risk-taking activities and establishment of minimum capital levels were appropriate considering the size of the GSEs' financial obligations, their public policy purposes, and the probability that the federal government would assist a financially troubled enterprise.[3]

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 was enacted to reduce the risk of the GSEs' failure. While it was recognized that the GSEs posed a low risk of insolvency when the legislation was passed, the act required increased federal regulatory oversight and established minimum and risk-based[4] capital levels to provide taxpayer protection. The act requires the amounts used to measure compliance with its various capital requirements to be determined in accordance with GAAP.

Loan loss reserves are established to provide for estimated losses resulting from problem loans. At any given date, loan loss reserves should be adequate to cover both specifically identified loss exposures as well as other inherent[5] loss exposures in the portfolio. Appropriate levels of loan loss reserves are critically important for investors, auditors, and regulators

[2]Securitizing refers to the process of converting loans or other assets into marketable securities for sale to investors.

[3]Government-Sponsored Enterprises: The Government's Exposure to Risks (GAO/GGD-90-97, August 15, 1990).

[4]Currently, only minimum capital requirements are in effect. The act did not specify detailed risk-based capital requirements, but rather required the Office of Federal Housing Enterprise Oversight to set these detailed requirements by regulation. These regulations are expected to be issued by the end of 1994 and will become effective upon issuance.

[5]Inherent losses exist when events or conditions have occurred that will ultimately result in loan losses, but are not yet apparent in individual loans.

when evaluating the financial condition of the GSEs and the quality of the loan portfolios. Loan loss reserves should be periodically reviewed by management for adequacy in light of the current condition of the loan portfolio. If management determines that loan loss reserves are either inadequate or excessive, the reserves should be adjusted through the loan loss provisions reflected in the income statement. When a loan is determined to be uncollectible, the amount of the loss should be charged off against the reserve, thus reducing the amount of the reserve reflected on the balance sheet.

Expenses related to loan losses and foreclosed assets include foreclosure, holding, and selling costs. Foreclosure costs include legal fees and other costs to acquire the title to the property pledged as collateral for the loan. Holding costs include property taxes, hazard insurance, and costs to maintain the property. If the property is a rental property, operating costs, net of operating income, may also be included in holding costs. Selling costs include sales commissions and other costs to dispose of the property.

Generally accepted accounting principles allow for a wide range of acceptable alternatives as to when expenses related to loan losses and foreclosed assets should be recorded. The AICPA issued SOP 92-3 to reduce the inconsistencies and diversity in accounting for foreclosed assets that existed in the accounting literature and practice. Under SOP 92-3, foreclosed assets are to be carried at the lower of fair value minus estimated selling costs, or cost. The cost of a foreclosed asset is defined in SOP 92-3 as its fair value as of the date of foreclosure. The fair value of an asset, as used in SOP 92-3 and other existing accounting standards, is the amount that a creditor could reasonably be expected to receive for the asset in a current sale between a willing buyer and a willing seller. This valuation does not include consideration of holding costs.

The term loan loss reserves is used in this report to refer to both loss reserves for loans owned by the GSEs as well as the GSEs' liabilities for losses on sold/securitized loans (loans underlying mortgage-backed securities whose payments to investors are guaranteed by the GSEs).

Scope and Methodology

To assess the accounting changes made and the effects of the changes, we met with representatives of Freddie Mac and Fannie Mae and their independent auditors. We reviewed financial statements and other information provided by the GSEs. Although we did not independently

verify this documentary and oral information, we did consider the information's consistency. We did not consider the adequacy of the GSEs' loan loss reserves.

To evaluate whether the accounting changes were in accordance with GAAP, we reviewed the accounting literature listed in appendix I. Based on our understanding of SOP 92-3, we assessed the GSEs' rationales for making the accounting changes. To confirm our understanding of SOP 92-3, we asked the AICPA about the statement's requirements regarding the timing of selling cost recognition. We discussed the AICPA's responses to our questions with AICPA staff and the GSEs' representatives. We discussed the relationship between guidance on recognizing selling costs in financial statements provided in SOP 92-3 and in the FASB's Statement of Financial Accounting Standards no. 114, Accounting by Creditors for Impairment of a Loan (SFAS 114) with staff from the AICPA and FASB.[6]

To determine the accounting changes' effects on compliance with minimum capital requirements, we reviewed the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 and analyzed the accounting changes' potential effects on loan loss reserves and capital.

We conducted our work from May 1993 through February 1994 in accordance with generally accepted government auditing standards. The GSES, AICPA, and FASB provided comments on a draft of this report. These comments are discussed in the "Agency Comments and Our Evaluation" section and are reprinted in appendixes II through V. We have incorporated their views where appropriate.

Accounting Changes Were in Accordance With GAAP

The GSEs told us they changed their methods of accounting for foreclosure, holding, and selling costs related to problem loans to comply with certain provisions of SOP 92-3. Changing an accounting policy to comply with new authoritative accounting guidance meets the GAAP criteria for making an accounting change. While the stated scope of SOP 92-3 does not extend to loan loss reserves, implementation of the statement resulted in a change in the types of costs to be covered by the GSEs' loan loss reserves. We believe the GSEs' position that language in the appendix of SOP 92-3 required these

[6]FASB is the primary accounting rule setting body that promulgates accounting principles, commonly known as GAAP, for private sector financial reporting. The AICPA may also issue GAAP accounting and auditing guidance to facilitate use of accounting rules and financial statement presentations and audits. If more than one accounting principle exists that could apply to a particular situation, the principle that is considered to have general acceptance under the hierarchy established for making these determinations should be followed.

accounting changes is reasonable and, therefore, that the GAAP criteria for making such a change was met.

Before the accounting changes, the GSEs' loan loss reserves included provisions for estimated losses of loan principal and foreclosure, holding, and selling costs associated with foreclosed assets to be received in satisfaction of delinquent loans. These amounts were included in loan loss reserves when these losses were considered probable and reasonably estimable. As a result of their new accounting method, GSEs' loan loss reserves are only to be used to absorb losses of loan principal. Foreclosure and holding costs are to be recognized in financial statements as an expense when these costs are incurred, and estimated selling costs are to be recognized immediately after foreclosure. This timing change results in the GSEs recognizing selling and other costs for groups of loans under the new accounting policy approximately 1 year later than under the previous accounting policy.[7] Under the new accounting policy, selling and other costs are recognized through a direct charge to income after foreclosure rather than as part of the loan loss provision.

Although more than one acceptable accounting policy or method may exist for recording a particular type of transaction, Accounting Principles Board Opinion no. 20 Accounting Changes (APB 20) requires similar types of transactions to be accounted for consistently. APB 20 states that after an entity adopts an acceptable accounting method, a change to another acceptable method may only be made if the entity can justify that the new accounting method is preferable to the previous method. A change required by a statement of position issued by the AICPA or a new FASB statement is considered adequate justification for an accounting change under APB 20.

The GSEs' management and their independent auditors told us that the accounting changes made for foreclosure, holding, and selling costs were required by SOP 92-3 and, therefore, met the criteria for making an accounting change under APB 20. While foreclosure and holding costs are not directly addressed by SOP 92-3, there is a clear implication that foreclosure and holding costs should not be included in valuation reserves prior to foreclosure. SOP 92-3, paragraph A-12, requires that immediately

[7]The initial timing difference of approximately 1 year was offset to the extent that selling and other costs provided for in loan loss reserves under the previous accounting policy were also subsequently charged directly against net income after foreclosure under the current accounting policy. These costs relate to problem loans identified during the year the GSEs adopted SOP 92-3. On an ongoing basis, this timing difference is likely to affect net income only to the extent that selling and other costs fluctuate significantly from period to period.

after foreclosure, foreclosed assets be valued at fair value less selling costs. Since SOP 92-3 essentially defines fair value to be the expected sales price of an asset, recognizing foreclosure and holding costs as part of loan loss provisions and including these costs in valuation reserves prior to foreclosure would not appear to be appropriate. This treatment of foreclosure costs also is consistent with Statement of Financial Accounting Standards no. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings (SFAS 15), paragraph 38, which requires foreclosure costs to be expensed when incurred (that is, after foreclosure commences).

The GSEs stated that SOP 92-3 also established a requirement that selling costs are to be recognized after foreclosure, thus requiring the accounting changes to be made for recognizing these costs. This position is based on paragraph A-12 in the appendix of SOP 92-3 which states that "immediately after foreclosure, a valuation allowance related to foreclosed assets held for sale should be recognized for estimated costs to sell through a charge to income."

Notwithstanding this language in SOP 92-3, the AICPA, in response to our inquiry, stated that the scope of SOP 92-3 is limited to accounting for foreclosed assets after foreclosure and does not extend to accounting for loan loss reserves. When we highlighted the requirements of paragraph A-12, AICPA staff responded that although some readers may conclude that SOP 92-3 implies that selling costs are no longer to be included in the calculation of loan loss reserves, SOP 92-3 was not intended to address this issue.

SOP 92-3 provides for consistent accounting for foreclosed assets, however, the requirements of paragraph A-12 of the statement appear to be focused on entities that did not include selling and other costs in loan loss reserves prior to foreclosure. Where these costs were not included, such entities' loan loss reserves would not be affected by adopting SOP 92-3, consistent with the statement's stated scope. However, the ramifications of the language in paragraph A-12 for entities, such as the GSEs, whose previous policy was to include selling and other costs in loan loss reserves do not appear to have been fully considered by the AICPA prior to issuing SOP 92-3.

Although the GSEs' implementation of SOP 92-3 for foreclosed assets affected their accounting for loan loss reserves which FASB and the AICPA stated is beyond the scope of SOP 92-3, we believe that the GSEs' application of the statement is reasonable and in accordance with GAAP.

Accounting Changes' Future Effects on Loan Loss Reserves Cannot Be Reliably Determined

While the initial effects of the accounting changes on loan loss reserves can be reasonably estimated, the future effects cannot be reliably predicted. Broad accounting standards provide flexibility with regard to establishing and maintaining loan loss reserves and do not provide benchmarks against which to measure the future impact of this change.

Based on information provided by the GSEs, as of December 31, 1992, loan loss reserves at Freddie Mac and Fannie Mae included approximately $251 million and $425 million, respectively, for estimated accumulated selling and other costs that will no longer be used to absorb these costs under the new accounting policies. These amounts, which were estimated using the GSEs' historical experience, represented approximately 32 percent and 55 percent of the GSEs' respective loan loss reserves as of December 31, 1992. The GSEs chose to substantially retain these amounts in the reserves upon the adoption of SOP 92-3, thus increasing the reserves available as of December 31, 1992, to offset principal losses.[8]

All else being equal, the GSEs' future loan loss reserve levels could theoretically be lower under the new method than under the old method, because reserves no longer must include estimated selling and other costs. However, GAAP allows a broad range of acceptable loan loss reserve approaches and flexibility in making management judgments about the appropriate level of reserves.[9] This flexibility in current GAAP does not permit us to reliably determine the future effects of the accounting changes on the GSEs' loan loss reserves. We are currently analyzing the effects of broad accounting standards for establishing loan loss reserves at banks and other financial institutions and will be reporting on this work during 1994.

[8]Although no overall reductions in loan loss reserves were made as of December 31, 1992, the GSEs estimated that their loan loss provisions for 1992 were less than they otherwise would have been in anticipation of the accounting change. The estimated reductions were $15 million for Freddie Mac and $10 million for Fannie Mae. However, the GSEs stated that GAAP would have allowed this flexibility even in the absence of the accounting change.

[9]GAAP allows the use of management judgment to estimate a range of probable losses and to choose an amount within this estimated range. Unless one loss amount in the range is a better estimate than any other amount, the minimum amount of the range should be recorded. However, management has flexibility in determining the range of probable losses. For future periods, GAAP does not require maintaining a consistent level of loss reserves relative to the range of possible losses, such as either the center or top quarter of the range, thus allowing for additional flexibility if no one amount in the range is a better estimate than any other.

Accounting Changes Did Not Significantly Impact GSEs' Ability to Meet Minimum Capital Requirements

The GSEs' ability to comply with minimum capital requirements established under the act was not affected at the date of the accounting change, since no adjustments to reserves were made at adoption. Any future adjustments to reserve levels resulting from the accounting changes would affect capital and, therefore, the GSEs' ability to meet the act's minimum capital requirements. However, even if the GSEs decreased reserves by the maximum amount that could theoretically be justified by the accounting changes, their ability to comply with the minimum capital requirements would not increase significantly based on the available capital levels as of December 31, 1992 and 1993.

The GSEs are required to maintain a level of capital sufficient to meet the minimum capital requirements specified in the act. As specified in the act, the required level of minimum capital is determined for each GSE based on specific percentages of the assets included in their respective balance sheets, outstanding guaranteed mortgage-backed securities, and any other obligations not included in their balance sheets, such as commitments to purchase loans or sell mortgage-backed securities. The amount available to comply with the minimum capital requirements is referred to as core capital. Core capital is the stockholders' equity shown on the GSEs' financial statements and must be determined in accordance with GAAP.

As of December 31, 1992, the time of the accounting changes, core capital available to comply with minimum capital requirements was $3.6 billion and $6.8 billion for Freddie Mac and Fannie Mae, respectively, and the GSEs stated that they were in compliance with the minimum capital requirements.[10] As previously noted, loan loss reserves at Freddie Mac and Fannie Mae included approximately $251 million and $425 million, respectively, for estimated selling and other costs as of December 31, 1992. Had the GSEs determined at that time that all or some of these additional amounts were not needed to offset estimated principal losses, it would have been permissible to reduce reserves by those amounts or a portion thereof, thus increasing core capital. The GSEs did not choose to make any substantial reductions in reserves at the time of the changes, but could do so in the future by reducing loan loss provisions from what they otherwise would have been absent the accounting changes.

The amount of the periodic loan loss provision can fluctuate for a number of reasons—changes in the economic climate, newly identified risk exposures, differences in loan underwriting standards, the size of the loan

[10]The GSEs' regulator stated that the GSEs complied with the applicable minimum capital requirements as of June 30, 1993, in its first report.

portfolio, and, as previously discussed, flexibility afforded management under GAAP. Aside from these types of reasons, the GSEs' loan loss provisions could fluctuate as a result of the accounting changes for two reasons. First, since the GSEs have adopted a policy that loan loss provisions no longer include selling and other costs, they will, by definition, be lower than under the previous method. However, the impact of these reduced loan loss provisions on net income and core capital is likely to be substantially offset by the direct expensing of selling and other costs as they are incurred. Second, to the extent that the GSEs determine that the $251 million and $425 million in additional amounts included in their reserves for principal losses (or a portion thereof) are not needed, they could reduce reserves through reductions in loan loss provisions. Increases in net income resulting from this second type of reduced loan loss provisions would increase the amount of core capital available to comply with the minimum capital requirements.

The maximum amount of any potential loan loss reserve reductions related to the accounting changes would be the estimated accumulated selling and other costs of approximately $251 million at Freddie Mac and $425 million at Fannie Mae as of December 31, 1992. If such maximum reductions were made, core capital would have increased by 4.9 percent and 4.3 percent at Freddie Mac and Fannie Mae, respectively, as of December 31, 1992, assuming a 31 percent effective tax rate. As of December 31, 1993, such reductions would have increased core capital by 3.9 percent and 3.6 percent for Freddie Mac and Fannie Mae, respectively.

Based on these capital levels, the maximum estimated reduction of the loan loss provision as of December 31, 1992, would not significantly affect the GSEs' capital available for compliance with minimum capital requirements. However, as previously stated, the actual amount, if any, of subsequent reductions in loan loss reserves resulting from the accounting changes cannot be reliably estimated given the flexibility of accounting rules for determining loan loss reserves.

New Accounting Guidance Conflicts With SOP 92-3; Inconsistent Accounting May Result

After the GSEs adopted SOP 92-3, the FASB issued Statement of Financial Accounting Standards no. 114, Accounting by Creditors for Impairment of a Loan. Guidance in SFAS 114 concerning the timing of when selling costs are to be recognized conflicts with SOP 92-3. Implementation of SFAS 114 by the GSEs could require a change back to the previous accounting method for selling costs for certain loans when it becomes effective in January 1995. As SFAS 114 does not apply to all loan types, its implementation by the GSEs could result in inconsistent treatment of selling costs between loan types.

SFAS 114 states that costs to sell collateral related to impaired loans should be included in any necessary loan loss provisions and reserves if these selling costs are expected to reduce the cash available to repay or otherwise satisfy a loan. This treatment conflicts with SOP 92-3, paragraph A-12, which states that selling costs should be recognized immediately after foreclosure. When effective, SFAS 114 will be the accounting principle that is considered to have general acceptance under the hierarchy of generally accepted accounting principles established by the AICPA for loans that are subject to its provisions. SFAS 114 specifically excludes large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment, such as single family, residential mortgage loans, and, therefore, is likely to apply only to the GSEs' multifamily loans.[11] SOP 92-3 will continue to apply to selling costs for foreclosed assets related to single family loans.

For accounting purposes, selling costs related to single family loans and multifamily loans are similar types of transactions that, considering the GAAP concept of consistency, should be accounted for in the same manner. For both types of loans, costs incurred to sell the collateral property will reduce proceeds available to repay the loan. The GSEs have historically accounted for selling costs for all loan types consistently.

Inconsistent accounting for selling costs could result when SFAS 114 becomes effective for the GSEs beginning in January 1995. When SFAS 114 is adopted, selling costs related to collateral for multifamily loans should be recognized as part of setting loan loss reserves that generally are estimated for troubled loans before foreclosure. However, estimated selling costs related to collateral for single family loans could be recognized immediately after foreclosure. This accounting treatment draws a false distinction between similar costs and is not consistent with

[11]The GSEs' mortgage loan portfolios consist of both single family residential loans as well as multifamily loans. Multifamily loans are loans secured by residences consisting of more than four units (that is, apartment buildings). Single family loans are secured by residences of one to four units.

GAAP's explicit presumption that there is to be consistency in accounting for similar transactions.

The AICPA is currently studying whether conflicts exist between SOP 92-3 and SFAS 114. However, even if the AICPA removes the requirement to recognize selling costs through a charge to income immediately after foreclosure, inconsistent accounting treatment for selling costs could still exist because of FASB's exclusion of large groups of smaller-balance homogeneous loans from SFAS 114.

Conclusions

The GSEs' interpretation of paragraph A-12 of SOP 92-3, which we believe is reasonable, affected the types of costs included in loan loss reserves—an area that is not specifically addressed by the AICPA's scope of accounting for foreclosed assets. Without clarification, the language in this paragraph could result in applications of the statement that differ from the AICPA's stated scope.

Although SOP 92-3 provides for consistent accounting for foreclosed assets, inconsistent accounting for selling costs may result when FASB's SFAS 114 becomes effective. Paragraph A-12 of SOP 92-3 conflicts with SFAS 114 regarding the timing of recognizing selling costs for certain types of impaired loans when setting loan loss reserves. Unless the AICPA promptly clarifies SOP 92-3 to eliminate this conflicting guidance, further accounting changes and confusion may result during the period prior to the effective date of SFAS 114.

When effective, SFAS 114 will be the accounting principle of general acceptance under the GAAP hierarchy of accounting standards for loans that are included in its scope, thus partially resolving this conflict. However, because SFAS 114 only affects loans that are within its stated scope, selling costs for all loan types may not be accounted for consistently. This type of inconsistent accounting for similar transactions diminishes the usefulness, consistency, and comparability of financial statements. Close coordination between the AICPA and FASB, consideration of consistency in accounting for similar transactions, and a comprehensive view of any potential ramifications are critical for developing any further guidance in this area.

Recommendations

To improve the consistency in accounting for selling costs related to foreclosed assets and to clarify ambiguities in current accounting

literature that may lead to results that differ from standards setters' intentions, we recommend that:

- The AICPA revise paragraph A-12 of SOP 92-3 by eliminating language which implies that selling costs cannot be recognized as part of loan loss reserves. Additionally, guidance for applying this revision of SOP 92-3 should specifically address the appropriate accounting treatment for entities that originally made accounting changes to adopt SOP 92-3 based on paragraph A-12 that resulted in delaying selling cost recognition until after foreclosure.
- FASB and the AICPA work together to establish consistent guidance for recognizing selling costs for loan types not included in the scope of SFAS 114.

Agency Comments and Our Evaluation

Freddie Mac, Fannie Mae, the AICPA, and FASB staff provided written comments on a draft of this report. These comments are presented and evaluated in appendixes II through V. Freddie Mac and Fannie Mae agreed with our conclusions regarding their interpretation and adoption of SOP 92-3 and its effect on their loan loss reserves and their ability to comply with minimum capital requirements. The AICPA and FASB staff disagreed with the GSEs' interpretation of SOP 92-3 as applied to loan loss reserves and the timing of recognizing selling costs. However, they believed that any ambiguity would be eliminated when the proposed FASB statement, Accounting for the Impairment of Long-Lived Assets is issued.

FASB staff and the AICPA commented that the scope of SOP 92-3 was limited to accounting for foreclosed assets after foreclosure and did not extend to accounting for loan loss reserves and the recognition of estimated loan loss expenses prior to foreclosure. While we do not take issue with FASB and the AICPA on what the stated scope of SOP 92-3 is, the specific language of paragraph A-12 resulted in a broader interpretation. The GSEs and their independent public accountants interpreted paragraph A-12 to require recognition of selling costs after foreclosure, thus precluding recognition before foreclosure. We believe the GSEs' interpretation and implementation of the SOP was reasonable in light of the specific language in paragraph A-12 of the appendix to the SOP.

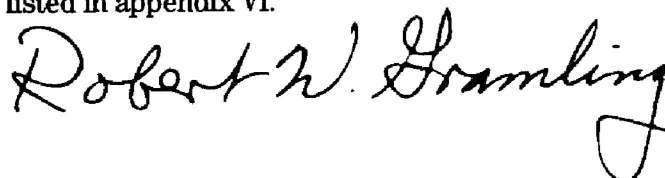
FASB staff and the AICPA stated that any ambiguity caused by paragraph A-12 should be resolved when SOP 92-3 is effectively superseded by a proposed FASB statement, "Accounting for the Impairment of Long-Lived Assets," and, therefore, that revision of the SOP is not needed. We agree

that the proposed FASB statement, if adopted, would effectively supersede SOP 92-3 since the FASB statement is ranked ahead of the SOP in the GAAP hierarchy. However, since the proposed statement does not explicitly supersede SOP 92-3, uncertainty remains whether financial statement preparers who applied SOP 92-3 will now look to the FASB statement. Also, until the FASB statement is adopted (proposed for 1995) others may interpret SOP 92-3 differently than intended. Further, for these same reasons, we believe there is uncertainty whether the proposed FASB statement will remove the direct conflict between the SOP and SFAS no. 114 with regard to the requirements for the timing of recognizing selling costs, since the proposed FASB statement is silent on this issue. Therefore, we believe the AICPA should issue clarifying guidance as we recommended.

Regarding our recommendation to provide consistent accounting guidance for recognizing selling costs related to collateral for loan types that are not included in the scope of SFAS 114, FASB staff stated that excluding large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment from SFAS 114 was essentially a cost/benefit consideration but that entities are free to apply SFAS 114 to every loan. We did not intend that consistency in recognizing selling costs be achieved through applying all of the requirements of SFAS 114 to smaller-balance homogeneous loans, but rather that the requirement to recognize selling costs as part of loan loss reserves be specifically extended to all loan types. This extension could be accomplished by an amendment to SFAS 114 with regard to this specific item or issuance of other interpretive guidance by FASB or the AICPA. As we recommended, FASB and the AICPA should work together to adopt accounting rules to achieve consistency in recognizing selling costs.

We are sending copies of this report to the Ranking Minority Members of your committees, the Office of Federal Housing Enterprise Oversight, the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, the American Institute of Certified Public Accountants, and the Financial Accounting Standards Board. Copies will also be made available to others upon request.

Please contact me at (202) 512-9406 if you or your staffs have any questions concerning this report. Major contributors to this report are listed in appendix VI.



Robert W. Gramling
Director, Corporate Financial Audits

Contents

Letter	1
Appendix I Relevant Accounting Literature	18
Appendix II Comments From the Federal Home Loan Mortgage Corporation	19
Appendix III Comments From the Federal National Mortgage Association	20
Appendix IV Comments From the Financial Accounting Standards Board Staff	21
Appendix V Comments From the American Institute of Certified Public Accountants	31
Appendix VI Major Contributors to This Report	34

Abbreviations

AICPA	American Institute of Certified Public Accountants
APB	Accounting Principles Board Opinion
FASB	Financial Accounting Standards Board
GAAP	generally accepted accounting principles
GSE	government-sponsored enterprise
SFAS	Statement of Financial Accounting Standards
SOP	Statement of Position

Relevant Accounting Literature

The following accounting literature was reviewed during this assignment:

American Institute of CPAs, Statement of Position 92-3 Accounting for Foreclosed Assets

Accounting Principles Board Opinion no. 20 Accounting Changes

FASB Interpretation no. 20 Reporting Accounting Changes Under AICPA Statements of Position (an interpretation of APB Opinion no. 20)

FASB Statement of Financial Accounting Standards no. 114 Accounting by Creditors for Impairment of a Loan

FASB Statement of Financial Accounting Standards no. 5 Accounting for Contingencies

FASB Interpretation no. 14 Reasonable Estimation of the Amount of a Loss (an interpretation of FASB Statement no. 5)

FASB Statement of Financial Accounting Standards no. 15 Accounting by Debtors and Creditors for Troubled Debt Restructurings

FASB Statement of Financial Accounting Standards no. 111 Rescission of FASB Statement No. 32 and Technical Corrections

AICPA Industry Audit Guide Audits of Banks

AICPA Audit and Accounting Guide Audits of Savings Institutions

Comments From the Federal Home Loan Mortgage Corporation

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Freddie Mac

March 25, 1994

Mr. Robert W. Gramling
Director, Corporate Financial Audits
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Dear Mr. Gramling:

The Federal Home Loan Mortgage Corporation ("Freddie Mac") appreciates having had the opportunity to meet with General Accounting Office ("GAO") personnel in connection with GAO's study of the effects of certain accounting changes made by Freddie Mac and by the Federal National Mortgage Association ("Fannie Mae"), and for this opportunity to respond to the resulting draft report entitled *Government Sponsored Enterprises' Freddie Mac's and Fannie Mae's Accounting for Costs of Foreclosed Property* (GAO/AIMD-94-75).

Most significantly, Freddie Mac agrees with GAO's conclusion that Freddie Mac's application of the American Institute of Certified Public Accountants' Statement of Position 92-3, "Accounting for Foreclosed Assets" (SOP 92-3), is reasonable and that Freddie Mac's application of SOP 93-2 is in accordance with generally accepted accounting principles ("GAAP"). Similarly, Freddie Mac agrees with GAO's conclusion that the adoption of SOP 92-3 did not significantly affect Freddie Mac's ability to comply with minimum capital requirements established under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 because the amounts in question are small compared to Freddie Mac's capital base.

Again, we appreciate having had the opportunity to participate in discussions with GAO staff regarding this accounting issue and its possible implications.

Sincerely,

Comments From the Federal National Mortgage Association

3900 Wisconsin Avenue, NW
Washington, DC 20016-2899
202 752 7457

James T. Parks
Vice President for Financial
Standards and Corporate Taxes

March 25, 1994

Mr. Robert W. Gramling
Director, Corporate Financial
Audits
U.S. General Accounting Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Gramling:

Thank you for the opportunity to review and comment on your report, "Government Sponsored Enterprises: Freddie Mac's and Fannie Mae's Accounting for Costs of Foreclosed Property" (GAO/AIMD-94-75).

We concur with the basic conclusions in this report, and in particular the findings that Fannie Mae followed generally accepted accounting principles in adopting AICPA Statement of Position No. 92-3 and that adoption of that statement will not have a significant effect on Fannie Mae's ability to meet minimum capital requirements.

Sincerely,

James T. Parks

Comments From the Financial Accounting Standards Board Staff

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

Financial Accounting Standards Board
401 Merritt 7, P.O. Box 5116, Norwalk, Connecticut 06856-5116 | 203-847-0700
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DENNIS R. BERESFORD
Chairman

March 22, 1994

Mr. Robert W. Gramling, Director
Corporate Financial Audits
Accounting and Information Management Division
United States General Accounting Office
Washington, DC 20548

Dear Bob:

I am writing in response to your letter dated March 10, 1994 requesting comments by March 25, 1994 on a GAO Draft Report, *Government Sponsored Enterprises: Freddie Mac's and Fannie Mae's Accounting for Costs of Foreclosed Property.*

The FASB staff has reviewed the GAO Draft Report and prepared the enclosed memorandum of comments about it. The FASB's normal process for commenting on such a draft submitted for FASB review includes circulating a copy of the document and a draft of the proposed comments to all Board members and senior staff for review and comment prior to sending a formal response. That has not been possible in this case, to meet your deadline for comments, due to the Board's existing commitments. During this week, all Board members and most of the senior staff will be holding two days of public hearings in Norwalk, CT, a one day public Board meeting, a meeting of the Emerging Issues Task Force, and two days of public hearings in San Jose, CA plus traveling from Connecticut to California and back. Given those commitments, I have decided to provide the enclosed FASB staff comments to you without the Board's normal review process. Accordingly, the enclosed memorandum contains the views of staff members who reviewed the Draft Report and their views only. In any event, the Board takes formal positions on accounting matters only after appropriate due process.

Please feel free to contact J. T. Ball of the FASB staff if you have any questions on the enclosed memorandum or this letter. If you would like us to take more time to allow all Board members to review your draft, please let J. T. or me know.

Sincerely,

Dennis R. Beresford
Enclosure

MEMORANDUM

To: Dennis R. Beresford

From: J. T. Ball

Subjec: FASB Staff Comments on GAO Draft Report on Government Sponsored Enterprises **Date:** March 22, 1994

cc: Board Members, T. Lucas, D. Mosso, C. Bass, C. Clarke, P. Rohan, J. Vernuccio

Carol Clarke, the project manager for FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan,* and I have reviewed the March 1994 GAO Draft Report, *Government Sponsored Enterprises: Freddie Mac's and Fannie Mae's Accounting for Costs of Foreclosed Property.* We have the following comments.

Background

The Draft Report indicates that two government sponsored enterprises (GSEs), the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae), changed their accounting for expected loan losses as a result of adopting AICPA Statement of Position 92-3, *Accounting for Foreclosed Assets* (SOP 92-3). Prior to adopting the SOP, they were accruing before foreclosure the estimated costs to foreclose, hold, and sell foreclosed real estate as part of the allowance for loan losses. Upon adoption of the SOP, they discontinued the accrual in a specific allowance prior to foreclosure and began to account for those costs after foreclosure. In making that change, however, they considered the amounts previously accrued as part of the general allowance for loan losses rather than as part of a specific allowance, so the change had no effect on total assets, net income, or capital.

See comment 1.

SOP 92-3 addresses the accounting for foreclosed assets after foreclosure. The AICPA issued it to conform inconsistent and diverse accounting for foreclosed

Page 2

assets; the SOP affected nine AICPA SOPs and Industry Audit and Accounting Guides (listed in paragraph 9 of the SOP). The SOP presumes that foreclosed assets will be sold; if that presumption is not rebutted, it requires a foreclosed asset held for sale to be carried after foreclosure at the lower of (a) fair value minus estimated costs to sell or (b) cost. Different accounting applies to other foreclosed assets (for example, those that will be held for the production of income).

A few months after the GSEs made the accounting change, the FASB issued Statement 114, which requires a creditor to measure impairment of a collateral-dependent loan for which foreclosure is probable at the fair value of the collateral less the estimated costs to sell the collateral. The GAO Report points out that the GSEs will thus have another accounting change back to their prior accounting upon the adoption of this Statement but is critical that Statement 114 applies only to certain loans and not to all loans.

See comment 2.

FASB Staff Reactions

We are surprised that SOP 92-3 was used as justification for the change in accounting described in the Draft Report. In our opinion, SOP 92-3 applies to foreclosed assets only ***after*** foreclosure. It states that specifically in paragraphs 1, 4, 12, 13, and 15. We would not have considered an accounting pronouncement that is concerned with the accounting only after foreclosure as having any effect on accounting before foreclosure. We note on page 14 of the Draft Report that the AICPA responded as follows to a GAO specific inquiry on this issue: "... the scope of SOP 92-3 is limited to accounting for foreclosed assets after foreclosure and does not extend to accounting for loan loss reserves." We concur with the AICPA's response.

Now on p. 7.

The GSEs indicate they made the accounting change "... based on paragraph A-12 in the appendix of SOP 92-3 which states that 'Immediately after foreclosure, a valuation allowance related to foreclosed assets held for sale should be recognized for estimated costs to sell through a charge to income' [page 14 of the Report]." The GAO indicates that "Although the GSEs' ... [accounting change] is beyond the scope of SOP 92-3, we believe that the GSEs' application of the statement is reasonable and in accordance with GAAP [page 15 and elsewhere in the Report]."

See comment 2.

Now on p. 7.

Page 3

We note that paragraph A-12 is in SOP 92-3's Appendix, "Discussion of Major Comments on the Exposure Draft," and is a response to comments on the Exposure Draft for SOP 92-3 about the definition of fair value. We do not see that the paragraph contains any directions for the accounting **prior** to foreclosure. Further, we would not expect an accounting change to be made based on any comment in an appendix to an accounting pronouncement whose scope explicitly does not encompass the subject of the change.

See comment 3.

Further, apparently the only effect of the change was to reclassify the accrual for selling and other costs from an allowance related to specific problem loans to an overall allowance related to all loans. Although that might have some future effect, it appears to have been a distinction without a difference, so we are unsure of how to evaluate it in practical terms.

See comment 1.

Omission in GAO Draft Report

On November 29, 1993, the Board issued an Exposure Draft of a proposed FASB Statement, *Accounting for the Impairment of Long-Lived Assets*, with a comment deadline of March 15, 1994. Paragraphs 15--18 of the Exposure Draft address "assets to be disposed of," which are to be reported at the lower of cost or fair value less costs to sell. A public hearing is scheduled on the Exposure Draft on May 15--16, 1994 and a final Statement is expected to be issued by the end of 1994 to be effective for financial statements for fiscal years beginning after December 15, 1994.

We believe this Statement would effectively supersede SOP 92-3 since it will be "Level A" GAAP while the SOP is "Level B" GAAP. The GAO Draft Report does not mention the Exposure Draft, perhaps because it is not yet a final Statement. Even though the accounting for foreclosed assets that will be sold is similar under the Exposure Draft and SOP 92-3, we note the Exposure Draft does not contain a paragraph similar to paragraph A-12 of SOP 92-3.

See comment 2.

Specific Comments

Now on p. 1.

Page 2 of the Draft Report states "... accounting guidance issued by the Financial Accounting Standards Board (FASB) in May 1993 that partially conflicts with SOP 92-3 relative to recognizing selling costs." This statement is discussed in detail on

Page 4

Now on pp. 11-12.

pages 21–24 and refers to the issuance of Statement 114, which requires selling costs to be included in measuring impairment of loans that are collateral dependent. We disagree that the requirement to include selling costs in measuring loan impairment prior to foreclosure is inconsistent with a requirement to also include selling costs after foreclosure. Any inconsistency is in the requirement in FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings,* for a creditor to account for receipt of the collateral at foreclosure at the fair value of the collateral. The inconsistency has no effect, however, except at the instant of foreclosure and disappears immediately through application of SOP 92-3. Consider a $120 loan that has collateral with a fair value (as defined in paragraph 13 of Statement 15) of $100 for which selling cost will be $10. The loan is impaired under Statement 114 and will have a loss allowance of $30 recognized ($120 -($100-$10)=$30). At foreclosure, the collateral will be recorded at its fair value of $100, which will produce a $10 gain on foreclosure ($100-($120-$30)=$10) that is immediately offset by the $10 loss from accruing selling cost under SOP 92-3. While it would be neater not to have the offsetting $10 gain and $10 loss at foreclosure, they cancel each other and have no effect. In any event, however, we believe the selling costs that are included in measuring the impairment of a collateral–dependent loan should continue to be included after foreclosure until the collateral is sold, as is currently required by SOP 92-3 and will be required when the SOP is superseded by the final FASB Statement on impairment if that Statement continues the provisions of the Exposure Draft. We point out that the Board saw absolutely no conflict in requiring selling cost to be included in measuring impairment of a collateral–dependent loan under Statement 114 and also requiring those same selling costs to be included as a reduction of fair value for an asset to be sold under the impairment Exposure Draft. In fact, not including the selling cost in both Statement 114 and the Exposure Draft would have been inconsistent and would have increased income and assets either before or after foreclosure in comparison to how Statement 114 and SOP 92-3 would currently apply.

See comment 4.
See comment 5.
See comment 4.
Now on pp. 5-6.
Now on pp. 6-7.

Page 11 of the Draft Report states "We [the GAO] believe the GSEs' position that the language in the appendix of SOP 92-3 required these accounting changes is reasonable ...." Pages 13, 14, and 15 contain similar statements by the GSEs and GAO. As we stated above, we concur with the AICPA that SOP 92-3 is limited to

See comment 3.

accounting for foreclosed assets after foreclosure and does not extend to the subject of these accounting changes.

See comment 1.
Now on p. 8.

Pages 16 and 17 state "All else being equal, the GSEs' future loan loss reserve levels could **theoretically** be lower under the new method than under the old method ... [emphasis added]." Given that the GSEs merely reclassified amounts in allowances for specific loan losses to allowances for general loan losses, we agree that this Report is addressing a **theoretical** concern.

Now on p. 8.

See comment 6.

Now on p. 10.

Page 17, especially footnote 9, suggests that GAAP allows greater latitude in accruing a loss in the range of probable losses than we believe is permitted by FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss.* Pages 20 and 21 contain similar statements about "flexibility in GAAP" in determining losses. We believe paragraph 3 of the Interpretation requires the best estimate in the range of probable losses to be accrued and, if no amount is a better estimate than any other, for the minimum amount in the range to be accrued. The latitude, in our opinion, is in the subjectivity involved in any such estimate of what will actually happen in the future, but we believe GAAP does not allow freely selecting different amounts in the range of probable loss from period to period. If the best estimate in the range changes, then the new best estimate should be used. We believe this is not flexibility in GAAP but rather is subjectivity in the estimation process.

Now on p. 11.
Now on p. 11.
See comments 3 and 4.

Page 21 states "Guidance in SFAS 114 concerning the timing of when selling costs are to be recognized conflicts with SOP 92-3." Page 22 contains a similar statement. We disagree for the reasons stated previously.

Now on pp. 11-12.

Pages 22 through 25 contain several comments about inconsistencies that may result because the scope of Statement 114 excludes large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment, including some but not all residential mortgage loans, and because selling costs will be included in impairment evaluations under Statement 114 but may not be included for impairment evaluations of loans outside its scope. Paragraph 38 of Statement 114 explains why the loans about which the GAO is concerned were excluded from the scope of the Statement and points out that a formula may be used to estimate impairment of these loans in practice. Essentially, we believe the

Page 6

Board did not want to impose all of the estimating and discounting requirements of the Statement on loans for which the results would not be significantly different from current practice. Thus, we view this as essentially a cost/benefit consideration and can only suggest that the GAO would prefer a different "cut" than the one the Board selected. We also point out that entities are permitted to apply Statement 114 to every loan, including those that are excluded from its scope; they are just not required to do so.

See comment 7.

FASB Staff Actions Contemplated

The Draft Report recommends that the AICPA and FASB work together to establish consistent guidance for recognizing selling costs. We believe that is already required in the process the FASB and AICPA have established for the FASB's clearance prior to issuance by the AICPA of exposure drafts and final pronouncements on financial accounting subjects. Nevertheless, we will be alert for opportunities to resolve any conflicts and call them to the Board's attention.

See comment 2.

We believe the FASB itself may have an opportunity to improve consistency in recognizing selling costs by including an amendment to Statement 15 in the final Statement on impairment to record assets received through foreclosure that are to be sold at fair value less cost to sell rather than at fair value. This would eliminate the gain on foreclosure with an immediate offsetting loss that is discussed above for the current application of Statement 114 and SOP 92-3. We have discussed that possible change with Paul Rohan and Carl Bass, project manager and consultant on the impairment project, and they agree it would be an improvement and plan to recommend it to the Board for inclusion in the final Statement. It was perhaps not done in the Exposure Draft because Statement 15 uses fair value for assets given up by a debtor as well as for assets received by a creditor. The amendment would only apply to the latter and then only to assets that will be sold and not to those that will be used by the creditor.

See comment 4.

The following are GAO's comments on the Financial Accounting Standards Board staff's letter dated March 22, 1994.

GAO Comments

1. The GSEs consider their loan loss reserves to be general reserves rather than specific reserves both before and after the accounting changes made to adopt SOP 92-3. The accounting changes affected the types of costs for which the reserves are available. These reserves are now available to cover losses of loan principal only; whereas, before the accounting changes, the reserves were intended to be adequate to also cover selling and other costs. This change in the characterization of the reserve could significantly impact the GSEs' analyses of reserve adequacy, thereby affecting future adjustments to the reserve. Although the GSEs chose to retain these amounts in the reserves upon adoption of SOP 92-3, the GSEs could have reduced the reserves at that time and may be able to reduce loan loss provisions in future periods.

2. See the "Agency Comments and Our Evaluation" section of the report.

3. The stated scope of SOP 92-3 is accounting for foreclosed assets after foreclosure; however, because of the explicit statement in paragraph A-12, SOP 92-3 was applied in a manner that was different than the AICPA's original intent. We discussed the authoritative standing of guidance provided in the body of a statement of position versus guidance provided in an appendix with AICPA staff during the course of our work. The AIPCA staff stated that although the AICPA does not try to set standards in an appendix, an appendix is an integral part of a statement of position.

Each of the GSEs' independent accountants concurred with the application of SOP 92-3. One of these accountants, in a report prepared on the appropriate application of GAAP in the GSE's situation, stated that it would no longer be appropriate under GAAP for the GSE to reserve for such selling costs prior to foreclosure.

4. We agree that there is no inconsistency in the measurement of foreclosed assets between SFAS 114 and the exposure draft and that the provisions of SOP 92-3 relating to the valuation of foreclosed assets would be effectively superseded under the GAAP hierarchy. The only inconsistency for valuing foreclosed assets at foreclosure by creditors would be the guidance under SFAS 15. We support FASB's efforts to amend SFAS 15 to eliminate this inconsistency.

However, due to lack of guidance for when selling costs are to be recognized for loans that are not subject to SFAS 114, inconsistent accounting for selling costs (and loss reserves for impaired loans) may result. Some entities may recognize an expense for these costs as part of loan loss provisions and, thus, include these costs in loan loss reserves. Others may not recognize these costs until the time of foreclosure (under either SOP 92-3 or under the exposure draft, whichever is effective), thus excluding these costs from loan loss provisions and reserves. Accordingly, we believe there will continue to be a need for consistent guidance in this area.

5. In the scenario described by FASB, although the gain and loss offset each other in terms of having no net effect on net income, we do not believe that this accounting treatment is appropriate. Recognizing a gain on foreclosure for the amount of the selling costs does not fairly reflect the substance of the transaction. Separate presentation of the gain on foreclosure and the second expense for selling costs in the income statement would be misleading. Further, this additional recognition of gain and selling costs would be burdensome to implement and may not be appropriate from a cost/benefit standpoint. This approach of recognizing selling costs as part of loan loss provisions, recognizing a gain at foreclosure, and recognizing an expense for selling costs again after foreclosure was considered by the GSEs and rejected.

The asset cycle of a loan—from origination through collection, including any foreclosure and sale of collateral property—should be viewed in its entirety. Selling costs should be recognized only once—either as part of loan loss provisions or immediately after foreclosure. The timing of selling cost recognition should be consistent between loan types regardless of which point in time is chosen.

6. We agree that GAAP requires accrual of the minimum amount in the range of probable losses if no amount is a better estimate than any other and have revised footnote 9 to reflect this requirement more clearly. However, we believe that flexibility exists for determining the range of probable losses. GAAP guidance with regard to determination of overall reserve adequacy is limited and, therefore, the determination of the range of probable losses is overly subjective. Such a large degree of subjectivity may result in unreliable, inconsistent loan loss estimates.

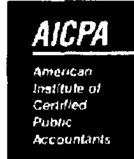
7. Our report focuses on the lack of accounting guidance for selling costs for the loans not covered by SFAS 114 and related potential ramifications.

While the report discusses the limited scope of SFAS 114, we are not criticizing this scope or recommending that FASB amend SFAS 114 to be fully applicable to all loan types. Rather we are recommending that specific guidance on recognition of selling costs which is included in SFAS 114 be extended to all loan types.

We do not disagree with FASB's conclusion that using a formula approach may be appropriate for calculating loan loss reserves for impaired loans that are excluded from the scope of SFAS 114, particularly when considered from a cost/benefit standpoint. However, the measurement of loan impairment should be consistent between loan types regardless of the approach used to estimate the loss amount. For example, there should be consistency as to whether the measurement of impairment should include selling costs and when these costs should be recognized. Inconsistent recognition of selling costs as part of loan loss reserves for different loan types may result from the current lack of consistent accounting guidance.

Comments From the American Institute of Certified Public Accountants

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



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Thomas P. Kelley, CPA
Group Vice President-Professional

March 28, 1994

Mr. Robert W. Gramling
Director, Corporate Financial Audits
U.S. General Accounting Office
Washington, DC 20548

Dear Bob:

You sent a copy of your March 1994 GAO draft report, "Government Sponsored Enterprises: Freddie Mac's and Fannie Mae's Accounting for Costs of Foreclosed Property," to our president, Philip B. Chenok, for comments. Mr. Chenok has asked me to reply, because I have overall staff responsibility for the technical divisions of the AICPA.

The recommendations in your draft report are:

- o AICPA should revise paragraph A-12 of SOP 92-3 by eliminating language which implies that selling costs cannot be recognized as part of loan loss reserves.
- o The FASB and AICPA should work together to establish consistent guidance for recognizing selling costs for loan types not included in the scope of FASB Statement No. 114.

See comment 1.

As the draft report states, I believe that the scope of SOP 92-3 is clearly limited to accounting for foreclosed assets after foreclosure. The SOP was not intended to have any effect on the accounting <u>before</u> foreclosure. The sentence in paragraph A-12 that causes your concern was intended to clarify that the estimated costs to sell <u>foreclosed</u> assets was to be recognized in the income statement as a charge related to those foreclosed assets. It was not intended to address the timing of loan loss expense.

See comment 2.

As noted in the FASB's response to you under date of March 22, the FASB has issued an exposure draft of a proposed FASB Statement, "Accounting for the Impairment of Long-Lived Assets," that, if adopted, "would effectively supersede SOP 92-3." In my opinion, if this happens, there is no need for AICPA action on this matter. If that is not the case, then I will ask the Accounting Standards Executive Committee to consider how the ambiguity that you perceive in paragraph A-12 can be addressed. An AICPA technical information services inquiry and reply in our Technical Practice Aids publication might be an appropriate vehicle.

Mr. Robert W. Gramling
March 28, 1994
Page 2.

See comment 3.

With respect to the second recommendation, I refer you to the FASB's response, which indicates that there is no inconsistency that needs to be dealt with.

If you or your staff would like to discuss our views in more detail, please contact Arleen Rodda, Director, Accounting Standards, in our New York office. Her direct line is 212-596-6159.

Sincerely,

Thomas P. Kelley

cc: Accounting Standards Planning Subcommittee
Philip B. Chenok
J. T. Ball
John Hudson
Arleen Rodda

The following are comments on the AICPA's letter dated March 28, 1994.

GAO Comments

1. See comment 3 in appendix IV.

2. See the "Agency Comments and Our Evaluation" section of this report.

3. See comment 4 in appendix IV.

Major Contributors to This Report

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