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Accounting for installment lending activities of finance companies; Issues paper (1981 June 25)

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AICPA American Institute of Certified Public Accountants
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June 25, 1981

J.T. Ball, CPA
Financial Accounting Standards Board
High Ridge Park
Stamford, CT 06905

Dear J.T.:

Enclosed for consideration by the Financial Accounting Standards Board is the accounting standards division's issues paper on "Accounting for Installment Lending Activities of Finance Companies." The AICPA Finance Companies Guide Committee prepared the paper as part of its project to revise and update the 1973 AICPA Industry Audit Guide, Audits of Finance Companies. The Accounting Standards Executive Committee (AcSEC) reviewed and approved the paper.

The paper addresses issues on

- methods of recognizing revenue, including nonrefundable fees,
- accounting for loan acquisition costs
- accounting for credit losses, and
- recognition of losses for anticipated revenue deficiencies.

It contains advisory conclusions on those issues as approved by both the committee and AcSEC.

The issues addressed are significant and merit early consideration by the Board. The Board's action on those issues will affect its project to extract the specialized accounting and reporting principles and practices for finance companies.

* * * * *

Representatives of the division would be pleased to discuss the issues paper with you or other representatives of the Board at your convenience.

Sincerely,

Dennis R. Beresford
Chairman
Accounting Standards Executive Committee

DRB:j-rg
Enclosure

cc: Securities and Exchange Commission

June 25, 1981

ISSUES PAPER

Accounting for Installment Lending Activities of Finance Companies

Prepared by
the Finance Companies Guide Committee
Accounting Standards Division
American Institute of Certified Public Accountants

830304

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Introduction

1. This paper addresses issues relating to accounting for installment lending[1] as part of a project to revise and update the 1973 AICPA Industry Audit Guide, Audits of Finance Companies (the Guide). The accounting issues need to be addressed primarily because the Guide permits alternative accounting practices, particularly methods of recognizing income, and the combination method of income recognition recommended by the Guide as preferable has not gained wide acceptance. Some of the methods recommended as acceptable in the Guide are not considered acceptable for enterprises in other industries, such as banks, savings and loan associations, and leasing companies, that are engaged in similar lending activities. Many accountants have expressed concern about the propriety of allowing finance companies to use methods that are not generally accepted in other industries and have expressed the view that alternatives in the finance companies industry provide unwarranted pressures for alternatives in accounting for similar activities in other industries.

2. The recommendations in the Guide also need to be reevaluated and revised because of the many changes in the industry since the Guide was issued. Expansion of finance companies into new types of lending activities and expansion of other types of financial institutions into installment lending have caused significant questions to be raised about the desirability of

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[1] Installment lending is a financing activity in which a creditor advances money or provides credit under contracts to borrowers for specified periods in exchange for either discount or interest bearing notes requiring the borrowers to pay the principal amounts advanced plus interest in periodic payments in accordance with the terms of the contracts.

uniform principles of accounting for installment lending. Most observers believe that installment lending activities, even though conducted by various types of financial institutions, have significant common characteristics that should lead to uniform accounting practices for such activity across industry lines. Many also believe that installment lending to consumers should be viewed in the same way as installment lending to businesses and that accounting for the two types of lending activities should be consistent.

3. The objectives of this paper are

a. to consider the extent to which changes in the existing specialized principles and practices for the industry are desirable,

b. to consider changes that will narrow the areas of difference within the industry and between practices within the industry and those that apply to similar activities in other industries to the extent that is desirable, and

c. to consider other changes that are deemed desirable.

Definitions

4. The appendix to this paper contains definitions of terms as they are used in this paper.

Background

5. The principal activities of finance companies include (a) consumer lending, (b) sales financing, and (c) commercial lending. Consumer lending consists principally of making cash loans to consumers. Sales financing consists primarily of financing

consumer purchases of durable goods and services through 1
retail dealers or manufacturers. Some finance companies, 2
called "captive" companies, are owned or controlled by manufac- 3
turers or dealers and are used principally to finance purchases 4
of the products of the controlling manufacturer or dealer. 5
Commercial lending activities include installment lending, 6
factoring, and providing other types of financing to business 7
enterprises generally with collateral such as receivables, 8
inventory, and plant and equipment. With the increasing 9
diversification of finance companies, only a few companies 10
limit their financing activities to a single type of lending. 11
Many finance companies engage in a wide spectrum of lending 12
activities, including not only direct cash loans and sales 13
financing but also through arrangements such as revolving 14
credit, credit card operations, and leasing. 15

Types of Financing Activities 16

6. The types of financing activities of finance companies 17
include 18

a. Direct cash loans - loans by consumer finance 19
companies directly to consumers, often without 20
collateral. State regulatory laws generally 21
prescribe the terms and conditions under 22
which such loans may be made. Direct cash 23
loans may be either interest bearing or 24
discounted. Interest is not included in the 25
face amount of interest bearing loans or in 26
the recorded receivable. Interest is included 27
in the face amount of discount loans and, in 28
current practice, in the recorded amount of such 29

receivables with unearned interest and 1
finance charges deducted from the 2
gross amount for balance sheet presentation. 3
An issue addressed in this paper is whether 4
such receivables should be presented at their 5
gross or net amounts. 6

b. Retail contracts (sales financing) - retail 7
conditional sales contracts or notes often 8
purchased from dealers and manufacturers at 9
a discount but sometimes arranged directly 10
with consumers. 11

c. Commercial loans - loans to business enterprises 12
under various types of commercial agreements. 13
The loans are usually secured by assets of 14
various types including notes and accounts 15
receivable, lease receivables, inventories, 16
and property and equipment. Commercial 17
installment lending (sometimes referred to as 18
time sales financing) includes financing of 19
receivables and commercial equipment. 20

d. Mortgage loans - loans collateralized by real 21
estate. 22

e. Wholesale (floor plan) loans - loans to 23
dealers, distributors, or manufacturers 24
collateralized by their inventory, sometimes 25
referred to as "floor plan" loans. 26

f. Consumer revolving credit and credit cards - 27
contracts with consumers to finance personal 28

lines of credit that are continuously available to the consumers either for the purchase of goods or for cash advances.

g. Factoring - the purchase, with or without recourse, of the trade accounts receivable of an enterprise.

Insurance Activity

7. Finance companies often provide or make available to their debtors, either through insurance company subsidiaries (captives) or through independent companies, three general types of insurance coverage: (a) life insurance on debtors generally intended to pay the outstanding loan balances if the debtors die, (b) health and accident insurance to make payments on loans when the debtors are ill or disabled, and (c) property and casualty insurance on assets accepted as collateral for loans. Finance companies generally receive income from sale of the insurance regardless of whether such insurance is provided by a subsidiary or by an independent company. Income from insurance is often a significant element of the revenue of finance companies.

Operating Environment and Business Risks

8. The operating environment and business risks of finance companies bear on the issues addressed in this paper. Characteristics of the environment and business risks include

a. Loan acquisition costs. Costs are incurred in selling, negotiating, and consummating installment loans.

b. Credit losses. The risk of credit losses, both anticipated and unanticipated, is inherent in

the lending process, and credit losses may be significant. Such losses are generally considered as part of the pricing equation evaluated when decisions are made to grant or reject loans.

c. Rebates. Many discount installment loans are paid off or renewed before maturity. As of the payoff dates, finance companies compute earned interest on the loans in accordance with statutory provisions. The resulting adjustments to unearned income are described in the industry as "rebates" even though funds are not physically returned to debtors.

d. Extension fees. Finance companies charge debtors fees for deferral of scheduled payments on installment loans. The amounts that may be charged are generally controlled by state regulation.

e. Delinquency fees. For discount loans, when debtors do not make their scheduled payments on time, finance companies charge delinquency fees, which may be the equivalent of interest on the delinquent installments for the period of delinquency. The amounts that may be charged are generally controlled by state regulations.

f. Dealer reserves and deferred dealer holdbacks. Finance companies often share with dealers the contract revenue from retail contracts purchased from such dealers. The amounts are

sometimes withheld until certain conditions 1
are met; withheld amounts are commonly 2
referred to as dealer reserves. Deferred 3
dealer holdbacks are amounts withheld from 4
the cash advanced on specific contracts 5
pending collection of the loans or fullfil- 6
ment of other terms, usually for loans with 7
greater than normal risks. Contractual or 8
other arrangements with dealers often provide 9
for credit losses to be charged against 10
dealer reserves or deferred dealer holdbacks. 11

g. Refinancings or renewals. Refinancings or re- 12
newals of accounts represent rewriting of 13
existing loan contracts into new contracts 14
and are an integral part of direct consumer 15
lending. Such refinancings are generally 16
associated with lending additional funds to 17
debtors although they may also be associated 18
with restructuring of loan terms. Loans to 19
businesses are frequently refinanced without 20
additional funds being advanced. 21

h. Interest cost. Finance companies obtain funds 22
for their installment lending activities in the 23
financial markets and are subject to market fluc- 24
tuations in interest rates. 25

i. Government regulation. The activities 26
of finance companies are regulated by 27
state and federal laws. State laws generally 28

require licensing and prescribe certain loan terms, including maximum interest rates, rebate policy, maximum maturities, and types of collateral. Federal laws also regulate several aspects of lending.

Financing

9. Finance companies have traditionally obtained short term funds under lines of credit from banks or from sale of commercial paper. Long term funds are generally obtained from sale of debt securities. Some companies obtain funds under rediscount arrangements with other finance companies. Companies have also obtained funds by selling a portion of their loan portfolios.

Scope

10. This paper addresses accounting issues related to installment lending activities of finance companies in these areas: (a) methods of recognizing revenue, including nonrefundable fees, (b) servicing and related costs, (c) loan acquisition costs, (d) credit losses, and (e) loss recognition for anticipated revenue deficiencies. The issues are addressed primarily in terms of accounting for discount installment loans and receivables, but the concepts and principles discussed also apply to interest bearing loans and other receivables, including commercial loans.

Relevant Accounting Literature

11. The accounting literature relevant to the issues discussed in this paper include the following:

Conceptual Literature

- FASB Statement of Concepts No. 1, Objectives of Financial Reporting by Business Enterprises.
- FASB Statement of Concepts No. 2, Qualitative Characteristics of Accounting Information.

- FASB Statement of Concepts No. 3, *Elements of Financial Statements of Business Enterprises*.
- APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*.

Rule 203 Literature

- ARB No. 43, *Restatement and Revision of Accounting Research Bulletins*.
- APB Opinion No. 21, *Interest on Receivables and Payables*.
- FASB Statement No. 5, *Accounting for Contingencies*.
- FASB Statement No. 13, *Accounting for Leases*.
- FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*.
- FASB Statement No. 17, *Accounting for Leases - Initial Direct Costs*.

AICPA SOPs and Guides

- Statement of Position 75-2, *Accounting Practices of Real Estate Investment Trusts*.
- Statement of Position 76-2, *Accounting for Origination Costs and Loan and Commitment Fees In the Mortgage Banking Industry*.
- AICPA, Industry Audit Guide, *Audits of Finance Companies*.
- AICPA, Industry Audit Guides, *Audits of Stock Life Insurance Companies*.
- AICPA Audit and Accounting Guide, *Audits of Savings and Loan Associations*.
- Exposure draft of proposed AICPA Industry Audit Guide, *Audits of Banks*.

Measuring Interest Income of Finance Companies and Assigning It to Accounting Periods

12. The first significant issue addressed in this paper is: How should revenue from installment lending be measured and assigned to accounting periods? The concern focuses on the desirability of adopting a single method for all finance companies.

13. The Guide recommends the combination method as "preferable" but also designates the effective yield without transfer method (no acquisition factor) and the pro rata with transfer method (acquisition factor consisting of anticipated bad debt losses and direct out of pocket acquisition costs) as acceptable alternatives. In addition, the Guide states that any other method that

> ...consistently produces results that fall between those that would be obtained by using the effective yield without transfer method (minimum balance in deferred finance income at end of period) and the pro rata with transfer method (maximum balance in deferred finance income at end of period) is also acceptable in accounting for income earned on finance receivables generally characterized by balances of $5,000 and under and with initial maturities of less than 61 months. (Page 37)

But the Guide states that effective yield with transfer, pro rata without transfer, and fixed percentage methods are not acceptable and should be discontinued.

Installment Lending Activity

14. Installment lending in its various forms is a major part of the profit directed activities of finance companies. Revenue from such lending is derived from permitting others to use the resources of the enterprise, primarily money, over a period of

time in exchange for payment of interest, the rent for the use of money. The extent to which the enterprise obtains revenue from that activity is a function of the interest rates, the length of the time periods, and the amounts of money provided to others. Revenue, such as interest, from permitting others to use enterprise resources is generally deemed to accrue continuously over time. In paragraph 63 of Statement of Financial Accounting Concepts No. 3, Elements of Financial Statements of Business Enterprises, the FASB defines revenue as

> ...inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or other activities that constitutes the entity's ongoing major or central operations.

The FASB's conceptual framework project on accounting recognition criteria will consider the timing of recognition of revenues. The existing source of guidance is APB Statement No. 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises. Paragraph 148 of APB Statement 4 classifies revenue sources as follows:

> Revenue under present generally accepted accounting principles is derived from three general activities: (a) selling products, (b) rendering services and permitting others to use enterprise resources, which results in interest, rent, royalties, fees, and the like, and (c) disposing of resources other than products--for example, plant and equipment or investments in other entities.

Paragraph 151 of Statement 4 indicates that revenue from permitting others to use enterprise resources is recognized as time passes or as resources are used.

15. A major difficulty in recognizing revenue from installment lending is that enterprises incur costs in the activity in a pattern that is not as clearly related to the passage of time as is the accrual of interest. In their installment lending activities, enterprises incur costs for acquiring, servicing, collecting, and carrying their receivables and for credit losses. The types of costs differ in their timing and in their relationship to the amount of resources provided and the period over which the amounts are provided. Acquisition costs are incurred in the process of acquiring loans; servicing and collecting costs are incurred in relatively level amounts over the contractual terms of loans; carrying or interest costs are incurred as time passes.

16. In this paper, issues related to measuring and assigning revenue to periods are considered independently of the manner in which the enterprise incurs related costs. The relationship of costs to revenue is considered in discussing issues related to assigning costs to periods. That approach is consistent with the general approach in accounting, described in paragraph 147 of APB Statement 4, that revenue for a period is generally determined independently of expenses.

Present Practice

17. The Guide describes three acceptable methods of accounting for finance income as follows:

- <u>Combination method (pages 24 to 25 and 36)</u>

  ...The combination method relates the accounting for finance income to all elements of cost incurred in connection with the loans....

The deferred finance income is broken down into three parts when the loan is recorded: (1) an amount equal to acquisition costs applicable to the loan (direct and indirect costs including an amount (provision for loss) based on anticipated loss experience); (2) an amount equal to anticipated servicing, collection, and other operating costs applicable to the loan; and (3) the cost of borrowed funds and the anticipated profit before income taxes. These parts are then transferred to operations in the same periods in which the related costs are incurred and charged to operations. (If the total amount of these three costs exceeds finance income, the resultant loss is recognized when the loan is made.)

The allocation to the three parts can be on an individual loan basis or in aggregates based on weighted average terms of loans by major types of receivables, as follows:

1. Acquisition costs. An allowance for credit losses is set as a percentage of the amount of the face of the loan, based on current economic conditions and prior loss experience, and is added to the estimated per loan direct and indirect acquisition costs, based on known factors, prior experience, and, in some cases, budgeted expenditures. This portion of deferred finance income is transferred to income in the month the loan is recorded if all such costs are likewise recorded.

2. Servicing, collection, and other operating costs. The estimated cost per loan should be computed for each type of receivable on the basis of budgeted expenditures. This portion of the total deferred finance income is credited to subsequent operations on the pro rata or straight-line method at a standard rate per month (accrual basis) or per payment received (collection basis).

3. Cost of borrowed funds and profit before income taxes. This element usually is the result of deducting from the total deferred finance income at the time of booking the loan the sum of the first two elements. This remaining portion is credited to operations using the effective yield method at a declining amount per month (accrual basis) or per payment received (collection basis).

...the most theoretically desirable objective is to account for all income from lending operations on the combination method...this method is preferable in accounting for income earned on discount-basis finance receivables. However, at present, the practicality of this method has not been sufficiently established, and for this reason the combination method should not now be designated as the only acceptable method.

- <u>Effective yield method (pages 23 and 26)</u>

The effective yield method transfers deferred finance income to operations in declining amounts as the related receivables are collected (collection basis) or on the basis of contract terms (accrual basis). This method, which is generally applied on a sum-of-digits basis, relates earned revenues to the funds invested in the loans....

The effective yield method without transfer (no acquisition factor) is an acceptable alternative to the combination method. The effective yield method is therefore acceptable in accounting for income earned on all discount-basis finance receivables.

- <u>Pro rata with transfer method (pages 23 to 24 and 27)</u>

The pro rata collection method, commonly known as the liquidation method, transfers deferred finance income to operations in amounts related to collections (as opposed to the loan balance)....

On an individual loan basis, the pro rata collection method results in a deferred finance income balance in excess of that under the effective yield method. When compared with the effective yield method, earnings are smaller during the early life of a loan and larger during the later life of the same loan.

The pro rata method with transfer (acquisition factor consisting of anticipated bad debt losses and direct-out-of-pocket-acquisition costs) is also an acceptable alternative to the combination method especially in circumstances in which the cost of borrowed funds is less than servicing, collection, and other operating costs. Accordingly, its use is acceptable in accounting for income earned on discount-basis finance receivables generally characterized by balances of $5,000 and under and with initial maturuties of less than 61 months. Indirect acquisition costs should not be included in the transfer calculated under this

> method. Such costs in most circumstances are difficult to measure and therefore are not subject to estimation within limits which are otherwise acceptable for use of this method. In those circumstances in which these costs can in fact be measured, the combination method should be used.

The Guide evaluates the three methods on the basis of how well they match costs with revenue, and concludes that the combination method achieves the best matching. A survey of the financial statements of 43 large finance companies indicated that 25 use the effective yield method, usually applied on the basis of the Rule of 78s, 8 use a modified Rule of 78s, 7 use the combination method, and 3 use the pro rata method. Three of the 25 companies that use the effective yield method also transferred to income a portion of unearned income to offset loan acquisition costs.

18. The Guide states that finance income on interest bearing direct cash loans has generally been recognized on the interest method, which achieves results comparable to that of the effective yield method on discount loans. However, the Guide states that the three alternative acceptable methods of recognizing finance income on discount loans are also appropriate for interest bearing loans. In addition to the three methods recommended in the Guide, variations of the acceptable methods, such as a modified effective yield approach and a sum of balances outstanding collection method, are sometimes used in practice. Use of diverse methods in practice suggest that some finance companies view differently the relationship between revenue and receipt of payments on loans, and the relationship between revenue and lending activity expense.

19. The combination method and the effective yield method may be applied on the accrual, accrual with suspension, or collection basis. The pro rata method is generally applied on the collection basis. The three bases are as follows:

- Accrual basis

  Interest income is recognized as revenue based on the passage of time without regard to collection.

- Accrual with suspension

  Interest income is recognized as revenue on the accrual basis, but accrual is suspended when payments are delinquent for a period of time.

- Collection basis

  Interest income is recognized as revenue only when payments are received.

All of the three bases are used in practice. The survey of 43 large finance companies indicated that 26 use the collection basis and 17 use the accrual basis.

Basic Concepts and Principles

20. The Guide emphasizes specific methods of recording revenue and expenses rather than basic principles and concepts essential in determining acceptable bases of revenue recognition. The principles and concepts for recognizing revenue inherent in present generally accepted accounting principles include

- Realization. The two general conditions for revenue recognition are the completion of the earning process and the occurrence of an exchange transaction. Paragraph 150 of APB Statement 4 states:

  > P-2. Realization Revenue is generally recognized when both of the following conditions are met:

(1) the earning process is complete or virtually complete, and (2) an exchange has taken place.

- "Matching" costs and revenue. In accounting, revenue is first independently assigned to time periods. Costs are then assigned to time periods as expenses based on (a) a cause and effect relationship with revenue, (b) systematic and rational allocation, or (c) immediate recognition.
- Accrual. The effects of transactions and other events on assets and liabilities are recognized when they occur rather than only when cash is received or paid.
- Substance over form. An enterprise's revenue should be reported in accordance with the economic substance of its activities and not simply by reference to the form of specific transactions.
- Net realizable value. Since revenue represents gross increases in assets (or gross decreases in liabilities), the net realizable value of the asset recorded is a significant factor in measuring revenue.

21. Finance companies make installment loans that are either interest bearing or discount. The type of loan often is a matter of operating choice or the results of compliance with laws. There are no substantive economic differences between the two types of loans. Therefore, a principle of revenue recognition should apply to both types of loans regardless of their form.

Application of the Basic Concepts and Principles

22. Issues relating to revenue recognition should be addressed under generally accepted accounting principles independently of issues relating to expense recognition. Issues relating to the costs that should be associated with the revenue assigned to the periods should then be considered. That approach differs from the approach in the Guide. The approach in this paper is needed in order to provide criteria for evaluating the methods recommended as acceptable in the Guide and other possible methods.

23. Interest income of finance companies from their installment lending accrues over time from providing others with funds. The services provided and the risks accepted by those enterprises are integral parts of that activity. The specific risks and associated services of one type of lending, and the level of risks and the extent of services of that lending activity, do not make the general nature of that type of lending different from the general nature of other types of lending. The response of lenders to variation in such factors usually has been to vary the interest rate charged.

24. Neither the designation of the amounts received nor the form and timing of the payments alter the nature of the process. The process is essentially that the enterprise provides an amount (principal) today and expects to receive a larger amount in the future. The difference between the two amounts is interest, an amount paid in compensation for the use of the enterprise's money for a time, given the attendant risks and circumstances. The

designation of specific amounts as interest, discount, or fees is arbitrary from an accounting perspective and should not alter the analysis of the activity. Paragraph 15 of APB Opinion 21, for example, requires discounts on receivables and payables to be amortized as interest income or expense.

25. The revenue recognition principle requires that interest income be continuously accrued while the enterprises's resources are held and used by others over a period of time. Under that principle, the amounts at which assets of the enterprise in the form of receivables are recorded are gradually increased over the period in which enterprise resources are held and used by others. Collections decrease the receivables However, the timing of the collection of amounts designated principal and amounts designated interest does not affect accrual of interest. Collection is necessarily in fixed payments at designated times over the period of the contract as determined by the terms of the contract. The failure of the debtor to meet the terms of the contract effectively extends the period and, through the operation of the principles of compound interest, increases the amount of the resources provided.

26. The three major determinants in the accrual of interest income are (a) the amount of resources provided to others, (b) the period over which the resources are provided, and (c) the effective (in contrast with the nominal) interest rate. As a general rule, for a given period and at a given effective rate, the amount of interest income should vary directly with the amount of resources provided to others. Also, for a given amount of resources

and a given effective interest rate, the amount of revenue should 1
vary directly with the length of the period over which the 2
resources are provided. Similarly, for a given amount and for a 3
given period, the amount of revenue should vary directly with the 4
effective interest rate. 5

27. The foregoing suggests that interest income from install- 6
ment lending should be based on the interest (actuarial) method. 7
For fixed rate loans, that method requires the determination of 8
an effective rate at the date of the lending transaction based on 9
the amount advanced and the amounts and timing of the expected 10
payments the debtor has agreed to pay. 11

28. The major questions relating to revenue to be addressed in 12
this paper focus on factors in installment lending that may justify13
departure from the general principles underlying the interest 14
method. The income recognition methods recommended in the Guide 15
and the arguments for and against each method are evaluated 16
against that method and the methods used in other industries. 17

Evaluation of the Methods in the Guide 18

29. The three methods recommended as acceptable in the Guide 19
are free alternatives, although the combination method is recom- 20
mended as preferable. Each of the three methods has its propo- 21
nents and critics. Arguments for and against each method are 22
usually presented in the context of whether the method should 23
continue to be an acceptable alternative, not whether the method 24
should be the only acceptable method. This section discusses and 25
evaluates each of the three methods in light of the basic princi- 26
ples and concepts underlying revenue recognition and of the 27

arguments for and against retaining the method as an acceptable 1
alternative. 2

Effective Yield Method (Without Transfer) 3

30. The effective yield method in concept is essentially the 4
interest method of measuring and assigning interest income to 5
periods. However, the method as described in the Guide includes 6
prescribed bases for recognizing costs. It is the method general- 7
ly used to recognize interest income from interest bearing loans. 8
The method is widely used in installment lending for discount 9
receivables, but is often applied on the basis of the Rule of 10
78s. It is generally considered an acceptable alternative for 11
consumer installment lending and is generally the basis used to 12
account for finance income in other areas, for example in the 13
banking industry. As a result, arguments for its exclusion as an 14
acceptable alternative are rarely presented. 15

31. In theory, the method requires the direct application of 16
the effective interest rate to the outstanding balances of 17
receivables, either single accounts or groups of accounts, to 18
measure the interest income for a period. Various mechanical 19
means of applying the method are recognized in the accounting 20
literature and are used in practice. The Rule of 78s (sum-of- 21
the-digits) approach to approximating effective yield is widely 22
used because of its simplicity. The Guide states (pages 36-37): 23

> Because sum-of-digits calculations running over 24
> a long number of years produce results which are 25
> materially different from those obtained by 26
> using other mathematical techniques, its use in 27
> applying the effective yield method should be 28
> limited to contracts and loans with initial 29
> maturities of not more than 84 months. 30

The discussion and the evaluation of the method in this paper are based on its conceptual merits. The mechanical means of applying it are considered only in the arguments for or against it.

32. Arguments for the Effective Yield Method. Arguments for the effective yield method include the following:

- The method recognizes interest income from permitting others to use enterprise resources as interest accrues. The method yields the same results for discount loans as for interest bearing loans. Under the method, reported interest income presents the gross yield for the period on the carrying amount of outstanding receivables.
- Under the method, the carrying amount of loans always equals their net realizable value determined by discounting future receipts at the effective interest rate determined at the date of the loan.
- The method is widely accepted and used in industries involved with installment lending.
- Under the method the income statement reflects a key measurement of performance in the lending industry -- net interest income of the enterprise on the basis of gross interest revenue accrued in relation to gross interest expense incurred for the period. As a result the cost of funds in a period can be compared to the revenue from the use of those funds in that period.

- The method does not depend for its justification on the pattern in which the enterprise incurs costs.
- It is the method required in accounting for receivables under APB Opinion 21 and for lease receivables under FASB Statement No. 13.
- Some argue that the effective yield method as prescribed in the Guide is conservative because it proscribes the early recognition of revenue to offset acquisition costs and credit losses that is required under the combination and pro rata methods.
- Some who emphasize the use of the Rule of 78s computational technique argue that the method is easy and inexpensive to apply and that the use of that technique in some circumstances approximates the interest method.

33. Arguments against the Effective Yield Method. The general criticism of the method is that the pattern by which it recognizes revenue is not coordinated with the pattern in which an enterprise incurs related costs. Specific criticisms of the method include the following:

- Some critics of the method argue that the method results in an inadequate matching of costs with revenue because, under the method as prescribed in the Guide, acquisition costs and the cost of credit losses are charged to expense when a loan is made, before the recognition of

revenue to offset those costs. For that reason, they believe, for example, that the costs of credit losses are reported as expenses in a manner unrelated to revenue and not in accordance with the economics of lending.

- Some critics believe that under the method, unearned revenue on loans approaching maturity tends to be less than future servicing and collection costs. They believe that is increasingly important in an inflationary environment.
- Some believe that the use of the method on the basis of the Rule of 78s as prescribed in the Guide results in recognition of revenue too rapidly as compared with the interest method.

Pro Rata Method with Transfer

34. The pro rata method with transfer is recognized in the Guide as an acceptable method and previously was widely accepted in the consumer finance industry. The method has been used for many years but was more commonly used ten to twenty years ago than today. Although the method can be applied on either the accrual or collection (liquidation) basis, it is almost always applied, as the Guide recommends, on the collection basis. Under the method as recommended by the Guide, an amount of unearned interest on discount basis receivables equal to direct out of pocket acquisition costs and anticipated bad debt losses is transferred to earned interest revenue when loans are recorded.

The remaining unearned interest revenue is recognized under the collection basis in proportion to the liquidation of the loans.

35. The method, whether applied on a collection or accrual basis, is a straight line method that recognizes revenue in level amounts over the terms of the loans. To illustrate, a direct cash loan with a face amount of $1,000 (including finance charges of $200) is repayable in ten equal payments of $100 each. Since the monthly payment represents 10% of the face amount, 10% of the $200 finance charge (ignoring the amount that would be transferred to income when the receivable is recorded to cover direct acquisition costs and anticipated bad debt losses), or $20, would be transferred to income as each payment is collected. If in any month less than the $100 scheduled payment is collected, a corresponding lesser amount of unearned interest is transferred to income (for example, if one half, $50, of a scheduled payment, is collected, only $10 is transferred from unearned interest to income).

36. The method was used widely in the early years of the consumer finance industry for several reasons. There were many small companies in the industry then, and many of the modern computerized and other mechanized recordkeeping techniques did not exist or were not economically feasible. The method is relatively simple to apply and can be applied on either an aggregate account or an account by account basis. The method is conservative because income is recognized only in periods in which collections are made. Some users contend that experience with the method demonstrates that it serves reasonably well in a

period of run off (reduction) in a portfolio in that the ratio of unearned interest to outstanding loans remains relatively constant as the amount of outstanding loans is reduced. They contend that the method reacts relatively promptly to changes in yields and terms of loans so that the method is relatively easy to monitor and control. For those reasons, they contend that lenders to companies in the consumer finance industry prefer the method and encourage companies to use it. Many companies contend that, under normal conditions, the results from using the method approximate the results obtained from using other methods.

37. Arguments for the Pro Rata Method with Transfer. Arguments for the pro rata method with transfer include the following:

- The method is simple and inexpensive to use.
- The method is widely used by small finance companies.
- The use of the method results in a conservative pattern of revenue recognition.
- Under the method, the matching of costs and revenue is improved in that a portion of unearned revenue is recognized when a receivable is recorded in an amount sufficient to offset direct acquisition costs and anticipated bad debt losses.
- The straight line, level pattern of revenue on discount basis receivables in periods following the period in which the receivables are recorded is consistent with the pattern in which the enterprise incurs related servicing and collection costs.

38. <u>Arguments against the Pro Rata Method with Transfer</u>. Arguments against the pro rata method with transfer include the following:

- The method does not recognize interest income as it accrues. After recognition of an initial amount to offset direct acquisition costs and anticipated credit losses, the method recognizes revenue on a straight line, level basis in proportion to collections.
- The pattern in which the enterprise incurs costs determines the amount and timing of revenue recognition.
- Under the method, the carrying amount of discount-basis receivables is not stated on the basis of their net realizable value.
- Under the method, the income statement does not reflect a key measurement of performance -- net interest income of the enterprise on the basis of gross interest revenue accrued in relation to gross interest expense incurred for the period. Therefore, the cost of funds for a period cannot be usefully compared to the revenue from the use of the funds in that period based on information in the income statement.

Combination Method

39. The primary objective of the combination method is to recognize revenue in accordance with the pattern in which the enterprise incurs costs: revenue recognition is a function of costs incurred. Support for the method is based primarily on the

claimed advantage of the relationship that is obtained each period between revenue recognized and costs incurred. The method depends for its application on estimates of the various types of costs associated with installment lending. Those companies using the method contend that it produces information that is useful in the management and control of the activities of the enterprise.

40. Arguments for the Combination Method. Arguments for the combination method include the following:

- Proponents of the method argue that the method matches costs with revenue more closely than other methods. They believe that matching is inherent in the method because it relates the accounting for finance revenue to all elements of cost incurred in making and servicing a loan.
- The application of the method produces information that is useful in evaluating and controlling performance. Management awareness of the costs of making and servicing loans is a particular benefit claimed for the information provided. Management is thus able to identify both marginally profitable and unprofitable accounts.

41. Arguments against the Combination Method. Arguments against the combination method include the following:

- Under the method, revenue on discount receivables is not recognized in the periods in which it accrues. Revenue is recognized instead when the various types of costs identified with the related receivable are incurred and charged to operations as expenses. Revenue is thus a function of the costs incurred instead of the amount of resources provided, the period in which they are provided, and the effective interest rate.
- Under the method, the carrying amount of discount basis receivables differs from their net realizable value. The amount of unearned interest, a contra account to gross receivables, is adjusted based on cost factors. Thus, revenue tends to be recognized too early, because substantial costs are incurred in the period in which a receivable is recorded.
- Under the method, the income statement of an enterprise does not reflect a key measurement of performance -- net interest income of the enterprise on the basis of gross interest revenue accrued in relation to gross interest expense incurred for the period. Users of the financial statements cannot usefully compare the cost of funds for a period to the revenue from the use of the funds in that period.

- A company's legal rebate obligation under the method exceeds the amount of its unearned finance charges.
- Some critics contend that the application of the method requires a complex accounting system that is expensive to install, maintain, monitor, and staff.
- Some critics of the method contend that by allowing early recognition of revenue to offset acquisition costs, broadly defined, and credit losses, the method is not conservative. They believe that acquisition costs are so broadly defined for that method in the Guide that they may include period costs.
- Some critics contend that it is difficult to validate the information from the cost studies necessary to identify and quantify the various types of costs that are required under the method.

Basis of Accumulation

42. The accrual, accrual with suspension, and collection basis of accumulating revenue are used in practice in various combinations with the three methods of income recognition recommended as acceptable in the Guide. The Guide acknowledges accrual as the theoretically correct basis for recording revenue but specifies circumstances in which accrual with suspension or the collection basis should be used on practical grounds. The use of the three bases are generally associated with specific

circumstances. The recommendations in the Guide and the use of the bases in practice raise a second issue in accounting for revenue: <u>Should use of three differing bases continue to be acceptable in the circumstances prescribed in the Guide or should only one be permitted?</u> The circumstances in which each of the bases is used and the rationale for its use are discussed in this section.

<u>Accrual Basis</u>

43. Accrual is a basic feature of financial accounting. Under that feature, the effects of transactions and other events on the assets and liabilities of an enterprise are recognized and reported in the time periods to which they relate rather than only when money is received or paid. Since the profit directed activity of finance companies is permitting others to use enterprise resources, the revenue from that activity should be accrued as time passes in accordance with the terms of the contract without regard to when payments are received. On that basis, the carrying amount of a receivable should be increased as time passes by the amount of interest that accrues. However, questions may arise about the collectibility of the amount recorded and, under those circumstances, the amount of accrued revenue may be deemed to be a contingent asset, which should not be recorded under generally accepted accounting principles. The alternative would be to record the asset and the related revenue and provide for a loss in the same amount, at the same time.

<u>Accrual with Suspension</u>

44. The accrual basis with suspension of accrual when payments on loans are delinquent for a specified period is an approach

that seeks to deal with the dilemma encountered in the application of the accrual basis. The approach recognizes that continuing to accrue revenue when collectibility is in doubt is unrealistic. It represents an application of the modifying convention of conservatism as described in paragraph 169 of APB Statement 4, which states that the modifying conventions, such as the principle of conservatism,

> ...have evolved to deal with some of the most difficult and controversial problem areas in financial accounting. They are applied because rigid adherence to the pervasive measurement principles (1) sometimes produces results that are not considered to be desirable...

However, in Statement of Financial Concepts No. 2, "Qualitative Characteristics of Accounting Information," the FASB rejects that notion of conservatism. In paragraph 95 of that Statement, the Board states:

> Conservatism is a prudent reaction to uncertainty to try to ensure that uncertainties and risks inherent in business situations are adequately considered.

45. The accrual basis with suspension in accounting for interest income is a method used by some large finance companies. The Guide (page 38) supports the method:

> If the accrual basis is used, its application should include appropriate limitations on transfer to operations of finance income on delinquent accounts, and the allowance for credit losses should include an amount to cover loss of income which has been accrued on delinquent accounts for which collection is not reasonably assured.

Many other lenders also use the method in accounting for both interest bearing and discount receivables. The exposure draft of the bank audit guide (page 73) states:

> Many banks have a policy of suspending the accrual of interest income on loans when the payment of interest has become delinquent or collection of the principal has become doubtful. Such action appears prudent and appropriate.

Statement of Position 75-2, Accounting Practices of Real Estate Investment Trusts, paragraphs 30 and 31, also endorses the discontinuance of the accrual of interest when collection is in doubt.

> While some REITs argue that recognition of interest revenue should never be discontinued, it seems clear that there is no sound basis in theory or practice for such a position, since it is well established in accounting that if sufficient doubt or uncertainty exists as to realization, recognition may not be appropriate.
>
> In practice, the recognition of interest revenue has usually been discontinued ..... when the amount of any final loss can be determined with a high degree of precision (e.g., upon final settlement)...

Collection Basis

46. The collection basis (recognition of interest income only when payments are received) is recommended in the Guide and is required by the Guide in some circumstances. It is widely used by finance companies. Some contend that the approach is used in recognition of the high level of risk associated with consumer finance activity.

47. At several places in the Guide, the collection basis is recommended or required. The Guide states (page 24):

> Finance income on interest-bearing direct cash loans has generally been recorded in operations as payments are collected.

The Guide (page 22) discusses the use of the collection basis as follows:

> Theoretically, the deferred finance income is "earned" on the accrual basis in relation to the actual terms of the receivables. However, because of uncertainty

> as to the ultimate realization of income that is inherently present with respect to delinquent accounts, and because of contract extensions and refinancings that are common practice in the industry, income on direct cash loans and small balance retail contracts generally has been recognized only when loan payments are received (collection basis). 1 2 3 4 5 6 7 8

The Guide (page 38) requires use of the collection basis, for example, in the following circumstances: 9 10

> ... Absence of these elements [appropriate limitations on accrual on delinquent accounts] from the accounting system dictates the use of the collection basis whenever the amount of delinquent accounts is material. 11 12 13 14 15

48. The use of the collection basis by finance companies is a response to uncertainty. The absence of its use in other industries raises a question as to its acceptability for finance companies. Some contend that its use is an overly conservative response to uncertainties about the collectibility of receivables. 16 17 18 19 20

Presentation of Discount Loans 21

49. The issue addressed on discount loans is: Should discount loans be recorded at their gross contractual amounts with the unearned interest account shown as an offset or should only the net amounts of funds advanced to the borrower be shown on the face of the balance sheet? There is general agreement (a) that the net amount advanced to the borrower represents the asset arising from the lending transaction and (b) that interest on the loan accrues over the term that the borrower has the use of the money. However, views differ on how the asset should be displayed (presented) in the financial statements. 22 23 24 25 26 27 28 29 30 31

50. Some believe a receivable for the gross amount should be presented because that is the amount the borrower is contractually obligated to pay. They believe presenting an unearned interest account as an offset to that amount presents complete information about the transaction.

51. Others believe that only the net amount should be presented in balance sheets. They believe presentation of discount loans and interest bearing loans should be comparable as the transactions do not differ in economic substance. They point out that it is quite common for actual interest income paid on transactions to vary from precomputed amounts. For instance, delinquency and default fees and extension and deferment fees are paid as contractual terms are modified or otherwise not adhered to. Further, loans are often paid off prior to maturity with amounts of interest being, therefore less than original precomputed amounts. Also, additional amounts are often borrowed causing terms of the original transaction to be modified. Further, the mix of loan portfolios (contractual maturities, average age of individual loans, interest rates, etc.) differs from lender to lender and from time to time. As a result, analysis of unearned discount shown on the face of balance sheets for portfolios of loans usually produces information that is of little or no relevance. They also point out that the traditional practice of presenting unearned interest in balance sheets has been one of the primary reasons why differences in accounting for discount loans versus interest bearing loans has developed. In their view, presenting the asset at the net (principal) amount due avoids this confusion.

Nonrefundable Fees

52. Nonrefundable fees may consist of commitment fees, loan origination fees, points, extension fees, and delinquency fees. Commitment fees, loan origination fees, and points were not historically a significant element in installment lending, and, accordingly, accounting for such fees is not discussed in the Guide. However, some view a portion of the charges included in the face amount of discount loans as origination fees included to offset acquisition costs and the cost of credit losses, as is evident by the rationale supporting the combination and pro rata methods of income recognition. Also, commitment fees and points are significant in mortgage lending, an activity that is becoming increasingly significant to the finance companies. In their installment lending, finance companies charge extension and delinquency fees for delays in scheduled payments on loans; accounting for those types of fees is discussed in the Guide.

53. The method recommended in the Guide for accounting for extension fees is governed by the method a company follows in accounting for deferred finance income. Under the Guide, extension fees are credited to operations if the collection basis is used, to compensate for deferral to future periods of deferred finance income that would otherwise have been recognized; they are credited to deferred finance income under the accrual basis. The Guide requires delinquency fees to be credited to operations under both the collection and accrual bases of income recognition.

54. The accounting issues relating to nonrefundable fees are

a. How should finance companies account for nonrefundable fees, such as commitment fees, points, and loan origination fees, charged at the inception of a loan?

b. How should finance companies account for non-refundable fees charged for delays in payments, such as extension and delinquency fees?

55. Some believe that nonrefundable fees charged at the inception of a loan represent charges for specific services rendered and should be recognized as revenue when received to the extent costs are incurred in providing those services. That view underlies the positions on commitment fees and loan origination fees in the savings and loan association audit guide, AICPA Statement of Position 76-2, and the exposure draft of the proposed bank audit guide.

56. Others believe that, since the basic activity of finance companies is permitting others to use enterprise resources, the fees charged are simply an element of interest and that the realization principle for recognizing interest income should apply. They support the view that neither the designation as fees nor the form and timing of payments should alter the nature of the earning process. They argue, for example, that amounts charged as points on mortgage loans represent yield adjustments.

57. Extension and delinquency fees are generally viewed as additional interest charges for payment delays. However, some believe that a part of such fees represent charges to offset additional collection costs.

Rebates

58. Rebates represent cancellations of portions of the initially calculated finance charges on discount loans when the entire balance due on an installment account is paid ahead of

schedule. The consumer finance laws of most states prescribe the bases for determining rebates. The accounting issue relating to rebates is: Should the amount of unearned revenue on discount loans be limited by the amount of the legal rebate obligation?

59. Some believe that the obligation to rebate a portion of the finance charges on discount loans represents a liability of a finance company and that an enterprise should not adopt a method of income recognition under which the rebate obligation at any time a loan is outstanding would exceed the amount of unearned finance charges.

60. Others believe that the rebate obligation should not be a limiting factor in the determination of the method of income recognition adopted. They believe that accounting is based on the going concern assumption and that, under that assumption, income should be recognized on the basis of the economics of the transactions. They also point out that the term "refund liability" is really a misnomer. The refund liability is merely an adjustment of the initially calculated (precomputed) interest. It is based on the terms of the loans as stated in the contract and assumes liquidation in accordance with the stated terms of the contract. The interest that will ultimately be collected will generally be more or less than the precomputed amount, since the cash stream to liquidate the loan often differs from initial contractual terms.

Accounting for Costs

61. Under the Guide, the costs associated with installment lending are classified into four types:

- servicing, collection, and other operating costs,
- interest costs (costs of borrowed funds),
- acquisition costs, and
- credit losses (bad debts).

The finance industry classification is based on the patterns in which the costs are incurred in relation to revenue. Acquisition costs are classified into direct and indirect cost categories, and, under some circumstances, anticipated credit losses are viewed as acquisition costs. Diverse methods of associating acquisition costs and the costs of anticipated credit losses are permitted by the literature and followed in practice. Servicing, collection, and other operating costs and interest costs are generally treated as period costs. However, revenue is recognized under the combination method in accordance with the pattern of those anticipated costs.

Servicing and Related Costs

62. The types of expenditures accounted for as servicing and related costs by a finance company normally include the company's outlay of resources (primarily employee costs) for administration, maintenance, and collection of loans. Generally, servicing costs are considered to be the types of costs a finance company incurs in the administrative handling of its entire loan portfolio, in contrast with expenses incurred on each individual loan. Costs related to the opening and closing of branch offices are also included in this category, as are the amounts related to finance companies' electronic data processing.

63. The costs a financial institution incurs in servicing its loans is a subject that has not been widely discussed in accounting literature, probably because accounting for those costs has traditionally not presented the conceptual "expense vs. deferral" problems such as are posed by loan origination costs. Statement of Position 76-2, Accounting for Origination Costs and Loan & Commitment Fees In The Mortgage Banking Industry, contains a description of servicing costs, which states:

> Loan servicing includes, among other functions, collecting monthly mortgagor payments; forwarding payments and related accounting reports to investors; collecting escrow deposits for the payments of mortgagor property taxes and insurance and paying taxes and insurance from escrow funds when due. (paragraph 6)

64. Although some finance companies report seasonal changes in servicing costs related to corresponding swings in their outstanding loans, servicing, collection, and other operating costs are normally incurred in approximately level amounts and do not fluctuate materially as a result of increases or decreases in the volume of loans. Recognition of such costs as charges to operation in the period incurred is the norm for finance companies as well as for many other types of financial institutions with similar costs.

65. Under the combination method of income recognition, estimated servicing and related costs are considered an element of deferred finance income when a loan is recorded. The estimated amount of servicing and related costs per loan is computed for each type of loan on the basis of budgeted expenditures. That

amount of deferred finance income is credited to subsequent 1
operations on a pro rata or straight line basis, at a standard 2
rate per month (accrual basis) or as payments are received 3
(collection basis). 4

66. The only issue pertaining to servicing and related costs 5
relates to the use of the combination method and is not separately 6
addressed. Some believe that a portion of revenue equal to antici- 7
pated servicing and related costs should be recognized on a level 8
basis to offset anticipated servicing and related costs as under 9
the combination method. Proponents of the combination method 10
believe that, if the combination approach is not followed, 11
revenue and servicing costs are mismatched since those costs 12
are level (or increasing in an inflationary environment), whereas 13
income, if recognized on the effective yield method, is declining. 14
They believe that an additional reason is that if the combination 15
approach is not followed, revenue will be insufficient to 16
cover costs when the portfolio of loans declines. Others believe 17
that all servicing and related costs are period costs and that 18
revenue for the period should be determined independently of them. 19
They do not accept the rationale underlying the combination method. 20

Interest Cost 21

67. Interest cost is a significant factor in the operations of 22
a finance company. The finance business can be described as an 23
industry that obtains (borrows) funds at wholesale and sells 24
(lends) those funds at retail. The debt structure of finance 25
companies ordinarily includes both senior and subordinated debt. 26
Most companies also have lines of credit with banks, which 27

usually require compensating balances, a fee, or both, and some companies also sell commercial paper. 1 2

68. All finance companies account for interest expense as a period cost. However, companies that use the "combination method" of recognizing income use a "standard cost" of money in determining whether to recognize a loss on a loan, but the combination method of income recognition has no effect on the recognition of interest cost as expense. Therefore, no issues pertaining to interest cost are raised. 3 4 5 6 7 8 9

Accounting for Loan Acquisition Costs 10

69. The accounting issues on loan acquisition costs considered in this paper are: 11 12

a. Should loan acquisition costs be charged to expense as incurred or deferred and amortized over the life of the loan? 13 14 15

b. If loan acquisition costs are required to be charged to expense as incurred, should a portion of unearned income equal to the amount of acquisition costs be recognized as income in the same period? 16 17 18 19 20

c. Should nonrefundable fees, such as loan origination fees, be accounted for as offsets to loan acquisition costs? 21 22 23

d. If loan acquisition costs are to be accounted for differently from other costs, what costs should be included? 24 25 26

70. An enterprise engaged in installment lending incurs costs before loans are made, whereas interest income from the loans accrues over their terms. The issues addressed deal with the timing of the recognition of acquisition costs as expenses as well as the identification of costs that should be treated as acquisition costs. Factors underlying the issues addressed are:

a. A fundamental objective in accounting for installment loans is to match costs with related revenue.

b. The deferral and amortization of acquisition costs and the recognition of unearned income to offset such costs are alternative procedures to accomplish the same objective.

c. Although industry accounting rules and practices differ, installment consumer lending by finance companies differs little in substance from installment lending by other financial institutions.

d. The types of acquisition costs incurred by industries or by enterprises may differ, but there are significant cost elements common to all industries and enterprises engaged in installment lending.

Present Practice

71. A wide diversity of practice in identifying and accounting for acquisition costs has developed in industries that make

installment loans, and the accounting literature has permitted or required diverse practices. Also, the accounting literature in related areas has special accounting rules for costs similar to loan acquisition costs.

72. Finance companies. The Guide calls for special treatment of loan acquisition costs under each of the acceptable methods of income recognition.

- Combination method. Acquisition costs are charged to expense as incurred and an equal amount of unearned income is transferred to income in the same period. Acquisition costs are defined as anticipated credit losses and the estimated direct and indirect costs of making loans.
- Pro rata method. The treatment of acquisition costs is the same as under the combination method, except that such costs are limited to anticipated credit losses and direct-out-of-pocket costs. Indirect acquisition costs are not included because "such costs in most instances are difficult to measure and therefore are not subject to estimation within limits acceptable for use" of the pro rata method. The Guide recommends the combination method in circumstances in which indirect acquisition costs can be reasonably estimated.

- <u>Effective yield method</u>. Acquisition costs are not distinguished from other costs and are charged to expense when incurred without recognizing unearned income to offset the costs. 1 2 3 4

73. The Guide defines direct acquisition costs as "directly identifiable out-of-pocket acquisition costs (such as filing fees and costs of credit investigation) paid to third parties." It defines indirect acquisition costs to "include allocable portions of salary costs, advertising and other operating expenses which are related to acquisition activities, including in-house costs of credit investigation." 5 6 7 8 9 10 11

74. <u>Banks</u>. The December 4, 1980 exposure draft of the audit guide, "Audits of Banks," does not provide for special treatment of loan acquisition costs except when loan origination fees or commitment fees are received as reimbursement for such costs. Origination fees may be recognized as income at the time of closing a loan to the extent that they are reimbursement for the cost of the underwriting process (obtaining appraisals, processing loan applications, reviewing legal title to real estate, and other procedures). Immediate recognition of income from commitment fees is limited to the amount of reasonably determinable direct costs incurred in making the commitment. Direct costs include costs such as salaries and fringe benefits of lending officers, and other costs directly related to making the commitment. 12 13 14 15 16 17 18 19 20 21 22 23 24 25

75. <u>Mortgage banking</u>. AICPA Statment of Position 76-2, <u>Accounting for Origination Costs and Loan and Commitment Fees in</u> 26 27

the Mortgage Banking Industry, defines origination costs to include (1) direct personnel expenses, (2) other direct costs, and (3) general and administrative expenses such as occupancy and equipment rental. The SOP concludes that origination costs should not be deferred but permits loan origination fees to be recognized as income when collected since the related costs are charged to expense as incurred.

76. Savings and loan associations. The AICPA Industry Audit Guide, Audits of Saving and Loan Associations, allows acquisition costs to be offset by commitment and origination fees. The guide describes such costs as "direct underwriting costs" which are defined to

> ...include the costs of salaries and related fringe benefits of loan underwriting personnel, appraisals, site inspections, processing, and other expenses incurred in excess of those recoverable as fees for originating loans in-house ... (page 71)

> ...the normal origination fee is essentially a reimbursement for the costs of the underwriting process of obtaining appraisals, processing the loan application, reviewing legal title to the real estate, and other procedures. Origination fees to the extent they are reimbursement for such costs should be recognized in income at the time the loans are made, since the costs of the services are normally charged to expense as incurred. Any fees in excess of that amount should be accounted for as an adjustment of yield...(page 74)

77. Credit unions. The proposed audit and accounting guide for credit unions would permit loan origination fees to be recognized in income immediately to the extent that they are a reimbursement for loan origination costs. The March 31, 1981 draft of the proposed guide (pages 6-12 to 6-13) states:

> Loan origination costs include all costs directly associated with loan origination, such as, salaries and related fringe benefits identifiable with the loan origination function, EDP loan set-up charges, loan file document costs, and appraisal and site inspection costs. Loan origination costs may also include certain identifiable general and administrative costs associated with loan origination, such as allocable occupancy and equipment costs (for example, depreciation, property taxes, and insurance), and telephone, postage, and advertising costs.

78. *Direct financing leases*. Under FASB Statement No. 13, *Accounting for Leases*, lessors are required to charge "initial direct costs" against income as incurred and to recognize a portion of the unearned income equal to the initial direct costs as income in the same period. FASB Statement No. 17, *Accounting for Leases--Initial Direct Costs*, defines initial direct costs as:

> those costs incurred by the lessor. . . directly associated with negotiating and consummating *completed leasing transactions*. Those costs include, but are not necessarily limited to, commissions, legal fees, costs of credit investigations, and costs of preparing and processing documents for *new leases acquired*. In addition, that portion of sales persons' compensation, other than commissions, and the compensation of other employees that is applicable to the time spent in the activities described above with respect to *completed* leasing transactions shall also be included in initial direct costs. That portion of sales persons' compensation and the compensation of other employees that is applicable to the time spent in negotiating leases that are not consummated shall *not be included in initial direct costs*. No *portion of supervisory and administrative* expense or other indirect expense, such as rent and facilities costs shall be included in initial direct costs. (Emphasis added.)

This definition of initial direct costs is somewhat narrower than the definition of loan acquisition costs and is limited to costs applicable <u>to completed</u> transactions.

79. Messrs. Gellein and Kirk of the FASB dissented to Statement No. 17 because they believe that there is now a lack of uniformity among industries in the accounting for acquisition costs. Among other things, the dissent states:

> Messrs. Gellein and Kirk object to piecemeal consideration of the accounting for such acquisition costs, particularly if the result is to establish a method followed by few, if any, companies, without offering the rationale for the method...Messrs. Gellein and Kirk believe that the revenue of a period is not determined by the expenses of the period and therefore they can accept a transfer to revenue of an amount equivalent to certain expenses of the period only as an expedient, pending further consideration of the accounting for business acquisition costs.

80. <u>Insurance industry</u>. Although insurance sales are generally unrelated to lending, insurance companies incur a significant amount of acquisition costs when they sell insurance, with the income being recognized over the period of coverage. Deferrable acquisition expenses are limited by the AICPA Industry Audit Guide, <u>Audits of Stock Life Insurance Companies</u>, to "only those expenses which both vary with, and are primarily related to, the production of new business."

81. <u>Summary of practice</u>. Practice varies both within the finance companies industry and between that industry and other industries. Acquisition costs are generally charged to expense as incurred. However, in some circumstances, amounts are sometimes recognized as revenue to offset such costs, particularly

when nonrefundable fees are associated with such costs. The table on the following page summarizes present practice in accounting for acquisition costs.

Views on Issues

82. Although some precedent exists for the deferral of acquisition costs, the authoritative literature provides little guidance as to the approach that should be taken. Some believe that matching costs with revenues is an important objective of accounting. They believe that if the lending process leads to costs that would not have been incurred had the loan not been made, the costs should not be charged off as incurred. They agree that the practice of deferring the costs leads to recognition of a soft asset, which may not appear to be conservative, but they argue that not doing so often means that an enterprise reports improved results in a period when loan balances are declining, a result that they contend is even less conservative.

83. Views vary on the types of costs that should be considered acquisition costs. Some believe that all costs associated with making a loan should be included, both direct out-of-pocket costs and indirect costs such as salaries, advertising, and corporate overhead. Others believe that if costs are to be deferred, they should be limited to "out-of-pocket" costs directly associated with the production of loans.

84. Should acquisition costs be charged to expense as incurred or deferred and amortized over the life of the loan? Some believe that acquisition costs should be charged to expense as incurred. They believe that acquisition costs represent an ordinary and necessary expense of doing business and should not

TABLE

ACCOUNTING FOR LOAN ACQUISITION COSTS

Summary of Present Practices

This table summarizes present practices in accounting for loan acquisition costs. In all cases, such costs are charged to expense as incurred. However, the predominant practice, particularly in circumstances in which specific fees are associated with such costs, is to recognize revenue, sometimes limited to the amount of fees, to offset such costs. Some believe that recognizing revenue to offset loan acquisition costs in the period incurred accomplishes the same results as deferral and amortization of such costs.

	Revenue Recognized to Offset		
	Direct Loan Acquisition Costs	Indirect Loan Acquisition Costs	Amount of Revenue Recognized Limited to Fees Received
Finance Companies:			
Combination Method	Yes	Yes	No
Pro rata method	Yes	No	No
Effective yield method	No	No	No
Banks	Yes	Yes	Yes
Direct finance leasing (limited to costs of completed transactions)	Yes	Yes	No
Savings and Loan Associations	Yes	Yes	Yes
Mortgage banking	Yes	Yes	Yes
Credit Unions	Yes	Yes	Yes

be accorded special treatment. They disagree with the procedures 1
used in the combination and pro rata methods and with proposals 2
to defer and amortize such costs. They believe that, although 3
acquisition costs can vary to an extent with volume, the correla- 4
tion is not direct. Many acquisition costs are indirectly 5
related to ongoing functions for which a specific relationship 6
to revenues is difficult to establish, except perhaps through the 7
use of arbitrary allocations. They believe that under current 8
accounting recognition criteria, expenses that cannot be related 9
directly to particular revenues are either recognized as incurred 10
or allocated among periods in a systematic and rational 11
manner. They also argue that deferred acquisition costs do not 12
meet the definition of assets in the FASB's Statement of Financial 13
Concepts No. 3, _Elements of Financial Statements of Business 14
Enterprises_. In their view, cost accounting estimation and 15
allocation procedures are not capable of producing a "systematic 16
and rational" allocation that is superior to the results of 17
charging acquisition costs to expense as incurred. 18

85. Others believe that acquisition costs should be distin- 19
guished from other costs of doing business and should be deferred 20
and amortized over the life of loans in relation to the recogni- 21
tion of revenue. They believe that acquisition costs are directly 22
related to revenue from loans and deferral and amortization is 23
necessary to match costs with related revenue. They also reject 24
the procedure followed under the combination and pro rata methods 25
of transferring an amount from unearned revenue to income to 26
offset the amount of acquisition costs charged to expense. They 27

argue that the amount of expenses should not determine the amount 1
of revenue recognized for a period. 2

86. Those who support the combination and pro rata methods 3
believe that acquisition costs should be charged to expense as 4
incurred and should be offset by a transfer of unearned income to 5
income. They point to the accounting literature, particularly 6
FASB Statement Nos. 13 and 17 and the literature dealing with 7
nonrefundable fees, to support their view. 8

87. Some believe that the transfer of unearned interest 9
revenue to income to offset loan acquisition costs or the recogni- 10
tion of designated nonrefundable fees to offset such costs is 11
essentially the same as the deferral and amortization of such 12
costs. Others argue that revenue of a period should not be 13
determined by the expenses of the period. However, proponents of 14
deferral and amortization believe that practice can be supported 15
on the basis of the matching concept, whereas the recognition of 16
revenue to offset such costs leads to an appearance of a lack of 17
conservatism. They believe that deferral and amortization is a 18
conceptually better approach under the present framework of 19
accounting. 20

88. <u>What costs should be treated as acquisition costs</u>? If 21
acquisition costs are accorded special treatment, the components 22
of acquisition costs need to be carefully specified. Some 23
believe that acquisition costs should be defined as under the 24
combination method to include direct and indirect costs asso- 25
ciated with making a loan as well as the estimated costs of 26
credit losses. Some believe that the cost of credit losses 27
should be excluded from acquisition costs. 28

89. Others believe that acquisition costs should be defined in a manner similar to the definition of initial direct costs in FASB Statement No. 17 without the limitation to completed transactions. They propose a definition as follows:

> Acquisition costs include costs incurred that are directly associated with negotiating and consummating loans, including but not necessarily limited to commissions, legal fees, costs of credit investigation, and costs of preparing and processing loan documents. In addition, they include the portion of employees' compensation applicable to activities directly associated with negotiating and consummating loans.

They believe that a limitation to completed transactions is inappropriate for installment lending because of the large volume of loans processed. In their view, leasing, in contrast, generally involves transactions that are for more substantial amounts and are generally processed individually.

90. Others would define acquisition costs to include only incremental costs or costs associated with making loans that are significant and unusual and to exclude the ordinary and recurring costs of doing business.

91. Views on whether acquisition costs should be deferred and amortized (or alternatively offset by earned revenue) vary depending on the definition of acquisition costs. Some support deferral of all costs related to loan acquisition; others support deferral of only significant amounts paid to third parties.

92. Should nonrefundable fees be accounted for as offsets to acquisition costs? The accounting literature tends to view

acquisition costs differently depending on whether nonrefundable 1
fees, such as loan origination or commitment fees, are 2
associated with loan transactions. The literature generally 3
permits recognition of such fees to offset amounts variously 4
identified as acquisition costs. Some agree with that approach. 5
Others disagree. They believe that nonrefundable fees represent 6
interest income yield adjustments and should be reported as such 7
over the life of the loans. 8

Accounting for the Cost of Credit Losses 9

93. Credit losses are inherent in installment lending, and 10
estimating, timing, and recording such losses affect the presenta- 11
tion of financial statements. The issues relating to credit 12
losses addressed in this paper include: 13

a. How should the provision for credit losses 14
be estimated? 15

b. Should the provision for credit losses be 16
recognized as an expense when loans are 17
made or should it be deferred and amortized 18
to expense over the terms of loans in 19
relation to the related interest income? 20

c. Is deferral and amortization of the provision 21
for credit losses consistent with the 22
concept of recording loan receivables at 23
their net realizable value? 24

Present Practice 25

94. FASB Statement No. 5, Accounting for Contingencies, and 26
the amendment to and interpretation of that Statement represent 27
the present authoritative literature underlying present practice 28

in accounting for credit losses in all industries. Appendix A of that Statement (paragraph 22) states:

> Losses from uncollectible receivables shall be accrued when both conditions in paragraph 8 are met. Those conditions may be considered in relation to individual receivables or in relation to groups of similar types of receivables. If the conditions are met, accrual shall be made even though the particular receivables that are uncollectible may not be identifiable.

Paragraph 8 of that Statement requires that

> An estimated loss from a loss contingency (as defined in paragraph 1) shall be accrued by a charge to income if <u>both</u> of the following conditions are met:
>
> a) Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
>
> b) The amount of loss can be reasonably estimated.

95. For the finance company industry, the Guide (page 44) discusses two segments of the provision for loan losses:

> (a) that portion needed to absorb losses which are anticipated based on the type of receivable, loss experience, etc. (provision for these losses should be made when the loans are made or when the receivables are otherwise acquired); and

> (b) that portion related to losses which occur because of a change in economic conditions, other unexpected factors, or adjustments to original estimates after the time of making the loan (provision for these should be made as soon as the change becomes evident).

The portion of the estimate described in (a) above is generally computed as a percentage (based on the enterprise's experience) of the outstanding loans and is referred to in this paper as the historical credit loss provision. Under the three methods of income recognition in the Guide (page 47),

> Provision for losses (both the amount provided at acquisition to cover anticipated losses and amounts subsequently provided to cover unanticipated losses) should appear in the income statement as a separate expense item.

However, since the practice of charging to expense the historical loss provision relating to finance receivables when loans were made was deemed to produce a "mismatching" of costs with related interest income, which is recognized over the life of loans, the Guide permits companies that use the combination and pro rata (with transfer) methods of accounting to transfer a portion of unearned interest income to income when the historical credit loss provision is made. Such transfers are not permitted under the effective yield method of accounting. That practice was proscribed for that method because of concern that the amount of unearned income that remained after the transfer for credit losses and acquisition costs might be insufficient to cover the remaining costs applicable to the loans.

Views on Issues 1

96. Views vary on the issues raised. Some believe credit 2
losses should be estimated based on an enterprise's experience 3
and recognized as an expense when loans are made. Some agree 4
with that basis of estimating credit losses but would defer the 5
charge and amortize the amount over the life of the loan or over 6
a shorter period. Others agree with the basis of estimating 7
credit losses and that the amount should be recorded as an 8
expense but would transfer a portion of unearned income to offset 9
the expense. Others believe that the amount cannot be reasonably 10
estimated when loans are made but that an allowance should be 11
provided by systematic charges to expense over the life of the 12
loan or over a shorter period. 13

97. How should the provision for credit losses be estimated? 14
It is reasonably clear that FASB Statement No. 5 requires that 15
the allowance for losses should be sufficient to cover known or 16
identifiable losses as well as unidentified but anticipated 17
losses. FASB Statement No. 5 leads many to believe that credit 18
losses should be recorded when it becomes probable that the 19
company will be unable to collect all amounts due and the amount 20
of the loss can be reasonably estimated based on "the experience 21
of the enterprise, information about the ability of the individual 22
debtors to pay, and appraisal of the receivables in the light of 23
the current environment." 24

98. Some believe that credit losses on consumer installment 25
lending are a predictable cost of doing business and therefore 26
differ in a qualitative sense from credit losses in commercial 27
installment lending. Credit losses on commercial installment 28
loans can and do vary widely from period to period; whereas 29

credit losses incurred on a given type of consumer loan in a given market are reasonably predictable over time. Periods of economic recession tend to push credit losses towards the upper end of expected loss ranges. However, given a portfolio with consistent characteristics, such as the average amount outstanding as well as the mix and quality, credit losses on consumer installment loans generally do not vary widely from year to year. For that reason many believe credit losses can be reasonably estimated on the basis of the enterprise's experience when loans are made.

99. Those who believe credit losses should be estimated on the basis of the enterprise's loss experience argue that the "reasonably estimable" criterion of FASB Statement No. 5 is met when loans are made. They believe that since at least a portion of credit losses can be determined and evaluated statistically based on the volume of loans made, loans outstanding, and loss experience, occurence of the loss is probable when the loans are made.

100. Some argue that percentages based on enterprise's experience measure only the total loss in a portfolio of loans and cannot be related to particular loans. They believe that recognizing credit losses as expenses when loans are made, in effect, requires the carrying amount of the loan receivable to be written down immediately even though no event has occurred to make probable the inability to fully recover the carrying amount of the asset. They believe a loss should not be recorded when no loss has been incurred. They believe instead that a provision should be made over the revenue period to establish the required

percentage as a portfolio of loans is developed. They believe that installment loan receivables differ from the typical trade receivables of commercial enterprises. They argue that for trade receivables, all eventual losses should be recognized when receivables are recorded, because that is when the earnings process is completed and the related sales revenue and profit are recognized; in contrast, revenue is not recognized when receivables from installment lending are recorded.

101. Some believe, however, that FASB Statement No. 5 requires only a periodic evaluation of a portfolio of loan receivables to determine their collectibility on the basis of the criteria in that Statement. They contend that applying a percentage developed from an enterprise's experience to loans as they are made, thus relating the amount to the volume of loans, is merely a convenient computational device for maintaining the allowance at the level required by the criteria in FASB Statement No. 5. In their view, arguments about whether a loss is incurred when a loan is made are not persuasive because they believe that whether the allowance is established by applying a percentage to each loan when made or from an evaluation of outstanding loans, the objective is the same and the amount of the allowance should theoretically be the same if the percentage used has been realistically developed based on the enterprise's experience.

102. Should the provision for credit losses be recognized as an expense when loans are made or should it be deferred and amortized to expense over the terms of loans in relation to the related interest income? Some believe that the historical portion of the provision for credit losses should be recognized

as an expense when loans are made. They argue that FASB Statement No. 5 requires such a provision because they believe that the criteria in that Statement for measuring loans are met when loans are made. They believe that recognizing credit losses as expenses when loans are made is necessary to measure the extent to which the carrying amount of an installment loan receivable cannot be recovered and the valuation allowance is needed to present installment loan receivables at their net realizable value. They point out that credit rating agencies and credit grantors believe that credit losses should be provided for in that way.

103. In their view, recording the provision for credit losses as a deferred charge or reducing unearned income to offset the provision states receivables at an amount higher than their net realizable value. They point out that references to credit losses in the accounting literature focus almost exclusively on the adequacy of the ending allowance in relation to the losses expected to result from the portfolio, not the provision charged to operating expenses. Therefore, they contend that the pervasiveness of the net realizable value concept in the literature precludes accounting for credit losses by either deferral and amortization or recognizing interest income to offset the cost.

104. They believe that FASB Statement No. 5 does not contemplate deferral and amortization of the cost of credit losses or the recognition of income to offset such losses. Although they acknowledge that matching is not achieved, they believe that the provision for credit losses should be accounted for as a period cost.

105. Others believe that the risk of credit losses is inherent in all lending transactions and that the cost of credit losses is appropriately associated with interest income from related loans. They contend that interest rates clearly vary according to the probability of loss on a loan or category of loans and thus the cost of credit losses should properly be matched with interest income from related loans. They contend that the operating results of a rapidly growing (or rapidly declining) enterprise are misstated if credit losses are not matched with related interest income and thus the users of financial statements are mislead

106. Proponents of deferral and amortization reject the practice of recognizing a portion of interest income to offset the cost of credit losses. They believe that the incurrence of a cost does not trigger the recognition of revenue under GAAP. Further, they believe that the existence of the deferred charge on the balance sheet allows users of financial statements to determine the magnitude of the costs that will have to be recognized in the future.

107. In contrast, proponents of the practice of recognizing a portion of interest income to offset the cost of credit losses point out that FASB Statement No. 13, Accounting for Leases, sets a precedent for that practice; it now requires that practice for initial direct costs of direct financing leases. They believe that the cost of credit losses is covered by expected interest income and that it is proper to offset that cost by recognizing the related income.

108. Is deferral and amortization of the provision for credit losses consistent with the concept of recording loan receivables

at their net realizable value? Proponents of recognizing the historical provision for credit losses as an expense when loans are made believe that the deferral and amortization of the cost of credit losses is not consistent with the concept of net realizable value. They point to the statement in Appendix A to FASB Statement No. 5 relating to carrying receivables in the financial statements at net realizable value. They define net realizable value as

> the contractual amounts expected to be collected in the future discounted by the effective interest rate implicit in the contract at its inception, less a provision for anticipated credit losses.

They believe that deferral and amortization is inappropriate because the amount of anticipated credit losses does not meet the definition of an asset in Statement of Financial Concepts No. 3. They argue that an anticipated loss that meets the criteria of FASB Statement No. 5 cannot be transformed into a probable future economic benefit to the enterprise despite its aknowledged relationship to future interest income.

109. Proponents of the deferral and amortization of the historical portion of the provision for credit losses believe that practice is consistent with the concept of net realizable value. In their view, the interest rate on a loan can be divided into identifiable parts related to the cost structure of an enterprise. That is, the interest rate or yield must be at least sufficient to cover administrative and acquisition costs, interest costs and credit losses for the enterprise to be able to earn a profit. The fact that interest rates change as perceived costs change can clearly be demonstrated by viewing the interest rates charged on

high risk loans compared with those charged on loans to prime borrowers. Since the cost of credit losses is built into the expected interest income from a loan, the net realizable value of the loan when it is made is determined without making an _additional_ charge or writedown for credit losses. Evidence to support that view is that a loan when made is readily salable to another lender with the same credit standards at the amount of cash advanced. Proponents of that view believe that realizable value should be defined as

> the contractual amounts expected to be collected discounted at the effective interest rate implicit in the contract, less an allowance for credit losses and _plus_ the balance of the credit loss provision deferred to future periods.

They believe that the amount anticipated as credit losses meets the definition of an asset in Statement of Financial Concepts No. 3. They argue that the interest rate on loans contains a risk factor to cover anticipated credit losses. Therefore, they argue that the future economic benefit to the enterprise is the right to recover such anticipated losses out of the future revenue as interest accrues. Accordingly, they believe that an asset should be recorded and amortized as interest accrues.

Loss Recognition on Finance Receivables

110. Finance receivables are ordinarily presented on the balance sheet of a finance company at their uncollected balances less unearned finance charges and a provision for credit losses. Under that conventional presentation, the net carrying amount of the receivables represents the estimated collection of principal that is expected ultimately to be realized on the

receivables outstanding at the balance sheet date. The net carrying amount does not include the anticipated revenues to be realized on the receivables. The allowance for credit losses is deducted in arriving at the net carrying amount to provide for losses expected to result from uncollectible receivables.

111. As a portfolio of installment loans is liquidated, cash receipts in addition to collections of principal and cash payments directly associated with the carrying, servicing, and collection activities occur as follows:

- Cash receipts for interest and charges (finance charges included in the face amount of discount loans, late charges, extension fees, and delinquency fees).
- Cash payments for (a) servicing debt incurred to finance the portfolio of installment loans, (b) servicing and collecting the loans, and (c) for payment of dealers reserves

112. Conventional accounting and financial presentation states the net carrying amount of receivables at amounts not in excess of the expected future collections of principal, on the assumption that future revenues from the receivables will be sufficient to cover the costs of carrying, servicing, and collecting the receivables. However, the following conditions sometimes exist that raise questions as to the validity of that assumption and that can result in a loss on the carrying, servicing, and collection activities.

- Curtailment of operations resulting in a significant reduction of the receivables portfolio (such a reduction can be caused by

allowing the receivables to run off in the normal course of business).

- Significant increases in the short term or long term cost of money.
- Economic conditions resulting in a significant increase in the amount of nonearning receivables.
- Significant increases in servicing and collection costs because of inflation or other factors.
- Presence of loss leaders in the portfolio (for example, purchase of low yield small balance retail paper to provide a source of higher yielding larger balance direct cash loans or making of moderate yielding wholesale loans to dealers which may be a source of profitable retail sales financing).

Those conditions can affect the entire loan portfolio or only parts of the portfolio.

113. Since the yields on consumer installment loans are usually fixed by lending laws, interest or other charges generally cannot be increased after loans are made to compensate for subsequent increases in costs.

114. In practice, finance companies have rarely revalued the carrying amount of their finance receivables to reflect such conditions. Instead, the adverse effects of those conditions are ordinarily reflected in the income statement over the periods in which they occur. The increased cost resulting from those

conditions are considered to be period charges and are not accounted for by presenting the ultimate future income statement effect in one accounting period. Finance companies also tend to consider their loan portfolios as a whole and do not ordinarily make adjustments to the carrying amounts of parts of their portfolios.

115. Current accounting literature contains various references to the problem of the inability to fully recover the carrying amount of assets but provides little, if any, guidance that is helpful on that issue. The Guide (page 38) discusses loan recognition as follows

> ...accounting for finance income within the limitations herein recommended will result in a balance in the deferred finance income account which should be sufficient on a going concern basis to cover the cost of carrying, servicing, and collecting the related receivables.
>
> However, if conditions at present are indicative of a curtailment of operations which could result in a significant reduction of the receivable portfolio, the estimated cost of such portfolio reduction should be determined and provision made for losses, if any, which may be incurred.

The Guide in effect expresses the view that income recognition methods specified by the Guide should ordinarily report revenues sufficient to cover the costs of carrying, servicing, and collecting loans and provides that a provision for loss should be made when a loss is expected due to curtailment of operations that could result in a significant reduction in the receivables portfolio. However, the Guide was written before present high and unstable interest rates, and the authors of the Guide probably did not consider the effects of sudden and substantial increases in the rates at which finance companies can borrow funds.

116. The following issues on loss recognition are raised: 1

a. Does the current accounting literature provide adequate guidance on accounting for the carrying amount of installment loans? 2 3 4

b. Should a portfolio of installment loans be revalued periodically with a view toward estimating the expected future cash receipts and cash payments and should provision be made currently for an expected net cash outflow? 5 6 7 8 9

c. If provision should be made for a net cash outflow, how should the provision be accounted for? 10 11 12

d. As an alternative to periodic valuation, should valuation be made only when certain prescribed conditions are present? 13 14 15

e. If so, what should the conditions be? 16

f. Should a special valuation be made of the entire portfolio or only of the part or parts of the portfolio affected by the conditions? 17 18 19 20

g. Should provision be made currently by a special valuation for a net projected cash outflow? 21 22 23

h. Should such a provision be made if a net cash outflow is projected for a part or parts of the portfolio but a net cash inflow is projected for the entire portfolio? 24 25 26 27

* * * * * * 28

Advisory Conclusions 1

117. Paragraphs 118 to 124 present the advisory conclusions of 2
the Finance Companies Guide Committee (FCGC) and the Accounting 3
Standards Executive Committee (AcSEC) on the issues raised in 4
this paper. The votes of the FCGC and of AcSEC are presented 5
following each advisory conclusion. 6

Measuring Interest Income and Assigning It to Periods 7

118. Income from permitting others to use enterprise resources 8
should be recognized when it accrues. The combination and pro 9
rata methods as described in the Guide are not in accordance with 10
that principle. Interest income on installment loans should be 11
recognized on the interest (actuarial) method. The effective 12
yield method as described in the Guide is an interest method but 13
emphasizes the Rule of 78s and has other features that are 14
undesirable. Accordingly, the committee and AcSEC conclude: 15

a. Interest income from installment loans should be 16
recognized on the interest (actuarial) method. 17
(Vote: FCGC, 11 to 0; AcSEC, 14 to 0) 18

b. The accrual with suspension basis should be 19
used to record interest income. Accrual of 20
interest income should be suspended if collec- 21
tibility of interest or principal is uncertain. 22
Examples of events that could cause uncertainty are 23

- The borrower is in default under the 24
terms of the loan agreement. 25
- The credit-worthiness of the borrower 26
is in doubt. 27
- The loan has been renegotiated. 28

- Interest or principal payments are a certain number of days past due.

(Vote: FCGC, 11 to 0; AcSEC, 14 to 0)

c. Origination, points, or other nonrefundable fees represent yield adjustments, which should be accounted for on the interest method. (Vote: FCGC, 11 to 0; AcSEC, 14 to 0)

d. Delinquency or default fees should be included in revenue when collected. (Vote: FCGC, 11 to 0; AcSEC, 14 to 0)

e. Extension or deferment fees represent adjustments to unearned interest income, which should be recognized on the interest method. (Vote: FCGC, 11 to 0; AcSEC, 14 to 0)

f. The accrual of interest income on the interest method should not be affected by the existence of a rebate contingency. However, rebate adjustments should be recognized in income when loans are prepaid or renewed. (Vote: FCGC, 11 to 0; AcSEC, 14 to 0)

g. Discount loans should be presented in the balance sheet at only the net amount advanced to the borrower. (Vote: FCGC, 9 to 2; AcSEC, 12 to 2)

Loan Acquisition Costs

119. Loan acquisition costs should be narrowly defined as "initial direct costs." The initial direct costs of new loans should should be defined as

costs directly associated with the production 1
of new loans. Those costs include comissions 2
or other fees paid to acquire loans, cost of 3
credit investigations, and other costs that 4
clearly vary directly with the production of 5
new loans. 6

Initial direct costs should be deferred and amortized on the 7
interest method over the shorter of (a) the expected lives or (b) 8
the contractual terms of the loans. Such costs should not be 9
deferred beyond the term of the original loan in anticipation of 10
extensions, renewals, or refinancing. 11

120. For a cost to clearly vary with the production of new 12
loans, there must be a direct cause and effect relationship 13
between loan activity and the cost. The committee believes that 14
internal costs rarely if ever qualify for deferral and meet the 15
requirement to "clearly vary with the production of new loans." 16
For example, compensation of clerical employees engaged solely in 17
processing loan application and credit investigations would 18
increase as volume increases because additional personnel would 19
have to be added to handle the increased volume. Conversely, 20
compensation of such personnel would decrease as volume decreases 21
because the number of personnel would have to be reduced. Such 22
personnel could not be assigned to other duties even for 23
temporary periods without violating the intent of this paragraph. 24
The cost of supervisory and other personnel who perform dual 25
functions would not qualify; although they may spend a part 26
of their time in reviewing loan applications, they would also 27
be involved in collection and other functions. 28

121. Certain costs such as advertising, marketing, and data 1
processing development, will affect or be affected by the volume 2
of new business. However, the intent of the narrow definition of 3
initial direct costs is to exclude such costs because it is 4
difficult to demonstrate that such costs clearly vary directly 5
with the production of new loans. 6
(Vote on paragraphs 119 to 121; FCGC, 10 to 1; AcSEC, 13 to 1) 7

<u>Credit Losses</u> 8

122. Eight members of the committee and nine members of AcSEC 9
believe that credit losses should be estimated and recognized 10
as expenses when is probable that a loss has occurred and the 11
amount of the loss can be reasonably estimated based on the 12
credit loss experience of the enterprise and in accordance 13
with the criteria of FASB Statement No. 5. Those criteria 14
are generally met for the historical portion of the provision 15
for credit losses when loans are made. However, estimating 16
the amount of the provision by applying an enterprise's 17
credit loss experience percentage to loans as they are made is 18
only a useful computational means of maintaining that portion of 19
the loan loss allowance at the amount required by FASB Statement 20
No. 5; whether the amount is established in that way or by a 21
periodic evaluation of the outstanding loan receivable portfolio, 22
the objective is the same--to state loans receivable at their net 23
realizable value--and the results should theoretically be the 24
same if either procedure is properly applied. Credit losses that 25
result from changes in economic conditions or other unexpected 26
events should be estimated and recognized as expenses when 27
information available before the issuance of the financial 28
statements indicates that the conditions or events are probable 29

and the amount can be reasonably estimated. (Vote: FCGC, 8 to 3; AcSEC, 9 to 4 with one abstention)

123. Three members of the committee and three members of AcSEC believe that the historical portion of the provision for credit losses should be estimated in accordance with the criteria of FASB Statement No. 5 when loans are made. However, they believe that the provision should be deferred and amortized to expense over the terms of the loans in relation to the related interest income. They believe that practice is consistent with stating loans receivable at their net realizable value because a portion of the interest income expected from loans when they are made is intended to cover the cost of credit losses. They also believe that deferral and amortization produce an improved matching of costs with revenue and display clearly to users of financial statements the amount of the credit loss provision to be matched with the future interest income inherent in the outstanding loans receivable. Moreover, they believe that, because of the close relationship between the deferred credit loss item and the expected interest income from loans, the deferred item qualifies as an asset under the definition of an asset in Statement of Financial Accounting Concepts No. 3, Elements of Financial Statements of Business Enterprises. (Vote: FCGC, 3 to 8; AcSEC, 3 to 11)

Loss Recognition on Finance Receivables

124. Although existing accounting literature does not provide adequate guidance on the issues raised in paragraph 116 on loss recognition, more definitive guidance on those issues should await further progress on the FASB's conceptual framework project,

on accounting recognition criteria. In the meantime, the 1
existing provisions of the Guide should be continued. (Vote: 2
FCGC, 10 to 1; AcSEC, 12 to 2) 3

APPENDIX 1

Definitions 2

Terms used in this paper are defined as follows: 3

- Accrual basis. A basis of recognizing in- 4
  terest income based on the passage of time 5
  without regard to collection. 6
- Accrual with suspension. A basis of recog- 7
  nizing interest income based on the contractual 8
  terms of the loan (accrual basis). The 9
  accrual of interest is suspended when 10
  certain conditions occur that cast doubt 11
  on the collectibility of the unpaid 12
  loan. 13
- Actuarial method. (See interest method.) 14
- Acquisition costs. Costs related to making 15
  or acquiring loans. 16
- Bulk purchase. The purchase of a group of 17
  loan receivables. 18
- Captive finance company. A finance company 19
  owned or controlled by a manufacturer or 20
  dealer and used principally to finance 21
  purchases of the products of the controll- 22
  ing manufacturer or dealer. 23
- Collection basis. A basis of recognizing 24
  interest income when loan payments are received 25
  rather than when interest income accrue based on 26
  contractual terms. 27

- Collection cost. Costs of collecting loans in excess of normal anticipated servicing costs.
- Combination method. A basis of recognizing interest income based on a "combination" of the effective yield and the pro rata methods. All costs incurred in making a loan are estimated, identified, and related to interest income. When the costs are incurred a portion of interest income is recognized to offset the costs and the resulting profit is recognized over the life of the loan.
- Commitment fee. Consideration paid by a potential borrower to a potential lender for a promise to lend money in the future.
- Consumer loans. Loans made to individuals either for personal use or to purchase personal property.
- Consumer revolving credit and credit cards Contracts with consumers to finance personal lines of credit that are continuously available to the consumer either for the purchase of goods or direct cash advance.
- Contractual rate. The rate of interest terest stated explicitly in a loan contract.
- Credit loss. The loss associated with a loan that is uncollectible.

- Dealer holdbacks. Portions of dealer reserves withheld from dealers on retail contracts with greater than normal credit risk until a certain amount of payments on the contracts have been received or contract balances have been reduced to specified amounts.
- Dealer reserves. Liabilities for dealers' shares of finance charges on retail contracts purchased from dealers.
- Delinquency (default) fees. Fees paid by debtors because of late payments.
- Direct acquisition costs: "Directly" identifiable out of pocket acquisition costs.
- Direct cash loan. A two party transaction in which the finance company lends funds directly to the borrower; such a loan may or may not be collaterized.
- Discount. Percentage of the face value of the loan deducted in advance as a charge for the loan; a deduction for interest at the time of the loan; any charge for credit which is precomputed and included in the face of the instrument.
- Discount loan. A loan that is written with the interest or finance charges included in the face amount of the note.

Discount loans are also called pre-compute or add-on loans.

- Effective interest rate. The rate of interest based on the amount advanced and the amount and timing of the specified receipts over the period of the contract.
- Effective yield method. (See interest method.)
- Estimated net realizable value. The value of a loan portfolio determined by discounting future net cash receipts at the effective interest rate.
- Extension (deferment) fee. Consideration paid by a debtor to extend the payment terms of his note payable.
- Implicit rate. (See "effective interest rate.")
- Interest bearing loan. A loan that is written for the principal amount advanced to the borrower.
- Interest method. Any actuarial method of computing interest income on loans under which interest income on fixed rate obligations is accrued over the life of the loan to result in a constant rate of interest when applied to the outstanding loan balance at any time in the life of the loan.

- <u>Legal rebate obligation</u>. The adjustment of precomputed interest income required by state statutes on a discount loan paid before the end of its contractual term.
- <u>Mortgage loans</u>. Loans collateralized by real estate.
- <u>Net interest spread</u>. The excess of interest income accruable in a period over interest expense incurred in the period.
- <u>Net realizable value for installment loans</u>. The contractual amounts expected to be collected in the future discounted by the effective interest rate implicit in the contract at its inception less the amount of anticipated credit losses.
- <u>Nonrefundable fee</u>. Charges made in connection with a loan that do not have to be refunded to the borrower when the loan is prepaid.
- <u>Origination fee</u>. An amount charged by finance companies for originating a loan. The amount generally covers the costs of underwriting, loan application processing, and reviewing legal title to property involved.
- <u>Points</u>. Amounts charged for granting loans, which are primarily adjustments of yield but may cover the cost of processing loans.

- Precompute loan. A loan that is written with the interest included in the face amount of the note (also called "discount loan").
- Pro rata method with transfer. A method of recognizing interest income on loans by transfers from unearned interest income to operations, using the straight line method, after a transfer at the inception of the loan to offset direct acquisition costs and credit losses.
- Rebate. Cancellation of a portion of the precomputed interest charge when the balance due on a discount basis loan is paid off before the originally scheduled maturity date.
- Rule of 78s. A sum of digits method of computing the amount of interest charges earned (78 is the sum of the monthly periods of a 12 month loan).
- Servicing costs. Costs a finance company incurs in the administration of its loan portfolio.
- Yield. Results of investment; annual rate of return to the creditors in a financial transaction.