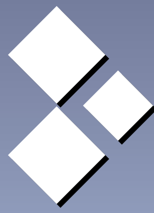

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NEW MARKETS TAX CREDITS

# GAAP Impairment of Loans Receivable

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Question: When is a loan receivable considered impaired for generally accepted accounting principles (GAAP) purposes and how does the impairment affect a company's financial statements?

Answer: A company, typically a community development entity (CDE) or subsidiary CDE that has made a qualified low-income community investment in the form of a loan to a qualified active low-income community business, should consider a loan impaired for GAAP purposes when, based on current information or factors, it is probable that the company will not collect the principal and interest payments according to the loan agreement. If a loan is considered impaired, a loss is recorded and presented in a company's statement of operations, in an amount representative of the excess of the cost basis of the loan over its fair value, and uncollectable interest previously accrued is charged off or an allowance for the interest is established, as detailed further herein.

The company's management should consider many factors in determining whether a loan is impaired, such as payment history and value of collateral. Pertaining to payment history, lenders generally don't consider loans that are contractually delinquent less than 90 days to be impaired, unless the borrower has claimed bankruptcy or the lending company has received specific information concerning loan impairment. Moreover, lending companies should review delinquent loans on a periodic basis to identify impaired accounts, while also considering additional economic conditions, business conditions and collection efforts.

In accordance with the Financial Accounting Standards Board Accounting Standards Codification (ASC) 310-10-35, "Subsequent Measurement", if either principal or interest payments will not be collected in accordance with their contractual terms, the lending company should determine whether their loans are appropriately identified and valued at the lower of aggregate cost or fair value by using one of the following methods:

- Present value of expected future cash flows;
- The receivables observable market price; or
- The fair value of the collateral.

As prescribed by ASC 310-10-35-21, although aggregation is allowed in some cases, companies typically measure impairment on a loan-by-loan basis by either using the fair value of collateral or the present value of expected cash flows, with most loans identified as impaired have been measured using the fair value of the collateral.

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The cost basis of the loan includes consideration of deferred origination fees and costs, which are fully recognized in earnings at the time of sale or maturity. The determination of fair value considers various factors including the terms of such loans, the intended exit strategy for such loans, changes in prevailing interest rates and anticipated credit losses. The amount by which the cost basis of the loans exceeds fair value is recorded as a valuation allowance in loans receivable and by a charge to net gains (losses) in the company's statement of operations.

In addition, as discussed in the American Institute of Certified Public Accountants' Audit and Accounting Guide for Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies, Chapter 9 – Credit Losses, Section 9.29, loans may be placed on nonaccrual status when management believes that the loans are impaired or collection of interest is doubtful. This is particularly important as a company's key credit quality indicator is a loan's performance status, defined as accruing or nonaccrual, with nonaccrual loans being those that the lender believes have a higher risk of loss. Additionally, loans that are 90 days or more past due, based on contractual terms, are typically classified on nonaccrual status. If deemed nonaccrual, uncollectible interest previously accrued is charged off, or an allowance is established by a charge to interest income and interest income is recognized only to the extent cash payments are received and the principal balance is believed to be collectible.

A loan previously classified on nonaccrual status will resume accruing interest based on the contractual terms of the loan when payments on the loan become current. Loans may also resume accruing interest if management no longer believes a loan is impaired or the collection of principal and interest is no longer in doubt.

For federal income tax purposes, the taxpayer must continue to accrue interest and is not allowed to write any of the principal off until the loan is deemed worthless and uncollectable, at which time the loan and any accrued interest shall be entirely written off as bad debt. Therefore, GAAP impairment will likely create a book/tax difference in the basis of the loan. See "Tax Non-Accrual Interest on Nonperforming Loans," in the May 2009 New Markets Tax Credit Report, for further discussion on the tax treatment of uncollectable loans.

Please contact your local Novogradac & Company LLP office to discuss any questions you have regarding the potential impairment of your loans. ❖

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