Purpose

To review and revise current write-off policy and propose changes to OMB circular A-129 as appropriate for debts unlikely to be collected.

Summary

Over 70 percent of Federal non-tax delinquent debt is over two years old. Despite its dubious economic value, this very old delinquent debt is not written off. This report recommends that Federal agencies establish a standard to write off delinquent debt older than two years. While a significant portion of delinquent debt would be written off, cost effective collection efforts will continue. Specifically, if an agency determines that continued collection efforts after mandatory write off is likely to yield higher returns (than the existing write-off and close out process) then this written off debt is not closed out but treated as currently not collectible (CNC). [1] While CNC debts are not accounts receivables on financial statements, the CNC process permits and encourages the use of tools of the Debt Collection Improvement Act allowing delinquent debt to be worked until the end of its statutory collection life cycle. If all debt over two years old were written off and closed out or written off and classified CNC on The Report On Receivables (TROR), the result would be to reduce active receivables of $51.9 billion by at least 50 percent.

Background

The current reporting of federal delinquent debt on the TROR does not accurately reflect its economic value. As a result, this treatment has created misperceptions about the prudent management of Federal non-tax delinquent debt. The source of this problem is largely due to differing collection life cycles and how agencies treat the linkage of the write off process and the close out process.

Federal delinquent debt is a significant problem and the focus of considerable Executive Branch and Congressional scrutiny. The Financial Management Service (FMS) of the United States Treasury reports that the gross nominal amount is $51.9 billion for FY1997. At first impression, this seems an extraordinary amount. However, economic reality is otherwise. The problem is that current delinquent debt policies and practices do not facilitate an accurate reporting of this asset at the net realizable value of the receivable. This report recommends approaches which seeks to accurately portray the true economic value of this debt while preserving management options which will maximize collections of this debt.

Current policy guidance as to the management of federal delinquent debt collection is discussed at Section V of Appendix A of OMB Circular A-129 (Revised), <u>Policies for Federal Credit Programs and Non-Tax Receivables.</u> Specifically, subsection 5 Write-Off and Close-Out Procedures states:

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1 **The term currently not collectible (CNC) is defined in Part V, Internal Revenue Service Manual, collections chapter as follows: "Reporting an account CNC does not abate the assessment. It only stops current efforts to collect it. Collection can start again at any time before the statutory period for collection expires."**

Effective write-off and close-out procedures ensure proper accounting for the costs of credit programs, and allow management to focus its efforts on delinquent accounts with the greatest potential for collection. Agencies shall develop a two-step process that:

(1) Identifies and removes uncollectible accounts from the active portfolio through write-off, although collection efforts may continue (individual write-offs greater than $100,000 require approval of the Department of Justice); and

(2) Establishes close-out procedures that result in the termination of all collection activity and elimination of the accounts from all further servicing. Agencies shall report closed-out accounts over $600 to the IRS as taxable income (Form 1099-G). Amounts less than $600 may be reported at an agency's discretion.

Accounting Standards

FASAB standards indicate that losses on receivables should be recognized when it is more likely than not that the receivables will not be totally collected. The language "more likely than not" means more than a 50 percent chance that the full delinquent amount will not be collected. An allowance for doubtful debt should be computed by reducing the gross receivables by the amount of the expected loss in order to determine its net realizable value. The allowance for uncollectible amounts should be re-estimated on each annual financial reporting date when information indicates that the latest estimate is no longer correct.

Based on research conducted to date it appears that proposed changes in write-off policy discussed in this paper are exclusively in the purview of management and not an accounting standards issue. However, the paper has been sent to the staff at FASAB for review and comment.

Current Policy and Practice

Agencies complete collection actions in accordance with agency regulations and the Debt Collection Improvement Act (DCIA) of 1996. Actions available to agencies include using Agency Debt Collection Centers, Collection Agencies, referral to Treasury (Financial Management Service) or the Department of Justice for collection or agency debt sales. Agencies may determine a debt to be uncollectible at anytime after due diligence is completed and then write-off and close-out the debt. In practice some agencies write-off but do not close-out for indefinite periods to maximize use of collection tools for up to the statutory limit of ten (10) years under DCIA.

Write-Off is defined as an action to remove an account from an entity's assets. A write-off of a loan occurs when an agency official determines, after all appropriate collection tools have been used, that a debt is uncollectible. Active collection on the account ceases and the account is removed from an entity's receivables.[2]

Closeout may occur concurrently with or subsequent to an agency decision to write-off a debt for which the agency has determined that future additional collection attempts would be futile. At closeout, an agency reports to the IRS the amount of an inactive taxable debt as income to the debtor on IRS form 1099C. No additional collection action may be taken by the agency after close-out.[3] Guidance for establishing an allowance for uncollectible amounts is found in FASAB Standard No. (SFFAS-1).[4]

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[2] **Standard No. (SFFAS 2), Accounting for Direct Loans and Loan FASAB Guarantees, Appendix C, Glossary**

[3] **Managing Federal Receivables, Glossary, G-3**

[4] **FASAB Standard No. (SFFAS1), Accounting for selected assets and liabilities, recognition of losses due to uncollectible amounts. PARA 44-45**

> **"Recognition of losses due to uncollectible amounts. Losses on receivables should be recognized when it is more likely than not the receivables will not be totally collected. The phrase more likely than not means more than a 50 percent chance of loss occurrence."**
>
> **"An Allowance for estimated uncollectible amounts should be recognized to reduce the gross amount of receivables to its net realizable value. The allowance for uncollectible amounts should be reestimated on each annual financial reporting date when information indicates that the latest estimate is no longer correct."**

Current Policy and Practice

Write-Off/ Close Out Process for Receivables

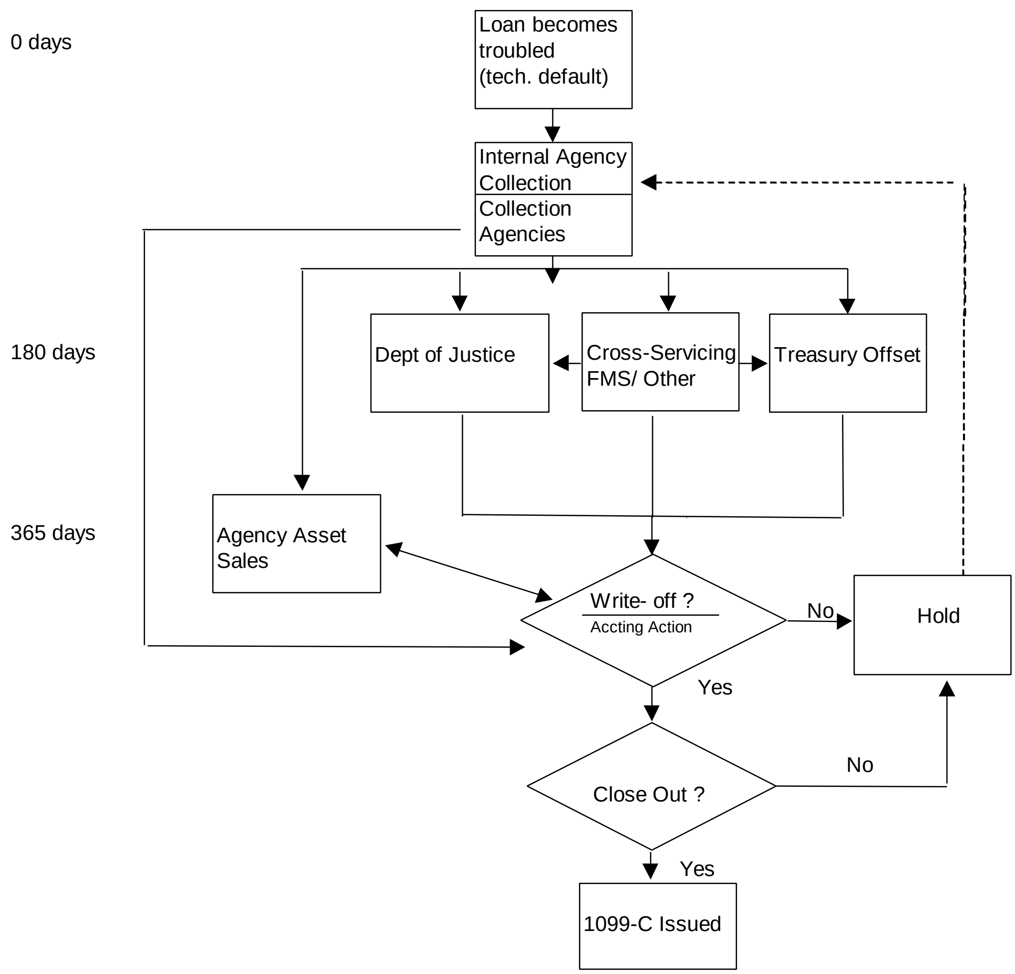

Figure 1

How the Process Works

As illustrated above when a debt becomes delinquent the agency has six to 12 months to collect the debt and restore it to currently performing status. Failing that, the agency must use the tools of federal debt management such as Treasury offset, cross servicing, wage garnishment, litigation, foreclosure etc. Lack of success through these efforts then requires that the debt be written off/charged off *and* closed out. Close out in this context means that the debtor is issued an IRS form 1099C except for tax exempt debts that do not produce taxable income, such as benefit-related debts where collection is waived. When a debt is closed out the agency removes any accounting records associated with this debt. The 1099C in effect states the debtor has received taxable income. The government no longer recognizes this debt and in effect has determined not to take action to enforce the claim. This final step in the close out process is "one last attempt to collect "the debt" as a tax liability of the borrower thereby creating the possibility that the debtor may pay some income tax.

The issuance of the 1099C is important legal step since the Federal government at that point gives up any further legal recourse against the debtor on the debt. In essence, the Government has given up further collection efforts and hopes the IRS can collect some tax revenues on this taxable income/forgiven debt. The conclusion of write-off and close out is that no further economic value exists and further efforts beyond the 1099C are futile. This view represents an agency's experience with these borrowers/debtors. The experiences of the Federal agencies with their borrowers or debtors varies due to different life cycles (e.g. characteristics, collateral, statutes of limitations, loan repayment cycles). From the initial disbursement of loan proceeds to the final payment, the duration and structure of cash flows by loan purpose varies significantly.

For some agencies, notably the Department of Education, their experience has shown that their life cycle of collecting is significantly different for seriously delinquent debt. Some of this is structural, namely there is no statute of limitations on delinquent student debt. In addition, the prospects for repayment may not occur under the presumed life cycle of expected repayment. In essence, there is a small but significant portion of seriously delinquent borrowers who will eventually repay their debt. However, this will occur over a time frame significantly longer than existing mandated debt collection management cycle. Importantly, the anticipated collection for this segment is expected to be larger than sums that might be realized using the existing 1099C process. However this bad debt can be written off and would be treated as CNC and reported as such in the Report on Receivables. CNC amounts, which are significant and likely to be collected in the near future, should also be footnoted on agency financial statements.

The problem is that the write-off and close out processes are not treated as a singular activity as is the case in commercial practice. In most circumstances, this is the proper and most appropriate way to handle this. While the write-off process recognizes the reduced value of the debt, future options for collection and the associated life-cycle issues, discussed above, are not clearly apparent and consistently applied. Given the differences between the federal debt collection model (Figure 1) and the peculiar life-cycle of certain student debt and other nontypical debt repayment flows, CNC permit a flexible approach which maximizes total returns to the government while still placing realistic values on this debt.

By permitting agencies to write-off and not close out recognizes that future use of the tools is likely to realize more dollars than the 1099C process. Since collections on 1099C's are not routinely tracked, we don't know for sure. However, we believe this process over a long period may be an improvement especially if the "alternative life-cycle" of student loans is realistic.

Action Forcing Events

The passage of The Debt Collection Improvement Act of 1996 (DCIA, Public Law 104-134) placed new emphasis on the collection of delinquent debt. The Act established the following seven purposes:

(1) To maximize collections of delinquent debts owed to the Government by ensuring quick action to enforce recovery of debts and the use of all appropriate collection tools.
(2) To minimize the costs of debt collection by consolidating related functions and activities and utilizing interagency teams.
(3) To reduce losses arising from debt management activities by requiring proper screening of potential borrowers, aggressive monitoring of all accounts, and sharing of information within and among Federal agencies.
(4) To ensure that the public is fully informed of the Federal Government's debt collection policies and that debtors are cognizant of their financial obligations to repay amounts owed to the Federal Government.
(5) To ensure that debtors have all appropriate due process rights, including the ability to verify, challenge, and compromise claims, and access to administrative appeals procedures which are both reasonable and protect the interests of the United States.
(6) To encourage agencies, when appropriate, to sell delinquent debt, particularly debts with underlying collateral.
(7) To rely on the experience and expertise of private sector professionals to provide debt collection services to Federal agencies.

To achieve these purposes important new tools were created; centralized administrative offset and government-wide cross-servicing. The offset provisions require that government payments must first be applied in full against delinquent debt before funds are disbursed. The cross-servicing requires that delinquent debts over 180 days be referred to Treasury for centralized collection efforts. These provisions have and will continue to provide an effective means to realize the maximum returns on seriously deteriorated assets. However there comes a point at which the nominal value of these assets is unrealistic and significantly overstates its economic value. The economic value of delinquent debt deteriorates rapidly with age. Two years is fair and reasonable time for the tools of DCIA to work. While collection efforts after that time may continue, there should be a recognition that it has no significant economic value and thus should be written off. Further, there should be annual reviews and purging of CNC accounts.

Some agencies have sold and are continuing to sell delinquent debt. Agencies may sell their written off debt and forego the issuance of 1099Cs if higher returns are likely. Through loan asset sales, agencies are able to focus on the "front end' or origination of the loan process and rely on the private sector to use its servicing and liquidation expertise.

Discussion of Federal Receivables

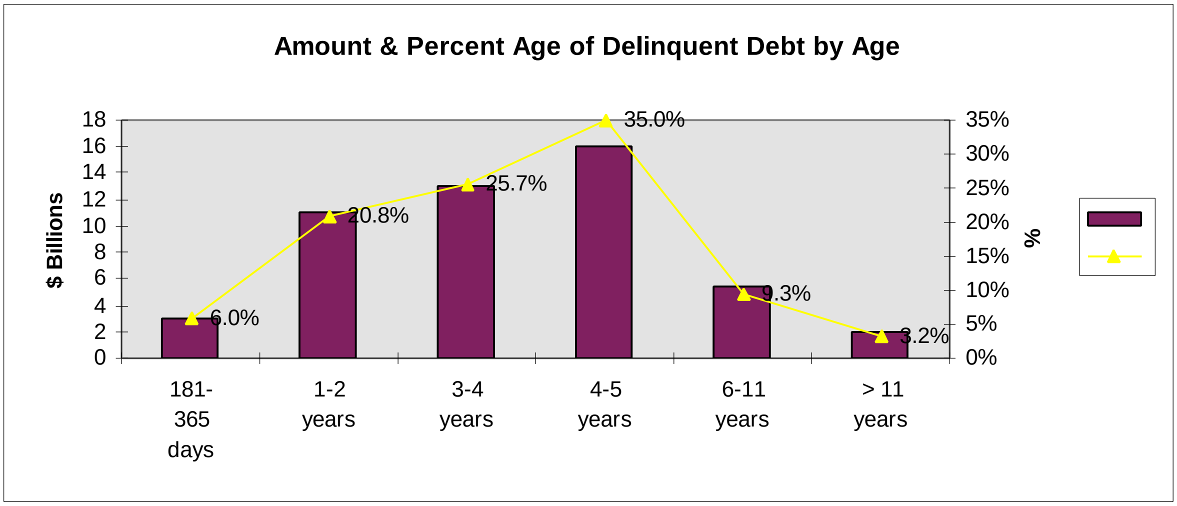

CHART A

Chart A above shows the age of federal delinquent debt. Nearly 73% or $38 billion is older than 24 months. Price Waterhouse (PW) reports that private collections on debt this old is less than 1%. [5] In other words, delinquent debts decline rapidly in value over time. After 24 months there is very little value left. A strengthened write-off policy recognizes this economic reality. While a mandated federal write-off policy on delinquent debt older than 24 months is considerably more liberal than bank standards, this approach at least establishes a minimum.

The following Charts B and C shows delinquent receivables and write off levels by agency. The data shows that as a portfolio, $44.3 billion of the $51.9 billion is over 1 year old (85%) and $38 billion is over 2 years old (73.2%). If we use PW's private sector recovery rate of 1%, the economic value of all debt over 2 years old is $380 million. We believe the Federal Government is likely to achieve higher than a 1% recovery rate because of the debt collection tools at its disposal. Nevertheless, there is good reason to write-off and close-out a substantial amount of the older debt and keep the remainder in CNC; the economic return may not exceed the cost of continued collection. There is also reason to believe that tax recovery from issuing 1099Cs has not been studied as a return of capital to the Treasury. In one sample year (1993), IRS collected $44.6 million from the 1099Cs (in 1993 they were named 1099Gs) having face value debts of $170 million or a 26% recovery rate.[6]

There is another important observation from Charts B and C data. The data shows that in FY 1997, new delinquent debts less than 1 year old amount to $7.5 billion and exceed write-offs of $6.0 billion. Therefore, it appears that gross delinquent debt of $51.9 billion will get larger if action is not taken on write-off/close-out and CNC policy. The proposed Write-Off/CNC policy is depicted in Figure 2 that follows:

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[5] **Price Waterhouse, Portfolio Analysis: Report on the Federal Government's Delinquent Non-Tax Debt, April 1997**

[6] **FMS has requested IRS track 1099C recoveries for the next 3 years and IRS has agreed.**

Proposed Write-Off/ Close Out Process for Receivables

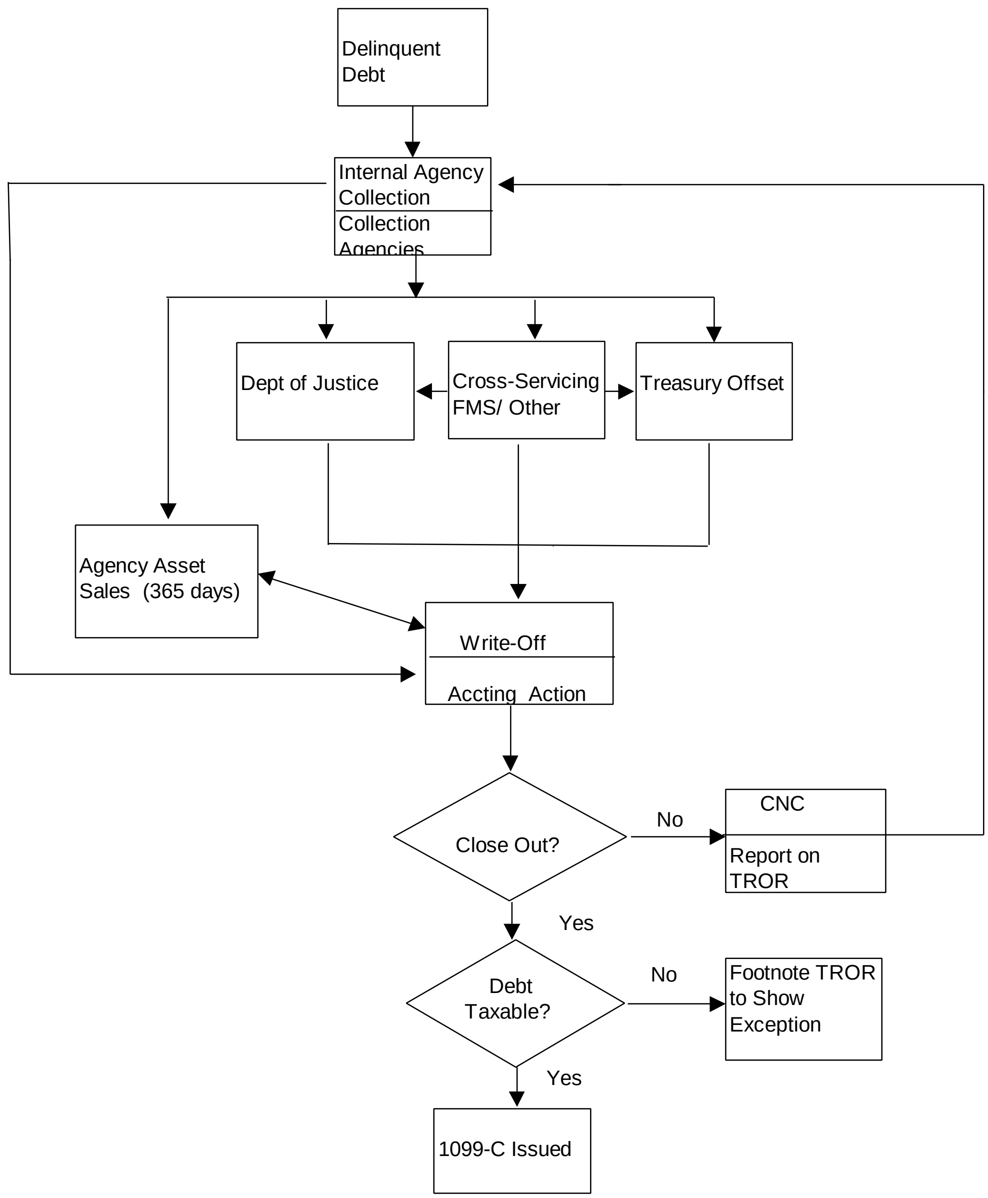

Figure 2

OMB Circular A-129

Recommendations

1. Agencies shall refer debts 180 days delinquent to Treasury for cross servicing under DCIA, unless an exemption is granted or an agency receives a debt collection center designation as prescribed by DCIA.

2. Establish Currently Not Collectible (CNC) as a reporting category for receivables reporting. CNC is defined as noted earlier and would require use of debt collection tools e.g., tax offset, salary offset and administrative offset, cross servicing and private collection agencies.

3. Agencies should write-off all debt older than two years unless it has empirical documentation that justifies a different write-off standard which should be reviewed by OMB in consultation with Treasury. Debt written off should either be (a) closed out with 1099Cs where applicable or (b) reclassified as CNC and continue working debts using debt collection tools or loan asset sales.

4. Agencies should continuously review delinquent debt and at least annually purge portfolios of Active Debt and CNC debt to reclassify debt that should be written-off and closed out.

Chart C

Write-Off Levels Compared to Total Delinquent debts

(in millions)

	Written-off	Total delinq.	% written-off of total delinq.
USDA	1,156	7,542	15.3
HUD	777	1,646	47.2
ED	352	22,036	1.6
VA	1,285	1,581	81.3
SBA	689	1,788	38.5
Other	1,807	17,310	10.4
Total	**6,066**	**51,903**	**11.7**

Source: Report on Receivables Due From the Public- FY97