

# A Critical Analysis of Accounting for Certain Debt Transactions

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In the course of teaching intermediate accounting over the past decade, I have often had my students analyze a particular APB Opinion or FASB Standard in the belief that this exercise would not only increase their understanding of the technical provisions of the promulgation, but also the rationale of the standard-setting body in arriving at its provisions.

My students' conclusions, at times, are that certain parts of various standards do not convey economic reality, which I feel most accountants would agree, should be an overriding objective of accounting. Accordingly, I have also undertaken these analytical exercises under the belief that what is good for the student is also good for the professor. In my analysis, I have often disagreed with the accounting treatment for certain transactions, two of which serve as the main focus of this paper. By restricting the discussion to these two issues, I do not mean to imply that I do not possess such strong biases regarding the shortcomings of other promulgations. Rather, these two were chosen because I feel that their deficiencies are rather glaring, they both involve the area of debt, and a thorough discussion can be accomplished within the space limitations of this paper. Given this background, the discussion will now turn to an analysis of the two issues, 1) Early Extinguishment of Debt and 2) Troubled Debt Restructurings.

## Early Extinguishment of Debt

The original pronouncement related to the early extinguishment of debt was APB 26. The term "early extinguishment" refers to the reacquisition and subsequent retirement of bonds before their scheduled maturity. Basically, APB 26 states that any gain or loss resulting from the early extinguishment should be recognized in income in the period of redemption.<sup>(1)</sup> The gain or loss is computed by comparing the reac-

quisition price (the amount paid, including all expenses of reacquisition, as well as any call premium) with the net carrying amount of the debt on the reacquisition date (the maturity amount, adjusted for unamortized issue costs, premiums, or discount). If the reacquisition price is less than the net carrying value, a gain results; if it is less, a loss occurs. The method by which the debt is reacquired is immaterial; it does not matter if it is a refunding exercise involving new bonds or not.

These gains and losses then, in accordance with APB 26, were reported as operating income before extraordinary earnings. FAS 4 superseded APB 26, and states that "gains and losses from extinguishment of debt that are included in the determination of net income shall be aggregated and, if material, classified as an extraordinary item, net of related income tax effect."<sup>(2)</sup> The reason given by the FASB for this disclosure was "that, on balance, this Statement represents a practical and reasonable solution to the question regarding income classification of gains and losses from extinguishment of debt until such time as the broader issues involved can be addressed."<sup>(3)</sup>

The point of my disagreement with FAS 4 is not whether to label the event extraordinary or ordinary, rather, it involves the calculation of the gain or loss. Take the case where interest rates have risen. Old debt may be retired at a discount from its net carrying amount at the reacquisition date, and an extraordinary gain is computed and disclosed. If the proceeds used to retire this old issue are obtained by floating a new issue bearing a higher interest rate than the old debt, the present value of the incremental interest cost associated with the new debt may very well exceed the gain. Thus, the company would have been better off to keep servicing the old debt until maturity.

The end result is that in the year of retirement, net income, upon which managerial bonuses might be computed and investment decisions made, is increased. The true cost to the shareholders, the incremental, after tax outlays associated with this dysfunctional action, is buried in the interest expense reported over the life of the new issue. Or, consider an example involving use of the working capital to retire the debt, without having to borrow additional funds. The funds used to retire the debt may have been invested at a rate high enough over the old interest rate to again cancel out any real gain, although a gain would be reported on the income statement. It was because of those two situations that Mr. Philip L. Defliese, the Chairman of the Accounting Principles Board when APB 26 was released, dissented.(4)

*"It fails to require recognition of the economic effects associated with an early extinguishment of debt to provide a profit...such a payment, whether from borrowed funds (debt refunding) or from working capital, is essentially in every case a refunding at a higher cost of money (over the remaining original term) than that of the debt being prepaid, equivalent to an arbitrage with a predetermined net profit consisting of the difference between the discount at par and the future increased interest differential....omission of a provision for this added interest cost overstates the profit in the year of prepayment and shifts the interest burden to future periods."*

Rather than overstating the profit as described by Defliese, a more realistic amount of gain could be determined by discounting the incremental after-tax interest over the life of the old issue by some factor, say the firm's cost of capital. Any after-tax gain computed in accordance with APB 26 and FAS 4 should then be reduced by this discounted amount, the present value at the time of refunding, of the additional interest cost resulting from the refunding. If this discounted amount exceeded the FASB gain on retirement, a loss on the refunding should be reported.

However, at this point let me introduce a numerical example of an actual company. Consumer Power Company issued 8 1/8% bonds on August 10, 1970 at par that mature in 2001. On February 12, 1986, the closing price on the New York Exchange was 75 1/4% (\$752.50) with

\$59,000,000 outstanding. The current interest rate on similar issues maturing in 2001 is 10.2%. Let us say Consumer Power retires the \$59,000,000 through open market purchases at a cost of \$44,397,500. To fund the retirement, Consumer Power floats a new issue maturing in 15 years at a coupon rate of 10.2%, which equals the effective rate. Under the provisions of APB 26 and FAS 4, an extraordinary gain (before tax) would be computed as illustrated on the next page.

Thus, my proposed calculation would have reduced the reported gain by \$3,503,543, a reduction of 47%. If, on the other hand, the old debt were retired without issuing new debt, but instead, utilized cash that the firm already possessed, the calculation of the gain would remain in accordance with the present provisions of APB 26 and FAS 4. This is consistent with reality because the cash paid to liquidate the debt is already the present value of the amount given up in the transaction. Having completed this analysis, the discussion will now turn to the other focal point of my paper, Troubled Debt Restructuring.

### **Troubled Debt Restructuring**

The promulgation addressing the area of troubled debt restructuring is FAS 15, which became effective beginning in 1978. The Statement affects APB 26, discussed previously, by excluding from its jurisdiction those early extinguishments of debt engendered by troubled debt restructurings. Those restructurings that do not meet the Statement's definition of "troubled", however, continue to be governed by APB 26.

The Statement defines a troubled debt restructuring as one in which "...the creditor for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise consider. The Statement further notes that a troubled debt restructuring may include, but is not limited to: 1) A modification of the terms of the debt; 2) A transfer of assets in full settlement of the debt; 3) A grant of equity (stock) interest in full settlement of the debt; 4) A combination of two or more of the preceding situations.

The main issue of my disagreement, and hence the thrust of the discussion, lies with the first

Per APB 26 and FAS 4

Carrying Value of Bonds Purchased.....	\$59,000,000
(59,000,000 x .7525) Price.....	44,397,500
Extraordinary Gain.....	\$14,602,500
After Tax.....	\$ 7,301,250
(assuming 50% tax rate)	

Proposed Measurement of Gain or Loss

Incremental interest per annum (10.2% - 8.125% x 44,397,500)	\$ 921,248
After tax cost (921,248 x .50)	460,624
Discounted present value at 10% for 15 periods* (discount factor = 7.60608) 7.60608 x 460,624	3,503,543
Extraordinary gain per APB 26 and FAS 4	\$7,301,250
Less: discounted present value of incremental interest	3,503,543
Revised gain	<u>\$3,797,707</u>

\*Assuming the firm's cost of capital is 10%.

category, a modification of the terms of the debt. In this type of restructuring, the debtor may forgive part of the principal, lower the interest rate, extend the maturity date, or employ any combination of concessions, in the hope that the future monies received are greater than if bankruptcy proceedings were initiated. The primary test established by the FASB to determine whether a gain or loss occurs, is that if the undiscounted future cash flows of the new, reduced debt are greater than the carrying amount of the old debt, no gain or loss is recorded. Thus, a debtor could forgive a substantial amount of debt and receive nothing in return, yet still not record a loss, even if he also lowered the interest rate and extended the maturity value, as long as the total amount of cash to be received in the future is still larger than the present carrying value of the debt. Therefore, to the detriment of

the creditor, the debtor could receive all three of these concessions, and the transaction does not impact the financial statements.

The deficiency, I perceive, is the absence of the concept of opportunity cost and present value analysis in the determination as to whether a loss is reported. However, before I proceed further with the narrative, perhaps a numerical example would help to illustrate the current provisions, as well as my proposed revisions. Assume the creditor (Credit Co.) undergoes the following restructuring with a debtor (Debt Co.): 1) a \$10,000,000 10% note is restructured by forgiving 3,000,000 principal and one year's accrued interest in the amount of \$1,000,000; 2) the maturity date is extended to December 31, 1994 from December 31, 1984, and 3) the interest rate is reduced to 6%. Thus the future cash flows are:

Future Cash Flows

Principal	\$7,000,000
Interest	
$\$7,000,000 \times .06 \times 10 \text{ years}$	4,200,000
Total	<u>\$11,200,000</u>
Carrying Amount of Old Debt	11,000,000
Difference	<u>\$ 200,000</u>

Since these future cash flows exceed the old debt's book value, no gain or loss is recorded at the time of the restructuring. Rather, FAS 15 defers recognition of the effects of restructuring until the years in which interest (at the reduced rate instead of the original rate) is received. The interest recorded by the creditor and debtor in those years will not be \$420,000 each year (\$7,000,000 @ 6%) as it would have been if the restructuring had not been necessary, but a total amount for the ten years of only \$200,000.

However, at this point let us view the transaction in terms of an opportunity cost perspective and employ a present value analysis.

Present value of forgiven principal and accrued interest	\$4,000,000
Present value of forgiven interest payments	
Interest on old debt	
$(11,000,000 \times 10\%)$	\$1,100,000
Interest on restructured debt	
$(7,000,000 \times 6\%)$	420,000
	<u>\$ 680,000</u>
Restated at its present value	
10% for 10 periods	
discount factor = 6.14457 x 680,000	4,178,307
Total loss	<u>\$8,178,307</u>

Thus, in my example, the "no action" provision in accordance with FAS 15 would be replaced with explicit recognition of a loss of over \$8,000,000. Indeed, even if one were to argue that the concept of "opportunity cost" related to the interest is too radical for an analysis based on historical cost accounting, faithfulness to historical cost requires that, at a minimum, forgiveness of principal should be recognized as a loss. Consider an inventory analogy; if its market value declined \$4,000,000 below its cost, a writedown would be recorded, even if the owner fully expected a recovery the next period. In my opinion, non-recognition of the forgiven principal in FAS 15 violates both the "matching concept" and the "conservatism convention." Furthermore, with the current economic conditions precipitating an abundance of troubled debt restructurings, failure of the FASB to revise the rules will result in misleading financial statements, which in turn will further jeopardize the status of accounting rule making by the private sector rather than by the SEC or other government agency(ies).

**Summary**

My discussion has focused on two areas of accounting: early extinguishment of debt and troubled debt restructuring, in which I perceive the current rules governing the accounting for the transactions to result in misleading financial statements. Although my proposals might appear to represent a radical departure from generally accepted accounting principles as a whole, I feel that the economic substance of the transaction should be the overriding criterion by which it is reported. It is for this reason that I chose to propose what I regard as a preferable solution containing somewhat far reaching accounting adjustments rather than an innocuous, less effective proposal. In any event, it is

my hope that at the very least, this discussion will engender a review of the provisions of APB 26 and FAS 15 by the FASB to insure the maximum protection for the users of financial statements.

### Footnotes

1. Prior to APB 26 there had been debate as to how to account for the gain or loss. Possible treatments were to:
  - a. Recognize as an extraordinary item in the period retired.
  - b. Recognize as an ordinary item in the period retired.
  - c. Amortize the gain or loss over the remaining life of the issue.
  - d. Amortize the gain or loss over the life of the new issue if it was floated to retire the old issue.
2. FASB Statement No. 4, paragraph 8
3. FASB Statement No. 4, paragraph 15
4. APB 26 paragraph 22.

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### FOOTNOTES

1. Penrose suggested that combining speaking and writing skills into one category, such as business communication, might have resulted in a higher ranking.
2. The questionnaire used in the present study was adapted, with permission of the American Accounting Association, from the questionnaire used by Ingram and Frazier [1980].
3. The responses of the graduates of the five schools whose students were surveyed did not differ significantly (as measured by Chi-Square tests) from the responses of the graduates of the other eight schools whose students were not surveyed. Therefore, the student ratings were compared to the ratings of all graduates.

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