Restructuring Charges: Are They an Abuse of Accounting Theory?

An Honors Thesis (ID 499)

by

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The term "debt restructuring" is not foreign to us. It can be described as a situation where the "creditor for economic or legal reasons related to the debtor's financial difficulty, grants a concession to the debtor that it would not otherwise consider." (1)

Today, approximately two-thirds of the existing debt is "troubled". There are several reasons for this high number. First of all, the economic events of the mid-1970's had a direct impact on society and is still lingering in our economy today. For instance, banks were loaning large amounts of money to foreign countries, and these foreign countries in turn used the money to purchase oil. With less oil revenues, the debt eventually turned sour. Another reason for the high amount of debt restructuring is the dramatic recession that has hit the real estate market in some sections of the country. These reasons, among others, have caused the topic of debt restructuring to become prevalent to debtors, banks, Congress and FASB.

Some controversy has arisen about a specific FASB statement (Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings) and the way restructuring is handled. In this paper, I will present the different options under Statement 15 available to those involved with debt restructuring, identify the problems, recognize some positive features, and draw some conclusions.

RESTRUCTURING OPTIONS

If a debtor is in financial difficulty and cannot make his payments, the answer could be to restructure the debt. Three options are available to those involved: Settlement of debt at less than its recorded amount, the continuance of debt with a modification in terms, and in-substance defeasance.

Settlement of debt at less than carrying amount

This type of settlement involves either a transfer of noncash assets or a granting of equity interest. In transferring noncash assets (real estate, receivables, or other assets), the assets are accounted for at their fair market value. The debtor first adjusts the assets' value to their fair value and recognizes a gain or loss on disposition. The adjusted basis of the asset is then compared with the debt. This usually results in the debtor's recognizing an extraordinary gain and the creditor's recognizing an ordinary loss. For example, suppose a debtor transfers land with a carrying value of $60,000 and a fair value of $70,000 in full settlement of its loan payable of $90,000. The debtor will write up his assets to fair market value and recognize a gain on disposition of $10,000 ($70,000 - $60,000). The excess of the debt over the fair value ($90,000 - $70,000) will result in a debtor's extraordinary gain on settlement of $20,000.

Another way to settle debt is to grant an equity interest. In this instance, stocks can be transferred instead of tangible property. To illustrate this, assume a creditor accepts 200,000 shares of the debtor's common stock ($5 par) that had a fair market value of $4,000,000 in full settlement of the $7,000,000 payable. The debtor would recognize an ordinary gain on restructuring of $3,000,000 ($7,000,000 - $4,000,000). The creditor would recognize a $3,000,000 loss.

Continuation of debt with modification of terms

This situation could include a reduction of the stated interest rate, an extention of the maturity date, a reduction of the face amount of the debt, or a reduction or deferral of any accrued interest. Gains and losses may or may not be recognized when modifying terms, depending on the carrying amount of the debt.

When the undiscounted future payments exceed the carrying value of the debt, no gain or loss is recognized and no adjustments are made to values of the payable and receivables. However, a new effective interest rate must be computed.

If the pre-restructure carrying value exceeds total future cash flows, then there is a recognized gain/loss.

For example, assume a debtor owes $10,500,000. The creditor allows a restructure, and the future cash flow is now $9,240,000, which leaves a $1,260,000 deficiency between cash flow and carrying value. The debtor will reduce the carrying amount of the debt and the creditor will reduce the receivable by $1,260,000. The debtor will recognize an extraordinary gain and the creditor will recognize an ordinary loss.

<u>In-substance defeasance</u>

A debt may also be extinguished through an in-substance defeasance. This takes place when the debtor places cash or risk-free securities in an irrevocable trust that services the interest and principle payments of the payable. Prior to the extinguishment, the securities are revalued to fair market value and a gain or loss is recorded by the debtor. In addition, the difference between the fair value of the securities and the book value of the debt is determined for recognition of a gain or loss. In 1982, for example, Exxon increased its second quarter earnings by approximately $130 million through a defeasance. (2)

It should be noted that although the debt is considered extenguished after a defeasance, the debtor is still not legally released from being the primary obligor.

<u>Disclosure requirements</u>

Along with these options are disclosure obligations of both the debtor and creditor. The debtor must disclose:

1) A description of significant changes in terms and the primary features of settlement.
2) The gain recognized and its tax consequences.
3) The gain/loss recognized on the transfer of assets.
4) The per-share amount of the gain recognized and net tax effect.
5) The extent to which contingent amounts are included in the carrying amount of the debt.
6) The amounts that are contingently payable and the conditions that would require payment of the contingent amounts.

The creditor is obligated to disclose:

1) The recorded investment.
2) The interest income that would have been earned without the restructuring.
3) The income that was earned.
4) The amount of additional funds to be loaned to the debtor. (3)

THE PROBLEMS

Because of the large amount of restructured debt today, certain rules and guidelines have been forced into the limelight and subjected to a great deal of scrutiny. As a result, four major problems have been identified.

Allowable mark-up of debtor's assets

In a forgiveness of debt, a debtor who is in financial difficulty is allowed to mark the assets up to fair market value and recognize a gain. Furthermore, another gain can be recognized to the extent of the excess of the liability over the fair value of the asset. For a troubled debt firm to show such (nonoperating) gains, it is likely to lead to a misimpression by the readers of the firm's financial statements. A statement user could see the gains and be unaware of the financial difficulty the company is in.

Creditor's disclosure

It seems that in FASB Statement No. 15 the lender (for instance, a bank) is well-favored to the point of possible distortion of their financial statements. According to Statement No. 15, a lender can modify terms of a debt restructure many different ways and still not recognize a loss, and is not required to classify the debt as troubled.

Lenders must only "disclose aspects of debt restructuring by major categories for outstanding debts whose terms had been modified in either the body of the financial statements or subsequent notes." (4) Banks, in particular, are affected by these rulings. They may engage in a great deal of debt restructuring without recognizing substantial losses. This could be deceiving. To the public, a bank could appear strong, yet losses and high risks lie behind the disguise. These FASB rulings even encourage the banking industry to accept greater credit risks to cope with current economic conditions.

Calculation of post-modification future payments

The use of "current value" accounting for calculating cash flows is viewed as a serious inconsistency in accounting theory. What current value is, and what FASB supports, is computing the future payments by using today's values, and not discounting them. The alternate method is to calculate the payments by applying the time value of money. In the following example, assume the original debt was a principle of $1,000, with an annual interest rate of 10% and a maturity date of 5 years from the restructure date. The restructure agreement reduces the annual interest payments from $100 to $60 and reduces the principle from $1,000 to $600.

	FASB Viewpoint	Conceptual Viewpoint	
Carrying amount of debt	$1000		$1000
Total cash payments after restructure:			
(60 x 5) + 600	900		
Present value of cash payments after restructure:			
Principal: 600 x .40188		241	
Interest: 60 x 2.99061		179	420
Gain (loss) by creditor	($100)		($580)

(5)

In this illustration, FASB supports the recognition of $100 loss, yet in considering the time value of money, the company will actually incur a $580 loss. This treatment is clearly a violation of the theories of neutrality and conservatism. In addition, this loss is not required to be disclosed. In consideration of these two factors, the amounts that most adequately reflect the current period's business is distorted. It could be nearly impossible for a user of financial statements to determine the effects of the troubled debt.

In-substance defeasance contingencies

When a firm elects to extinguish its debt through in-substance defeasance, the debt is reported on its books as being refunded and legally satisfied. However, an unreported contingency still exists for the debtor. There are many stipulations within an in-substance defeasance contract. If the debtor should violate any of these stipulations, it may be required to pay off the debt immediately, before the assumed due date. Consequently, the trust would not have accumulated emough interest to pay the full debt, and once again a contingency would be present.(6) The contingency of this possible occurrance is not required to be a disclosure in the debtor's financial statements. This could misinform the users of these financial statements.

CONCLUSIONS

At the center of the deficiencies in debt restructuring methods lies one question: Are they an abuse of accounting theory? The methods themselves are not flying in the face of theory. The issue is how these methods are handled. Presently, little disclosure is required in the debtor's and creditor's financial statements concerning important details of debt restructuring. This causes misinformation to be passed to the users of the financial statements of all parties involved. To remedy this problem and clear up the inconsistencies with accounting theory, disclosures should be more comprehensive. This would entail explanations of asset markups, in-depth descriptions of the terms accepted, and all contingencies associated with the restructuring. If these steps were taken, many of the misinformations would be eliminated.

<u>The brighter side of restructuring</u>

Despite the negative effects of debt restructuring, one must not overlook the advantages either. Restructuring allows a debtor experiencing financial trouble to be relieved of some burden, and make an honest attempt at regaining financial strength. The creditor is allowed to recover a portion of the debt owed to it, instead of nothing at all. Restructuring allows all parties involved to make the best out of what is available. This is the core principle behind debt restructuring and continues to justify its increased usage to this day.

ENDNOTES

1. Ratcliffe, Thomas A. and D. D. Baiborn. "Accounting for Troubled Debt Restructurings." Financial Executive, March 1981, pp. 20-23.

2. "In-Substance Defeasance Accounting," The CPA Journal, 53 (April 1983), 87.

3. Johnson, Roger. "Accounting for the Restructuring of Troubled Real Estate Debt." Real Estate Review, 14 (Winter 1985), pp. 90-94.

4. "Special Accounting Treatment Is Neither Dream nor Joke." Savings and Loan News, 103 (July 1982), pp. 29-31.

5. Welsch, Newman, and Zlatkovich. "Extinguishment of Debt." Intermediate Accounting, pp. 1025.

6. "In-Substance Defeasance Accounting." pp. 86-87.

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