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Practice Bulletin 4

May 1988

Accounting for Foreign Debt/Equity Swaps

Accounting Standards Executive Committee
and
Committee on Banking
American Institute of Certified Public Accountants

AICPA

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Practice Bulletin 4

Accounting for Foreign Debt/Equity Swaps

1. The Accounting Standards Executive Committee and the Banking Committee of the American Institute of Certified Public Accountants (AICPA) have considered the accounting treatment by financial institutions for exchanges of their public or private sector loans to debtors in financially troubled countries for equity investments in companies in the same countries. These transactions are generally referred to as *debt/equity swaps*. As a result of these deliberations, the committees have prepared the following guidance, based on existing authoritative accounting literature, for financial institutions and independent auditors.

2. Debt/equity swap programs are in place in several financially troubled countries. Although the programs differ somewhat among the countries, the principal elements of each program generally are as follows. Holders of U.S. dollar-denominated debt of these countries can choose to convert that debt into approved local equity investments. The holders are credited with local currency, at the official exchange rate, approximately equal to the U.S. dollar debt. A discount from the official exchange rate is usually imposed as a transaction fee. The local currency credited to the holder must be used for an approved equity investment. The local currency is not available to the holders for any other purpose. Dividends on the equity investment can generally be paid annually, although there may be restrictions on the amounts of the dividends or on payment of dividends in the early years of the investment. Capital usually cannot be repatriated for several years, and although some countries permit the investment to be sold, the proceeds from any such sale are generally subject to similar repatriation restrictions.

3. A debt/equity swap is an exchange transaction of a monetary for a nonmonetary asset, which should be measured at fair value at the date the transaction is agreed to by both parties. (See paragraph 11 for a discussion of loss recoveries or gains.)

4. There is a significant amount of precedent in the accounting for exchange transactions to consider both the fair value of the consideration given up as well as the fair value of the assets received in arriving at the most informed valuation—especially if the value of the consideration given up is not readily determinable or may not be a good indicator of the value received. For example, in acquisitions involving consideration in the form of stock, an examination of the value of the net assets received is often considered necessary if the stock is thinly traded or restricted.

5. APB Opinion 16, *Business Combinations*, deals with the acquisition of assets (paragraph 67) and with determining the cost of an acquired company (paragraphs 72–75). In summary, paragraph 67 states that assets acquired should be recorded based on the fair value of assets exchanged, liabilities incurred, or stock issued, unless the fair value of the assets received is more clearly determinable (“cost may be determined either by fair value of consideration given up or by fair value of property acquired, whichever is the more clearly evident”). Paragraph 72 states that the same accounting principles apply to determining the cost of assets acquired individually, those acquired in a group, and those acquired in business combinations. APB Opinion 29, *Accounting for Nonmonetary Transactions*, paragraph 18, provides similar guidance.

6. FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, deals with the receipt of assets in satisfaction of a loan and, in paragraph 28, states that a creditor shall account for assets received (including an equity interest) at their fair value at the time of the restructuring, unless the fair value of the receivable satisfied is more clearly evident.

7. Debt/equity swaps have characteristics similar to both the acquisition of assets contemplated by APB Opinions 16 and 29 and the receipt of assets in satisfaction of a loan contemplated by FASB Statement No. 15. Since the secondary market for debt of financially troubled countries is presently considered to be thin, it may not be the best indicator of the value of the equity investment or of net assets received. In light of this thin secondary market and of the unique nature of the transaction, it is also necessary to examine the value of the equity investment or net assets received. The committees therefore believe that in arriv-

ing at the fair value of a debt/equity swap, both the secondary market price of the loan given up and the fair value of the equity investment or net assets received should be considered. It is the responsibility of management to make the valuation considering all of the circumstances. It is the responsibility of independent auditors to become satisfied that the valuation is based on reasonable methods and assumptions, including, as needed, information from independent appraisals. Factors to consider in determining current fair values include the following:

- Similar transactions for cash
- Estimated cash flows from the equity investment or net assets received
- Market value, if any, of similar equity investments
- Currency restrictions, if any, affecting dividends, the sale of the investment, or the repatriation of capital

8. In accordance with generally accepted accounting principles, a financial institution's loan portfolio should be carried at amortized historical cost less both loan write-offs and the allowance for loan losses, as long as the financial institution has the ability and intent to hold the loans until their maturity. Management may decide to dispose (by sale or swap) of loans prior to maturity for a number of reasons, including liquidity needs, tax considerations, portfolio diversification objectives, and management practices of generating loans specifically for disposition, in which case the loans should be carried at the lower of cost (amortized historical cost less loan write-offs) or fair value.

9. If the fair value of the equity investment or net assets received in a debt/equity swap is less than the recorded investment in the loan, the committees believe that a loss should be recognized and recorded at the date the transaction is agreed to by both parties. Although some portion of the swap loss may result from factors such as a change in the interest rate environment for similar loans, the committees believe that the loss results principally from a concern as to the ultimate collectibility of the loan. Therefore, the swap loss generally should be charged to the allowance for loan losses and should include any discounts from the official exchange rate that are imposed as a transaction fee.

10. All other fees and transaction costs involved in a debt/equity swap should not be capitalized but should be charged to expense as incurred.

11. Loss recoveries or even gains might be indicated in a swap transaction as a result of the valuation process. However, due to the subjective nature of the valuation process, the committees believe that such loss recoveries or gains ordinarily should not be recorded until the equity investment or net assets received in the swap transaction are realized in unrestricted cash or cash equivalents.

12. In addition to recording specific transactions during an accounting period, a financial institution, in the course of preparing its financial statements, should review its loan portfolio in order to assess the adequacy of the allowance for loan losses. Allowances are established and write-offs taken based on management's judgment regarding ultimate collectibility of the loans in the normal course of business. Recognition of a debt/equity swap loss should be among the factors to be considered by management in its periodic assessment of the adequacy of the allowance for loan losses with respect to its remaining portfolio of loans to debtors in financially troubled countries.

13. The committees recommend that the guidance in this practice bulletin be adopted upon issuance.

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