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Volume 48 | Issue 2 Article 5

4-1986

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Sharon M. McKinnon

James F. Volkert

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Accounting Rules Fueling the International Banking Crisis

By Sharon M. McKinnon and James F. Volkert

Some corporate debtors have problems satisfying their financial obligations during periods of depressed economic conditions or other financial hardship. Consequently, debt obligations are often restructured to permit the debtor either to defer or to reduce the interest or the principal obligation. There is considerable variety in the form these restructurings may take. Not surprisingly, in the absence of guidelines before 1977, there was also considerable variety in the ways that both debtors and creditors accounted for these events.

Statement of Financial Accounting Standards No. 15, effective for restructurings occurring after December 31, 1977, prescribes accounting treatment for both extinguishments and revised loan covenants of debts defined as "troubled." While the statement could be said to have resolved the consistency and comparability problems associated with troubled debt, its issuance did little to advance the FASB's claims as an impartial standard-setting body devoted to theoretical consistency.

Several issues merit a re-examination, over six years later, of the circumstances surrounding issuance of *SFAS No. 15*. First, economic events of the mid-1970's played a significant role in the promulgation of standards on troubled debt restructurings. These economic factors have loomed even larger in the early 1980's and provide a startling example of how accounting and reporting requirements can significantly interact with macroeconomic events. Second, the ability of one industry group to impose its viewpoint on the standard-setting process warrants analysis in retrospect of the consequences of the FASB's acquiescence. Third, in light of subsequent issuances in the FASB's conceptual framework project, the choices made in SFAS No. 15 appear all the more indefensible.

International debt crises are putting pressure on the World Bank to take action.

Historical Setting for SFAS No. 15

Several factors contributed to an increase in loan restructurings in the mid-1970's. The real estate market experienced a dramatic recession, much to the dismay of the commercial banks investing heavily in Real Estate Investment Trusts (REITs). Debt restructurings occurred as a result of tightening financial conditions. Compounding these problems was the fiscal distress of large entities such as Penn Central, W. T. Grant, and the city of New York.

In addition, banks had increased their foreign loans substantially. Large deposits of dollars by oil-producing countries allowed banks to loan dollars to developing countries. They in turn used the dollars to purchase oil, and dollars were again deposited by the oil-producers. This cycle dramatically increased the availability of dollar-denominated loans. In hindsight, the problems caused by liberal loans to developing countries appear easy to predict, but for several years the significant growth of many less developed countries postponed what now seems so inevitable.

Accounting Choices

Various events can occur when a debtor is faced with difficulties in fulfilling a debt obligation. One course of action is to settle the debt on some terms agreeable to both parties, usually resulting in an economic loss to the creditor. The creditor may believe that some lesser repayment is better than to chance losing the entire amount owed. Accounting and reporting of this type of definite transaction is relatively straightforward because the traditional accounting model "sees" the settlement as an income or expense recognition event within the standard accounting framework.

What is more difficult to address is a continuation of the debt with a modification in terms, generally consisting of a lower interest rate, lower principal amount, or extended time to repay. The nature of these concessions is that the debtor will economically benefit and the creditor will lose. Whether or not the concession itself is an event worthy of triggering immediate recognition of this loss was the controversial issue confronting the FASB in 1977.

Exhibit 1 provides a simple numerical example of how changes in terms can affect the present value of a loan. The original loan of $10,000 is recorded by both parties at its face value (ignoring complications such as discounted notes). In addition to being *face* value, this is also the *present* value of the loan, as demonstrated in the exhibit. Each of the three modifications in terms reduces the present value of the loan, yet in each the absolute amount of cash to be received over the life of the debt exceeds the original amount of $10,000.

Prevalent practice before 1977 for restructurings was *not* to change the carrying amount of the loan receivable to reflect a new present value unless the change was a reduction of principal. Instead of immediate recognition that a loss had occurred, future interest income was reduced. Most financial institutions, in many cases adhering to state or federal banking laws, take other steps to deal with problem loans. Accrual of overdue interest income ceases after a certain time. For example, New York banking laws prohibit recognition of interest income that is thirty days past the billing due date. U.S. regulations allow ninety days. Levels of allowances for loan losses are tied to estimates of potential loan portfolio risk and closely correlated to the amount of "non-performing" loans.

But banks have been particularly reluctant to recognize immediately the economic losses associated with restructuring. When the FASB issued a Discussion Memorandum in 1976 which addressed various suggested proposals for dealing with restructurings, the response from the banking industry was overwhelmingly negative. The Board received close to 900 letters of comment, most from bankers. According to Marshall Armstrong, then chairman of the FASB, most of the responses failed to discuss the issues, being "unreasoned protests against current value accounting."

Of the five alternatives in the Discussion Memorandum, four involved some approach to recognizing the current value of the loan receivable by using present value techniques. By focusing on the controversial terminology "current value," the banking industry tried to shift its arguments to a theoretical level. Most of the controversy surrounding "current value" accounting concerns difficulties in determining the worth of tangible assets. Debt obligations with fixed terms actually provide ideal examples of assets whose true value is quite easily determinable.

The arguments to postpone use of present value until formulation of a conceptual framework were merely window dressing for more pragmatic objections. All the current value methods would result in larger additions to loan loss reserves than the historical methods in use at that time. Federal Reserve regulations are quite strict regarding the size of these reserves. When a loan becomes a bad debt, the bank must adjust its loan loss reserves. These reserves act as offsets to banks' primary capital, of which American banks are required to maintain $1 for every $20 in outstanding loans. Because banks generally stay as close to that ratio as possible, writing off losses due to restructuring could reduce lending by some 20 times the capital loss. This threat of decreased income could discourage banks from renegotiating loans and have negative effects on firms in financial distress.

The FASB Reaction

The banking industry was granted a reprieve by the provisions of *Statement No. 15*, issued in June 1977. The FASB reacted to the negative response to its Discussion Memorandum by prescribing standards which

EXHIBIT 1

Terms of Original Loan: Principal-$10,000; Interest-12%; Term-5 years

Present Value:	Principal-$10,000 x .56743	= $ 5,674
	Interest-$1,200 x 3.60478	= 4,326
	Recorded amount of loan	$10,000

Modifications:

1. Change interest rate to 8 percent:

Present Value:	Principal-$10,000 x .56743	= $ 5,674
	Interest-$800 x 3.60478	= 2,884
		$ 8,558
Absolute amount of cash:	Principal	= $10,000
	Interest	4,000
		$14,000

2. Change principal to $8,000:

Present Value:	Principal-$8,000 x .56743	= $ 4,539
	Interest-$960 x 3.60478	= 3,461
		$ 8,000
Absolute amount of cash:	Principal	= $ 8,000
	Interest	= 4,800
		$12,800

3. Change life to 8 years with the same absolute amount of interest as for previous 5 years life:

Present Value:	Principal-$10,000 x .40388	= $ 4,039
	Interest-$750 x 4.96764	= 3,726
		$ 7,765
Absolute amount of cash:	Principal	= $10,000
	Interest	6,000
		$16,000

A look should be taken at how theory and reality relate to the standard-setting process.

basically continued existing practice. Instead of recognition of losses in the value of receivables, increased disclosure was deemed sufficient.

Statement No. 15 applied only to troubled debt restructurings defined as occurring when "...the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor it would not otherwise consider." In the case where the debt is settled, gains and losses are recognized by each party based on the fair value of assets exchanged in relation to the recorded value of the debt.

When debt is continued with a modification in terms, treatment depends upon the amount of the total future cash flows. If this total is less than the carrying amount of the debt (a rare situation), gains and losses are recognized. If, however, the new terms result in total future cash flows greater than the carrying amount of the debt, no gain or loss is recognized by either party. Instead, a new effective interest rate is used to recognize a smaller amount of interest revenue or expense over the remaining life of the debt. No distinction was made as to the type of change. Accounting for reductions in face amount was made consistent with other modifications.

Theoretical Inconsistencies

As highlighted previously, much of the dissent of the banking industry focused on their displeasure with current value accounting. Letters cited a desire to let the FASB complete its conceptual framework project instead of taking a "piecemeal" approach with regard to one industry. The intervening seven years have produced several Statements of Financial Accounting Concepts in the framework project. Analysis of *Statement No. 15* in conjunction with these conceptual pronouncements indicates that the debt restructuring statement exhibits serious deficiencies.

The FASB has continually emphasized that conceptual framework pronouncements are suggestive rather than definitive. It has also disclaimed attempts to apply concepts retroactively to prior statements. But given the obvious concurrent work on concepts and actual statements, it does not seem to be asking too much to expect some consistency in standards. *Statement No. 15* presents an unfortunate example where the FASB appears to have thrown out the theory when the political pressures intervened.

This is not to say that industry pressure always produces unwanted consequences. Economic aftereffects of standards are at least as important as internal theoretical consistency, and industry is frequently most cognizant of what standards will do to their operations and the economy in which they interact. But it does warrant a look at how theory and reality relate to the standard-setting process.

Objectives of Financial Reporting. As part of the conceptual framework, the FASB defines the purposes of financial reporting. The three primary objectives are to provide (1) information useful in investment and credit decisions, (2) information useful in assessing cash flow prospects, and (3) information about enterprise resources, claims to those resources and changes in them. For industries whose resources consist materially of monetary assets and liabilities, the course prescribed by *Statement No. 15* appears to run counter to each of these objectives.

Consider the example in Exhibit 1. A firm holding the $10,000 receivable would suffer an economic loss under any of the three modifications. Under *Statement No. 15*, there would be no loss on the income statement and no indication on the balance sheet that assets were less valuable than before the restructuring. The negative effects on future cash flows are obscured; the changes in the value of the enterprises resources are ignored; and potential debt or equity investors are forced to rely on additional disclosures to analyze what is really happening in the firm.

And what of the additional disclosures? The Statement prescribes that creditors disclose the income that would have been recorded in the period ignoring restructure in comparison to that which was recorded. Commitments to lend additional funds are also disclosed. It does not require disclosure of information that would enable investors to assess future cash flows. In addition, the FASB specifically allows firms to choose their own forms of disclosure. The disclosure requirements can be met by discussion of reduced earnings potential of entire portfolios of receivables, grouped into major categories, without separate mention of troubled restructured receivables. Thus it is generally impossible for the user of financial statements to determine the effects of debt restructurings on the firm.

What is a transaction? The traditional accounting model records assets at their historical cost. Because this cost is not changed to reflect changes in value, the model has been subject to criticism that cost loses relevance as it diverges from value, and that value should replace cost in a new accounting model. Bankers objected to being among the first to be subject to new current value techniques.

Transactions are not prerequisites for accrual-based accounting systems, but existence of economic substance and change are.

But parties on both sides of the current value/historical cost debate agree that the two are identical at the moment of the arms' length transaction between parties. The primary flaw in the outcry against using present value to measure the value of the restructured receivable is the misunderstanding of this fact. Present value is merely the technique that is used to measure value, and at the point of the transaction it is the technique used to measure cost as well. The $10,000 recorded value of the original transaction is historical cost. It is a combination of the present value of the principal to be received in five years and the present value of the stream of interest cash flows over five years.

The key to what the receivable should reflect concerns not whether or not present value techniques should be used but whether or not a transaction has occurred which triggers determination of a new "cost" to the firm. The FASB rationale was that a transaction of substance has not occurred. Without a transaction, no new carrying value (and consequently no recognized loss) is required.

Not only is this argument itself without merit, but it is also one which appears to be trotted out when rationale is needed for selected pronouncements and completely ignored for others. Transactions are not prerequisites for accrual-based accounting systems, but existence of economic substance and change are. Wearing out of fixed assets is of sufficient economic significance to record periodic depreciation. Gains and losses on foreign currency commitments are accrued for reporting because exchange rate changes indicate economic gain or loss. Leases which are sales in disguise must be capitalized and depreciated, regardless of the lack of "ownership." Even more closely tied to the debt restructuring situation are accruals of losses for warranties and contingent liabilities. In each case the present period is assessed for losses expected to physically occur in the future. This accounting is justified on the basis that the future losses will result from events that have already occurred, and in spite of the necessity to estimate.

Troubled debt restructurings are no different in concept. Future losses will occur because of new loan terms, transacted in the present and precisely measurable. The old recorded value incorporated expectations of future income. A transaction has occurred and new expectations of reduced future income should define a new historical cost.

Public Pressure

Restructuring of debt joined that group of controversial issues where special interest groups influence decisions to ignore economic substance with the argument of "no transaction." Most prominent among these is non-accounting for pension liabilities. Public outcry against FASB proposals to recognize unfunded pensions as liabilities may very well result in theory again taking a back seat.

The FASB is in an unenviable position, fighting for its existence between two formidable parties. On one hand, business demands favorable accounting standards; on the other the SEC expects standards to keep business in line. Funding comes from the business community; the right to exist from the SEC. It is little wonder that pronouncements frequently reflect desperate attempts to keep each at bay. Unfortunately, evidence increasingly suggests that the FASB will not stand up to strong business lobbying. Complaints of income fluctuations by multinational businesses led to rescission of *Statement No. 8* on foreign currency translation. Accounting for changing prices was only addressed after the SEC stepped in with its own requirements. And the FASB was never able to get past business' objections to its proposals for dealing with the controversial sales/leasebacks of investment tax credit assets allowed by the first Reagan tax bill. On that subject no definitive pronouncement was ever issued.

Business demands favorable accounting standards; the SEC expects standards to keep business in line.

Economic Reality

Theoretical inconsistency and bowing to industry pressure have both been defended by arguments invoking potential effects of accounting rules on "the greater good." *Statement No. 8* was said to inspire inefficient foreign currency management practices and was even accused of contributing to the decline of the dollar. The same type of arguments were advanced by the banking lobbying efforts for *Statement No. 15*. Bankers claimed that recognizing losses would stifle the economy by inhibiting loans to needy parties and by drying up capital reserves. It is true that, in the face of severe macroeconomic effects, an insistence on theoretical consistency appears trivial. To analyze this argument, it is necessary to consider what economic effects *Statement No. 15* has contributed to in its brief history.

The accounting rules which allowed banks to postpone recognizing economic losses have had more negative than positive economic consequences.

The major effect of the statement is that it allows creditors to avoid reducing their income, with the concurrent effects on capital, as long as new terms guarantee that future cash flows equal or exceed the debt's carrying amount. If the debt were instead settled for whatever the creditor could get, a loss would ensue. This is the real inefficiency of the statement: creditors are lured into the more pleasing route of income statement restructuring, despite the real possibility that they would be economically better off to settle immediately.

One has to look at the events in the international lending community to understand the negative economic reality that has been fueled by an accounting anomaly. Since 1973, debt of the 16 largest third world debtors has increased by over $480 billion reaching $520 billion by early 1985. As the dollar strengthened with high interest rates, many of these countries began experiencing disruptions of debt servicing in the early 1980's. About two-thirds of this debt is in trouble. In

1981, $2.6 billion debt was rescheduled; in 1985 it may reach or exceed $100 billion.

As long as the debtors can continue borrowing enough to pay interest on old loans, the merry-go-round continues. When debtors begin faltering, the recycling slows. Some worried creditors, usually the least exposed, stop throwing good money after bad. Others are too involved to cut their losses. If you owe the bank $1000 and cannot pay, it is your problem. If you owe the banks $300 billion and cannot pay, the banks are in trouble. Consider Citibank, for example. As the largest U.S. bank, it has capital of $5.5 billion. Citibank's Brazilian loans alone amount to $4.4 billion. Manufacturers Hanover has $3.7 billion, 112 percent of its net worth, tied up in loans to Brazil and Argentina. Chase Manhattan also has $3.6 billion, or 92 percent of its net worth, in loans to the same two countries. The nine largest U.S. banks together have $28 billion in capital, but $64 billion in loans outstanding to troubled economies.[1] One year of no interest or principal payments from Latin America would eliminate all profits and most capital of these U.S. banks. If Brazil, Argentina, and Mexico decided to join forces and repudiate their debts, the nine largest U.S. banks would be wiped out.

Of course this will not happen. Governments, both of debt troubled countries and strong banking countries, cannot allow the massive collapse of the international monetary system this situation portends. Efforts are being made by the International Monetary Fund, groups of debtor countries, and others to forestall each confrontation between bank and debtor country. The banks may come out in the end solely because they are too vital to let go under.

Whatever the ultimate resolution of the crisis, it is obvious that the accounting rules which allowed banks to postpone recognizing economic losses have had more negative than positive economic consequences. What would have happened given the necessity to write down restructured loans is impossible to reconstruct. But in retrospect it is easy to believe that the loan merry-go-round would have slowed more gradually, with time for the world economy to readjust, than face the present fear of total collapse.

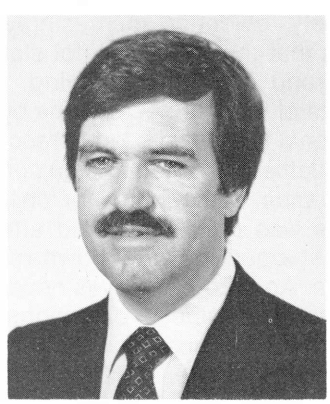
Conclusion

Standard setting for financial reporting is a complex process affected concurrently by the need to serve numerous masters, maintain theoretical consistency, and accommodate the realities of the world economic structure. Ideally, financial reporting should measure and report behavior, not become the object of behavior. The accounting principle should not influence the economic decision, but merely report it. The troubled debt pronouncement is an unfortunate example where all the negative factors came into place at one time. The primary arguments against recognizing losses on restructuring were theoretical consistency and the potential effects on the economy. The resulting statement is a model for inconsistency, and has probably exacerbated the largest financial crisis in history. The FASB's pronouncement provides heavy fuel for those parties who scorn the ability of business and the accounting profession to regulate themselves.Ω

NOTE

[1]Von Hoffman, Nicholas, *The New Republic*, October 14, 1985, pp. 21-22.

Sharon M. McKinnon, Ph.D., *is associate professor of accounting at Northeastern University, Boston, Massachusetts. She is the author of* The Seventh Directive *on EEC accounting and has published in several business journals.*



James F. Volkert, Ph.D., *is assistant professor of accounting at Northeastern University, Boston, Massachusetts. He is a member of the American Accounting Association.*

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by looking to the nature of the business activities, the attributes of the space in which the business activities can be carried out and the necessity of using a home office to carry out such activities.

While the Weissman decision is relatively narrow in scope, many university professors may be able to apply their factual situations thereto in substantiating a home office deduction.Ω

NOTES

[1]Weissman v. Commissioner, TC Memo 1983-724, rev'd, 55 AFTR 2d 85-539.
[2]S. Rep. No. 94-938, 94th Cong., 2d Sess. 148 (1976).
[3]Weightman v. Commissioner, TC Memo 1981-301.
[4]S. Rep. No. 94-938, 94th Cong., 2d Sess. 148-149 (1976).
[5]Proposed Regulation §1.280A-2(b)(3).
[6]Bodzin v. Commissioner, 60 TC 820 (1973), rev'd, 509 F.2d 679 (CA-4), 35 AFTR 2d 75-618.
[7]Weissman, at 541.
[8]Ibid., at 540-541.
[9]Drucker v. Commissioner, 79 TC 605, rev'd, 715 F.2d 67 (CA-2), 52 AFTR2d 83-5804.
[10]Weissman, at 542.
[11]Ibid., at 542-543.
[12]§280F(d)(3)(A).
[13]Curphey v. Commissioner, 73 TC 766.