DEBT RESTRUCTURING: ALTERNATIVES AND IMPLICATIONS

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A financially distressed company and its lenders can employ debt restructuring schemes that sufficiently reduce the debtor's cash crunch so it can improve operations and avoid bankruptcy. These schemes include reducing the principal amount of debt, extending maturity dates, adjusting interest rates, granting payment holidays and exchanging debt for equity or for assets.

Financially troubled companies may resort to debt restructuring as an avenue to financial recovery. According to Financial Accounting Statements Board (FASB) Statement No. 15, the factors to consider when assessing whether a debtor experiences financial difficulties include whether the company (1) is in default on its debt; (2) has filed or will soon file for bankruptcy; (3) can continue as a going concern; (4) projections indicate that cash flows will be insufficient to satisfy its contractual debt obligations; (5) has outstanding securities that have been de-listed; or (6) has limited access to capital due to deteriorating credit worthiness. If these financial difficulties are caused by temporary market forces and not by bad management, they may still be cured by restructuring debt agreements. When changing the original terms of a debt agreement involves some concessions on the part of the lender, the arrangement is referred to as troubled debt restructuring. FASB Statement No. 15 further states that troubled debt restructuring occurs when the creditor, for reasons related to the debtor's financial difficulties, grants a concession that it would otherwise not consider. The creditor's objective, whatever the form of concession that may be granted, is to make the best of a difficult situation. That is, the creditor expects to obtain more cash or other value from the debtor by granting the concession than by not granting it.

Troubled debt restructuring may be achieved in either of two ways. First, the debt may be settled at the time of restructuring. The debtor will try to actually settle the debt outright at the time of the troubled debt restructuring. The creditor may accept as final settlement an asset with a fair value less than the carrying amount of the liability. The assets that companies offer in troubled debt restructuring include cash, receivables, inventory, property, plant and equipment and intangible assets. This arrangement is called an asset swap.

In an asset swap, the debtor may need to adjust the carrying amount of the asset to its fair value prior to recording its exchange for a debt. The difference between the carrying amount and the fair value of the asset is recorded as an ordinary gain or loss on disposition of assets. The difference between the carrying amount of the debt and the fair value of the asset given up is recorded as an ordinary gain on debt restructuring.

Lenders may also accept other forms of payment such as equity instruments like common stock and preferred stock. This arrangement is referred to as equity swap. Under Philippine accounting standards, no accounting gain on debt restructuring is recognized. The carrying amount of the liability is the basis of recording

the issuance of shares of stocks. Any difference between the carrying amount of the liability and the par value of the shares of stock is credited to an additional paid in capital account.

The second mode of restructuring continues the debt, but with modified terms. Under this scheme, the lender allows the debt to continue but makes it easier for the debtor to comply. Creditors often consider partial principal settlements, payment extensions or holidays, interest rate adjustments or combination of the above. Some lenders also accept modifications to non-cash terms such as covenants, waivers, recourse, provisions or collaterization, or demand representation in the company's board of directors. .

The accounting procedures depend on whether, under the modified agreement, total cash payments (a) are less than the carrying amount of the debt or (b) still exceed the carrying amount. When the total future cash payments are less than the carrying amount of the debt, a journal entry records the difference between the carrying amount of the old debt and the future cash payments under the restructured debt as an ordinary gain on the date of restructure. No interest is recorded thereafter. All subsequent cash payments result in the reduction of principal.

The special accounting procedures applied by companies undergoing troubled debt restructuring affect the reporting of debt and equity in the balance sheet, the subsequent operating and income performance as shown on the income statement and cash flow position.

For example, an asset swap will lead to a decrease in total assets. The total financial resources available for business operations will decline. Liquidity and long term solvency may suffer because the decrease in total assets may affect the firm's ability to pay its future commitments. On the other hand, debt to equity ratio will improve because the amount of liability is reduced without affecting the capital of the business. An asset swap will have a positive effect on the income statement because an accounting gain is recognized as a result of the debt restructuring with a follow-on increase to reported stockholders' equity. The increase in the overall net income of the company, however, will affect the income tax due. An asset swap will have no effect on the cash flow statement, unless the asset given as payment is in the form of cash. Only the applicable income tax resulting from recognition of gain on debt restructuring will affect the cash position.

An equity swap has no effect on total assets because no asset is used to settle debt. Liquidity and solvency position remain unaffected by this arrangement. On the other hand, total liabilities will decline as a result of the payment of a debt while stockholders' equity will increase as a result of the issuance of the shares of stocks. An equity swap has no effect on the income statement because no accounting gain is recognized, and no effect on the cash flow statement because the cash account is not affected by the transaction. However, the equity interest of the stockholders may be affected by additional issued shares. The ownership of existing stockholders will be diluted when creditors are converted into stockholders. Existing stockholders should be

aware of this before pursuing an equity swap because the voting power and policy making power that they used to enjoy may be curtailed by the new stockholders.

If debt terms are modified, the firm's financial position as of the date of restructure is not affected by the restructuring agreement because there is no change in total assets, total liabilities and total stockholders' equity. Consequently, stockholders of a financially distressed company find modification of debt terms favorable because the overall effect on the financial position and income performance of a business is minimal. The debt will still be paid but not currently. Hence, on the date of the debt restructure there is no effect on the balance sheet. If ever a gain is recognized, the effect on the income statement is positive.

Payment of the debt is usually delayed. The corresponding effect on the financial statements is likewise delayed and spread over the new repayment period. The peso amount of the effect is sometimes reduced because of concessions accepted by the creditor.

Most lenders also find modification of debt terms acceptable because the debt is paid in cash although the amount may be reduced and the schedule of payment may be delayed. The liquidity and solvency position of the business may not be adversely affected by the new arrangement because the same effects would have happened even if there is no debt restructuring.

In conclusion, there are alternative courses of action to financially distressed companies other than bankruptcy proceedings. However, companies should assess how debt restructuring will affect aspects of the business. Debtors must be aware that debt restructurings affect cash flow, performance measures and key balance sheet accounts. Management should understand the impact of debt restructuring on their company's key financial indicators and how various stakeholders such as creditors and the investing public will view these results.

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