

Debt restructuring: alternatives and implications

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Introduction

Many companies across the world currently experience financial trouble during the past few years because of recent global economic setbacks. Cash-strapped companies struggle to meet debt obligations and covenants at a time when lenders who are also facing the same economic problems look for ways to protect their own financial interests. Before being forced into bankruptcy, 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. A classic example of this is the case of a big steel company in the USA which has been struggling with its earning performance since 2003. The company proceeded with a restructuring of its debt and became optimistic they will emerge financially stronger because of a vastly reduced debt (see Box 1).

Financially troubled companies may resort to debt restructuring as an avenue to financial recovery. FASB (Financial Accounting Standards Board) Statement No. 15 states that a troubled debt restructuring occurs when the creditor, for reasons related to the



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debtor's financial difficulties grants a concession to the debtor that it would otherwise not consider. The standard goes on to say that the creditor's objective, whatever the form of concession that may be granted, is to make the best out of a difficult situation. The creditor expects to obtain more cash or other value from the debtor to increase the probability of receipt, by granting the concession than by not granting it (Pariser 1989).

FASB Statement No. 15 further states that among the factors to consider when assessing whether debtors are experiencing financial difficulties include whether the company (1) is in default on its debt; (2) has either filed or will soon file for bankruptcy; (3) is able to 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 (Beier and Prinzivalli 2003). If these financial difficulties are caused by temporary market forces and not by bad management, it may still be cured by restructuring debt agreements rather than by forcing liquidation.

A troubled debt restructuring may be achieved in either of two ways. First, the debt may be settled at the time of restructuring. In this situation, the creditor may try to actually settle the debt outright at the time of the troubled debt restructuring. The creditor may agree to accept an asset with a fair value less than the carrying amount of the liability as final settlement of the debt. The types

Box 1.

A big steel company in Ohio, USA has been struggling with its earnings performance because sales volumes are down to depressed levels and resulting price pressures. During 2004, this steel company reported a fiscal second quarter net loss of \$13.4 million compared with an \$11.8 million loss in the same period last year. For the first six months of fiscal year 2004, the company posted a \$17.5 million net loss compared with a \$37.4 million loss a year earlier. Instead of giving up and turning to bankruptcy proceedings, management kept the flame of hope burning by pursuing alternative courses of action. Management continued to concern itself on how to make the company a viable and financially sound steel supplier.



The company proceeded with a restructuring of its cost and debt to support operations and meet capital expenditure needs. The restructuring focused on reducing the aggregate principal amount outstanding in its \$300 million secured notes and revising the terms governing interest payments. At the same time, the company's parent company is willing to make additional significant cash infusion necessary for a successful financial restructuring. Management is optimistic that they will emerge from this process financially stronger with a vastly reduced debt load (Sacco 2004)

of asset that companies may offer in troubled debt restructuring include cash, receivables, inventory, property, plant and equipment and intangible assets. This arrangement is called an asset swap.

Creditors 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.

The debt may also be continued but with modified terms. Under this likely occurrence, the creditor allows the debt to continue but modifies the terms of the debt agreement to make it easier for the debtor to comply. To recoup part of their investment, creditors often consider partial principal settlements, payment extensions or holidays, interest rate adjustments or any combination of the above concessions. Some lenders may also accept modifications to non-cash terms such as covenants, waivers, recourse, provisions or collateralization, while others may demand representation to the company's board of directors

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Box 2.

An example of shares of stock given in exchange for debt forgiveness is the Maynilad case. The local creditors of Maynilad Water Services had agreed in principle to convert three billion pesos of debt to coupon-generating voting, convertible and redeemable preferred shares of Maynilad. After the restructuring, Maynilad would be 39 percent owned by MWSS, 19 percent by Suez group, 2 percent by Metrobank and 4 percent by Maynilad employees. Benpres Holdings Corporation would continue to hold the remaining 36 percent of the total equity interest of Maynilad (www.money.inq7.net, 2004).



If the asset given up in an asset swap is cash, total cash outflows will increase thereby reducing the balance of the cash account. Otherwise, an asset swap will have no effect on the cash flow statement. Only the applicable income tax resulting from the recognition of the gain on debt restructuring will affect the cash position of the business.

Key Stakeholders' Concerns

Owners of the business will find asset swap both favorable and unfavorable. It can be considered favorable because of the positive effect on the income performance brought about by the recognition of the accounting gain on debt restructuring. This will provide a higher return on their investment improving earnings per share. On the other hand, owners may find an asset swap uncomfortable because of the decrease in total assets. A decline in total assets may have a negative financial and operating impact.

Creditors will be wary of the paying ability of the company even after the debt restructuring agreement because of the effect of the asset payment on the liquidity and solvency position of the company.

Equity Swap

In an equity swap, the payment to settle debt is in the form of shares of the debtor's stocks. An example of this is the celebrated Maynilad case where its local creditors agreed to convert the debt to preferred shares (see Box 2). The debtor must have available unissued shares available for issuance. 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 (Valix 2004).

(Beier and Prinzivalli 2003). This type is known as modification of debt terms.

Special accounting procedures are applied when companies undergo troubled debt restructuring. Proper application of these accounting rules affects the reporting of debt and equity in the balance sheet and subsequent operating and income performance as shown on the income statement.

Asset Swap

Under asset swap, the debt is settled through the use of an asset. The debtor must have an asset available for payment of the loan. 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. Moreover, the difference between the carrying amount of the debt and the fair value of the asset given up is also recorded as an ordinary gain on debt restructuring (Valix, 2004).

Impact on Financial Statements

An asset swap will certainly bring a decrease in total assets and total liabilities. The total financial resources available for business operations will decline. Liquidity and long term solvency will suffer because the decrease in total assets will affect the ability of the business to meet its future commitments. It is therefore imperative for the debtor to consider this implication before pursuing an asset swap. Limited financial assets may hamper the company's access to credit thereby hampering business operations. On the other hand, debt to equity ratio will improve because of the reduction in the amount of liability without affecting the capital of the business.

An asset swap will have a positive effect on the income statement because of the recognition of an accounting gain as a result of the debt restructuring and a follow-on increase to reported stockholders' equity. The increase in the overall net income of the company, however, will warrant consideration in terms of income tax.

Impact on Financial Statements

An equity swap has no effect on total assets because no asset was used to settle the debt. Liquidity and solvency position will remain the same. 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. Debt to equity ratio will improve because of the decrease in total liabilities.

An equity swap has no effect on the income statement because no accounting gain is recognized.

Likewise, it has no effect on the cash flow statement because the cash account is not affected by the transaction.

Key Stakeholders' Concerns

Stockholders may favor an equity swap because there is no significant effect on the financial position of the business and no adverse effect whatsoever on the income performance of the business. However, the equity interest of the stockholders may be affected with the infusion of additional issued shares. Ownership interest of existing stockholders will be diluted with the conversion of the status of the creditors to that of stockholders. Existing stockholders should be aware of this implication before pursuing an equity swap because some of the powers like voting powers and policy making powers that they used to enjoy may be curtailed by the new stockholders.

Prospective lenders will find an equity swap to be a convenient debt restructuring scheme because the liquidity and solvency position of the business remain unaffected by this arrangement.



Modification of Debt Terms

If a troubled company does not wish to make use of an asset or issue shares of stocks as payment for a loan, the debtor may negotiate with the creditor certain concessions referred to as modifications of debt terms. The creditor may agree to reduce or delay interest payments. Sometimes, the maturity amount is reduced or the maturity date is postponed to a later date. The more likely occurrence is it will call for a combination of these concessions.

The accounting procedures depends on whether, under the new agreement, total cash payments are less than the carrying amount of the debt or total cash payments still exceed the

carrying amount of the debt. When the total future cash payments are less than the carrying amount of the debt, a journal entry is prepared closing the existing liability accounts and setting up a new liability account equal to the future cash payments. The difference between the carrying amount of the old debt and the future cash payments under the restructured debt is recorded as a gain on the date of restructure. The gain is recorded as an ordinary gain in the income statement. No interest is recorded thereafter. All subsequent cash payments result in the reduction of principal (Spiceland 2004)

When the total future cash payments are more than the carrying amount of the debt, no reduction of the existing debt is necessary and no entry is required at the time of the debt restructuring. Future cash payments are applied as payment on the accrued interest, interest expense and principal. (Valix 2004). In other instances, the company simply reports a reduced interest charge in future income

If a troubled company does not wish to make use of an asset or issue shares of stocks as payment for a loan, the debtor may negotiate with the creditor certain concessions referred to as modifications of debt terms.

Stockholders of a financially distressed company will find modification of debt terms favorable because the overall effect on the financial position and income performance of a business is not much affected.

statements. The interest charge will be the discount rate that equates the present value of the future cash payments to the carrying amount of the debt. No accounting gain is recognized in the books of the debtor. (Beier and Prinzivalli 2003).

Impact on Financial Statements

If the future cash payments under the restructured debt are less than the carrying amount of the debt, a journal entry is prepared debiting the existing liability accounts and crediting a new liability account for the restructured debt and a gain account for the difference. This entry is prepared on the date of restructure. As such, the financial position of the business is not affected by the restructuring agreement because there is no change in total assets, total liabilities and total stockholders' equity. The troubled debt still exists in the books of the debtor as of this date but under new terms. However, the future cash payments will certainly affect balance sheet accounts, in particular the cash and the liability accounts.

If the future cash payments of the restructured debt are more than the existing debt, no journal entry is prepared at the time of the restructuring. The financial position of the business remains the same on the date of the restructure. The troubled debt continues to exist in the books of the debtor and is carried under their existing liability account. However, the future payments on interest and principal will decrease total assets and total liabilities.

Under the modification of debt terms, the effect of the restructuring on the balance sheet accounts is delayed and spread over the new repayment

period. The income statement will only be affected if the future cash payments under the restructured debt are less than the carrying amount of the old debt because an accounting gain is recognized. This gain is recorded as an ordinary gain which increases net income. However, the future cash payments will affect the income statement once interest expense is recorded. The recording of interest expense will decrease net income.

On the date of restructuring, there is no effect on the cash flow statement because there is no payment made yet on this date. However, the future cash payments whether applied as payment on accrued interest, interest expense or principal will increase cash outflow thereby decreasing the cash balance. The effect on the cash flow of the business is spread over the new repayment period.

Key Stockholders' Concern

Stockholders of a financially distressed company will find modification of debt terms favorable because the overall effect on the financial position and income performance of a business is not much affected. The debt will still be paid but at a later date. Hence, on the date of the debt restructure there is no effect on the balance sheet. If a gain is to be recognized, the effect on the income statement is positive.

Payment of the debt is usually postponed to a later date. Hence, 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 the concessions accepted by the creditor.

Most lenders will 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.

Conclusion and Recommendations

In conclusion, modification of debt terms seems to be the safest and most convenient debt restructuring scheme. The effect on the balance sheet and income statement is minimal. Cash outflows in all future periods are significantly reduced because of the concessions that may be allowed on interest and principal payments. Stockholders may find this arrangement favorable because their equity interest will be maintained thus preserving powers that they currently enjoy. Creditors may also find this scheme safe because the liquidity and solvency position of the company remain unaffected by the modification of the debt terms.

It is important for companies to assess how debt restructuring will affect certain aspects of the business. Debtors must be aware that debt restructurings affect cash flow, performance measures and key balance sheet accounts. These consequences should not be overlooked. Management should understand the impact of debt restructuring on their company's key financial indicators and how various stakeholders will view the results.

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Ms. Hilda Salendrez of the Accountancy Department discusses the main changes in IAS16 like recognition of subsequent costs, measurement, and depreciation.

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