Early Extinguishment of Debt
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Introduction

When debt is extinguished before its scheduled maturity, the amount paid upon reacquisition of debt securities will generally differ from the net carrying amount of the debt. This paper will deal with the accounting principles on the treatment of the difference between the reacquisition price and the net carrying amount of extinguished debt.

Some definitions

Early extinguishment: the reacquisition of any form of debt security or instrument before its scheduled maturity except through conversion by the holder.

Net carrying amount of debt: the amount due at maturity, adjusted for unamortized premium, discount and cost of insurance.

Reacquisition price of debt: the amount paid on early extinguishment, including a call premium and miscellaneous costs of reacquisition. If early extinguishment is achieved by a direct exchange of new securities, the reacquisition price is the total present value of the new securities.

Difference: the excess of the reacquisition price over the net carrying amount or the excess of the net carrying amount over the reacquisition price.

Scope of this paper

This paper does not cover the early extinguishment of debt which is made through

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1) Accounting Principles Board of the AICPA, Opinion No.26, New York, AICPA, October, 1972, paragraph 3.
troubled debt restructuring. So in such a case the creditor, for economic or legal reasons related to the debtor’s financial difficulties, grants a concession to that debtor that it would not otherwise consider; the extinguishment of debt will be covered by FASB Statement No. 15. “Accounting by Debtors and Creditors for Troubled Debt Restructurings” (June 1977).

*Short history on the treatment of the gain or loss from early extinguishment of debt*


Early extinguishment of debt is often accomplished by one of three ways:2) (1) refunding, i.e., the replacement of existing debt with another debt, (2) the use of the company’s existing liquid assets, and (3) by the use of funds obtained by the issuance of equity securities. Any difference resulting from nonrefunding extinguishment (above methods (2) and (3)) was generally treated as either gains or losses in the current year. Any difference resulting from refunding extinguishment (above method (1)) was treated by any of these three basic methods:

1. Amortization over the remaining original life of the existing original life of the extinguished issue,
2. Amortization over the life of the new issue, and
3. Recognition currently in income as a loss or gain.

ARB No. 2 (issued September, 1939) was the first formal pronouncement of the AICPA on the topic. It accepted the first and third methods and rejected the second method, amortization over the life of the new issue. Later APB Opinion No. 6 modified the ARB No. 2 which was restated in ARB No. 43 and accepted the second method also.3) So before the APB Opinion No. 26, all of the above three methods had been supported in court decisions, in rulings of regulatory agencies and in accounting literature. In October 1972 the APB Opinion No. 26 was issued and it reduced the diversity in practice for the extinguishment of long-term debt. According to the new rule only one method—recognition currently in income as a loss or gain—is accepted and the other methods which amortize the difference in the future periods were rejected.

For the determination of whether the gains or losses are ordinary or extraordinary items, the Opinion says “the criteria in APB Opinion No. 9 should be used.”4) On Sep-

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tember 1973 APB Opinion No. 30 was issued and superseded APB Opinion No. 9 with respect to the determination of extraordinary items. According to the APB Opinion No. 30, most gains or losses from early extinguishment of debt should not be classified as extraordinary items. After that, there were many respondents to the FASB, and SEC showed concern to the FASB about including gains and losses from extinguishment of debt in the determination of income before extraordinary items in the income statement. In March, 1975, FASB issued Statement No. 4 “Reporting Gains and Losses from Extinguishment of Debt.” And it required “gains and losses from extinguishment of debt that are included in the determination of net income shall be aggregated and if material, classified as an extraordinary item, net of related income tax effect.” After this statement there has been no major change in the accounting for early extinguishment of debt. Only the FASB Statement No. 15 “Accounting by Debtors and Creditors for Troubled Debt Restructuring” (issued June 1977) changed the scope of the APB Opinion No. 26 to the extent needed to exclude from that Opinion’s scope early extinguishment of debt through troubled debt restructuring.

Current Rule

Current accounting rule for early extinguishment of debt is mainly covered by APB Opinion No. 26 and FASB Statement No. 4. Early extinguishment of debt through troubled debt restructuring is covered by FASB Statement No. 15, and this part is excluded from this paper except for comparison purposes.

APB Opinion No. 26 says the difference between the reacquisition price and the net carrying amount of the extinguished debt “should be recognized currently in income of the period of extinguishment as losses or gains and identified as a separate item.” And it specifically prohibits amortizing gains or losses to the future periods. This rule applies also to convertible debt, as well as debt securities to meet sinking fund requirements. But when convertible debt is extinguished through conversion by the holder, “regardless of whether the debt is viewed as terminated or is held as so called treasury bonds”, it is not covered by the Opinion.

6) APB Opinion No.26, paragraph 20.
8) FASB Statement No.15, June, 1977, paragraph 010.
9) APB Opinion No.26, paragraph 20.
10) Ibid., paragraph 21.
The rationale behind the APB's decision on the treatment of any difference from early extinguishment of debt is well expressed by the Opinion's paragraphs 8 and 19. The reason the Board reduced other alternative methods is explained in paragraph 19 as "all extinguishments of debt before scheduled maturities are fundamentally alike." So "the accounting for such transactions should be the same regardless of the means used to achieve the extinguishment," i.e., refunding or nonrefunding methods. The reason the Board chose the specific method, i.e., recognition currently in income, among the three methods is explained in paragraph 8. The reason there is any difference between reacquisition price and the net carrying amount is "the value of the old debt has changed over time caused by a change in the market rate of interest", and the change "has not been reflected in the accounts. Therefore, the entire difference is recorded when the specific contract is terminated because it relates to the past periods when the contract was in effect". With this reasoning the Board concluded that the difference should be recognized currently in income as losses or gains. For the treatment of early extinguishment of convertible debt the Board explained in paragraph 11 that "the Board placed greater weight on the inseparability of debt and conversion option and less weight on practical difficulties". This same opinion was expressed in APB Opinion No. 14 "Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants." And the Board followed the APB Opinion No. 14 which implies that "a difference on extinguishing convertible debt needs to be recognized in the same way as a difference on extinguishment of debt without conversion features."

The classification of any gain or loss from early extinguishment of debt as an ordinary or extraordinary item is determined by FASB Statement No. 4. The Statement says "Gain and losses from extinguishment of debt shall be aggregated and if material, classified as an extraordinary item, net of related income tax effect." \(^{11}\)

This rule does apply regardless of whether an extinguishment is early or at the scheduled maturing date or later. However "the conclusion does not apply to gains or losses from cash purchases of debt made to satisfy current or future sinking fund requirements...Those gains and losses shall be aggregated and the amount shall be identified as a separate item.\(^{12}\) The Statement No. 4 also calls for special disclosure for the following information: \(^{13}\)

1. A description of the extinguishment transactions, including the sources of any

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11) FASB Statement No. 4, paragraph 8.
12) Ibid.
13) Ibid., paragraph 9.
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funds used to extinguish debt if it is practicable to identify the sources.

2. The income tax effect in the period of extinguishment.

3. The per share amount of the aggregate gain or loss net of related income tax effect.

Alternative Methods

After the APB Opinion No. 26 was issued there were some reflections on the Opinion. Abel, for example, showed a few alleged economic consequences of the current rule and suggested amortization method. Johnson and Benis argued that “Since financial analysts have historically viewed long-term debt as well as stock holders equity as part of the corporation’s permanent capital... It is suggested therefore, that any gain or loss arising from the early extinguishment of long-term debt be recorded as an adjustment of paid-in capital, and not as an increase or decrease of the current year’s income.” But this paid-in capital treatment view was critized by Cunningham and Beams in their article “Some legal aspects of the premature retirement of debt.” They explained the legal aspect concerning the relationship between shareholders and capital, as “except for donations to a corporation, capital and capital surplus can be adjusted only by transactions with shareholders... Except for donations, transactions with nonequity holders would represent adjustment of earned surplus.” And they concluded with the opinion that “because the debtholders have no ownership rights in corporations, the gain or loss from early extinguishment of debt is highly probable to be viewed legally as increases or decreases of earned surplus.”

Before the APB made its conclusion, it had considered many alternative methods in the treatment of the gain or loss from early extinguishment of debt. Those methods are listed below with brief underlying reasons for those methods.

- Amortization over life of old issue. (Difference is regarded as an adjustment of cash cost of borrowing)
- Amortization over life of new issue. (Difference is regarded as an expected benefit to be obtained over the life of new debt)

17) APB Opinion No. 26, paragraph 6–16.
When convertible debt is extinguished, the initial value of the conversion feature should be recorded as an increase in stockholder’s equity. (A portion of conversion debt proceed is attributable to the convertible feature)

- All the difference on extinguishment of convertible debt should be an increase or decrease of paid-in capital. (Convertible debt is in substance an equity security)

- Difference attributable to the interest rate should be accounted for as gain or loss in income, and the difference attributable to the market price of the issuer’s common stock should be accounted for as an increase or decrease in paid-in capital. (Market price reflects both the level of interest rates on debt and the prices of the related common stock or both)

- Convertible debt that is selling below the call or redemption price at the time of extinguishment is essentially debt; the difference should be a gain in current income.

If it is selling above the call or redemption price because of the conversion privilege, it is essentially a common stock. (Accounting should report the substance of the transaction rather than its form)

**Alleged economic consequences**

For the current accounting rule on the treatment of gain or loss from early extinguishment of debt, several economic consequences are alleged. Rein Abel says “An immediate recognition of the gain upon reacquisition may induce hard-pressed managements into an economically unsound financial policy.” The example was also shown in APB Opinion No. 26, paragraph 10 as “This rule may induce a company to report income by borrowing money at high rates of interest in order to pay off discounted low rate debt. Or conversely, a large potential charge to income may discourage refunding even though it is economically desirable.” Another case Abel mentioned is that public utility rate making considerations might be influenced by this accounting method. The article quoted Federal Power Commission’s comment on this problem, as “The question present is simply who should benefit from the gain generated solely because of economic conditions?... the cumulative effect will be to add large sums to retained earnings, with no benefit to consumers. Yet consumers will continue to pay the cost of the debt, including new debt issued at higher rates to replace that retired.” Abel also pointed

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18) Rein Abel *op. cit.*, p. 578
out that the consequences of immediate recognition are particularly objectionable when the change of current market value of bonds outstanding is a result of a change in the current creditworthiness of the borrower, instead of a general change in the prevailing market rates of interest. For example, "if an ailing business reacquires its bonds on the open market in those circumstances, it may record a substantial gain." And he quoted Paton's opinion on that case as "this is a most questionable practice because actually the transaction with the bondholders is conclusive evidence of a major shrinkage in the stockholders' equity previously ignored." With all these alleged economic consequences from the immediate recognition rule, Abel stated his opinion as "the amortization method would somewhat lower the accountants' exposure to possible dangers in this area."

**Tax Aspect**

The tax aspects of debt reacquisition is well summarized in Gunther's article, "Accounting and Tax Aspect of Securities Reacquisitions." He described the tax aspects as "As a general rule, such gain (from reacquisition of debt) is taxable income. Companies having available net operating loss carryovers absorb these gains against the carryovers thereby sheltering the income and causing no negative cash flow implications... The IRC contains a relief provision allowing as election under which, in lieu of immediate income recognition, the gain may be deferred by applying it as a reduction of selected defined assets... (In holding company's case), allocating the gain as a reduction in the parent's tax basis in its subsidiaries may permanently defer the taxability of the gain, assuming that the subsidiaries are not sold subsequently."

**Comparison with FASB No. 15**

The accounting standards for troubled debt restructuring is consistent with the APB Opinion No 26 in cases when either assets are transferred or equity interest is granted as a full settlement of a payable; a gain is recognized, and measured as the difference between (i) fair value of assets transferred or equity interest granted and the (ii) carrying amount of the payable. When only the terms of a payable are modified,
the Statement says no effect should be accounted at the time of restructuring, and the effect shall be accounted prospectively unless the carrying amount exceeds the total future cash payment specified by the new terms. Meanwhile, the Opinion No. 26 says when an old debt is extinguished through issuance of new debt a gain or loss should be recognized as the amount of the difference between net carrying amount of the old debt and the amount paid to reacquire the debt. Then the difference on the treatment of the effect arises from the basic concept i.e., a modification of terms of a payable does not constitute an extinguishment of the old payable. In other words a modification of terms does not accompany any transfer of resources or obligations. In my opinion, ” compatibility with expected economic effect” concept can be applied in this case. In the compatibility concept which was explained in the FASB Statement No. 8, 231 can be applied in this case the gain should be recognized in the difference between the carrying amount of the old debt and the fair value of the new modified debt. The modification of terms on payable usually result in a beneficial effect to a debtor, and the amount compatible to that economic effect should be recognized as a gain. Also the same reasoning which was expressed in the Opinion No. 26 might be applied here; i.e., the difference between the carrying amount and the fair value of an old debt is related to the past period so it should not be cauued over the future period. If a modification is such a one as to confirm the fair value of an old debt or change the fair value of it, in my opinion, the old debt should be considered as substantially extinguished. If those views are accepted, then there is inconsistency between the Opinion No. 26 and Statement No. 15.

Conclusion

In spite of the fact that when APB Opinion No. 26 was adopted three members dissented and three members assented with qualifications, after the issuance of the opinion, there has not been much criticism or argument on the present accounting standard on the treatment of early extinguishment of debt. Besides the Johnson and Benis’s article which is more related to the basic accounting concept, i.e., entity concept for accounting, there were only a few criticism. The main reflection was in Abel’s article, and although he pointed out many unfavorable effects from current rule, he could not present a convincing alternative method.

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There has been some concern over FASB Statement No. 4, which requires classification of gain or loss from early extinguishment of debt as an extraordinary item. For example, Cunningham and Beams expressed their opinion on the FASB Statement No. 4 as "a continuation of the current economic instability with widely fluctuating long-term interest rates could lead to increasing numbers of early retirements of debt... In such an economic climate, it would be difficult to justify reporting most gains and losses from these transactions as extraordinary items."24)

After FASB Statement No. 4, there has been little change in the accounting standard on the early extinguishment of debt. But as FASB mentioned in paragraph 04 of Statement No. 4 there had been some suggestions that APB Opinion No. 26 be reconsidered. Also SEC mentioned on this matter, that the FASB recueved sine cinnebts "for failing to deal with the fundamental question of whether the gain on an early extinguishment of debt should be recognized at all"; the SEC showed their concern, stating "Standard Board has evaded this issue by failing to even comment upon it in its statement No. 4."25)

In my opinion, the current rule is consistent with the existing accounting framework. Like all other accounting Standards, this accounting standard for early extinguishment of debt is based on many basic accounting concepts and principles, i.e., historical cost accounting, propriety concept, some concepts on convertible bonds, etc. If any of these basic concepts or principles change, the accounting rule should be changed accordingly. When the FASB's Conceptual Framework project is accomplished, I hope, it will give more solid ground for this accounting standard as well as all other accounting standards.