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ABSTRACT (100-200 words):

The recent outbreak of company restructuring has demanded attention. The two most common methods involve the write-down of assets and the restructuring of debts.

When writing down assets, a company aggregates its losses and reports one gross loss in the fourth quarter of its fiscal year. Financial statement users view this as "big bath accounting" and depend more timely information. Management merely views this as a function of identification—when they can finally gather sufficient evidence to measure the value of asset impairment.

In debt restructuring, a company reports gains to the extent that its obligations have been discharged. A debate still in process is concerned with whether the reported gains are justifiable. Questions have arisen as to when the gains are earned as part of the culmination of the earnings process.

Information and complete financial statement disclosures can alleviate some doubts the users may have. Auditors have the responsibility to determine that the financial statements present fairly the company's financial position, but it is up to the users to evaluate the company's financial health and future prospects.

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NORTHERN ILLINOIS UNIVERSITY

"RESTRUCTURING CHARGES: ARE THEY AN ABUSE TO ACCOUNTING THEORY?"

A Report submitted to the University Honors Program in Partial Fulfillment of the Requirements of the Baccalaureate Degree With Upper Division Honors

Department of Accountancy

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I. **AUDIT APPROACH**

When an auditor has an engagement with a client who is experiencing financial difficulties and who is undergoing the restructuring process, be it the write-down of assets and/or the restructuring of troubled debt, the auditor must first understand the restructuring concept. Write-downs will usually entail loss recognition while troubled debt restructuring will normally include gain recognition. The auditor must review charge components on the client's Statement of Income and investigate the client's methodologies for handling such charges.

When reviewing the estimated losses, the auditor should determine that the amounts recorded are reasonable. The recognized loss on productive assets should reflect a permanent loss in value to the company. The auditor should also determine whether the loss recorded represents the asset's cost deemed unrecoverable or the unrecoverable cost plus a normal profit margin, two acceptable methods still under debate. The auditor should also determine if the recoverable amount remaining in the client's books represents expected future cash flows to be generated by the asset or the asset's net realizable value.

When the auditor reviews the recognized gains realized from troubled debt restructuring, the auditor should investigate the concessions made by creditors. If the
client was able to settle a debt by transferring assets or granting equity to the creditor, the debtor probably recognized two gains: the gain realized on the asset and reported as "Other Income" and the gain realized from the discharge of debt reported as an extraordinary gain. If the debt restructure merely consisted of a modification of terms, an extraordinary gain would only be recognized when the liability's carrying value exceeds the total future amount to be paid.

Another factor the auditor must consider is the client's timing of recognition. The measurement date concept plays a large role in recognition. Management controls measurement of gains or losses and usually aggregates the losses from write-downs of assets and recognizes one large loss in the fourth quarter. The auditor should determine if this process is acceptable.

One more step an auditor should take in auditing the client's restructuring process is to review the client's disclosures set forth in the financial statements. The auditor should determine that thorough description is provided such as the nature and causes of productive asset write-down and of changes in debt agreements, the tax implications of the gains and losses, and the methods for determining such gains and losses.
Taking into account that it is the auditor’s final responsibility to verify that management’s representations fairly present the client’s financial position, the auditor should perform additional procedures where needed. The auditor must conclude that an asset’s new carrying value is fairly stated after a write-down and that a debt was properly settled or modified by concession of the creditor.

II. WRITE-DOWN OF ASSETS

Business restructuring consists of a great many events of which troubled-debt restructuring is only a portion. Restructuring entails a wide range of focuses including management’s decision to discontinue certain operations of a business, to consolidate operating units, to write-off idle or excess manufacturing capacity, to dispose assets that become obsolescent, unprofitable, or idle, to cut back on personnel, and to centralize functions of administration.

According to Pearson and Okubara, recent restructurings have three things in common: 1) the sudden increase in the number of companies undergoing the process; 2) the magnitude of monetary involvement; and 3) the inclusion in the financial statements of the write-down of assets still in use because of doubts as to whether the assets’ costs will be recovered through normal business operations.
Because of the difficulties arising from the ability to recognize and measure the impairment of value of operating assets on a timely basis and due to the lack of detailed authoritative guidance on the subject, the write-down of assets remaining in use should be closely scrutinized.

Even though General Accepted Accounting Principles (GAAP) still has not settled the issue of accounting for impairments in value of tangible productive assets still in use, the general practice is to recognize a charge against earnings in the period incurred for a permanent loss in value of any asset. The write-down of the assets' carrying amounts should be to a value that is reasonably expected to be recovered through future use of those assets.

The financial accounting standards board (FASB) does require that before a loss can be recognized, it must first be measurable. It is apparent that measurability may be the very root of the restructuring issue. Accordingly, the basis for a write-down is to reflect permanent losses in value to a company and to recognize that those assets will not make further contributions to profit. The over or understatement of a loss affects the company in different aspects. To overstate a loss may reap higher profits in the future because of the depreciation foregone, while to underestimate a loss would wreak havoc on financial statement credibility due to the additional loss adjustments reported year after year.
But what are good measurements for the amount of loss to be recognized and the remaining recoverable amount to be kept on the books? There is no direct guidance as to whether the impairment in value of an asset should be measured purely as the cost deemed unrecoverable or as to the cost deemed unrecoverable plus a normal profit margin. Inventory may be used as an example because inventory can be written down to net realizable value (selling price less selling costs) less a normal profit margin, but an inconsistency exists between inventory and productive assets. "Inventory contributes directly to the profit margin, while productive assets contribute indirectly to profits." Thus, deducting a normal profit margin for the write-down of productive assets may prove to be inaccurate due to the lack of direct contribution to profits.

As to the amount measured to be recoverable, there are two possibilities of measurement: 1) the expected net future cash flow, and 2) the net realizable value. The expected future cash flow is an estimate of future cash inflows and outflows that the asset is expected to generate throughout its remaining life. The estimate can be formulated from trends within the industry or from market and engineering studies. The net realizable value is merely the amount expected to be generated from the sale of the asset less any selling costs incurred. The use of net realizable value is especially appropriate for assets held for sale.
Pearson and Okubara set forth two methodologies for estimating cash flows, one being the "portfolio vs. Individual Asset" approach and the other being the discounting of cash flows. The portfolio approach considers whether to use the cash flows that the impaired asset will generate, that the total business segment using that asset will generate, or that the whole company will generate. If the cash flows generated only from the asset in question are considered, the circumstances would be similar to evaluating inventory at lower of cost or market. "Like inventory, a productive asset should be evaluated for permanent impairment based on its character and composition, - how the asset fits into the company's overall operations." 4 On the other hand, if the company's aggregate cash flows are used to measure the asset's recoverable amount, it would be more consistent with the process for marketable equity securities set forth in FASB Statement 12. The company would look at the entire "portfolio" of cash flows to measure the recoverable amount to be recorded.

Concerning the second methodology of discounting, "current practice leans toward not discounting an impairment write-down" 5 because it is not appropriate to apply discounting procedures to non-monetary assets. Some do believe, though, that discounting is essential to properly reflect the time value of money.
With measurement of impairment value being a first-hand problem for management, timely recognition is a hot debate among financial statement users. Shareholders, creditors, and other users question whether companies are reporting restructurings or impairment of values in the period of occurrence or if companies are delaying this reporting until year end. According to Pearson & Okubara, some view the companies as partaking in "big bath accounting" which occurs when a company reaps all losses together and reports them as one large loss in one period so as to bear more fruitful profits in the future. Another view Pearson and Okubara bring to light is that some believe companies recognize their losses when it is convenient, usually in the third or fourth quarter when the company could start a new year on the right foot and not belabor the company's problems in interim financial statements.

There does seem to be a justifiable reason for year-end reporting though. It is in the fourth quarter that management can finally gather sufficient evidence after analyzing trends to aid in assessing value impairment and the estimated recoverable cost. Thus, "fourth quarter announcements is a function of identification - not manipulation or arbitrary recognition." 6

When reporting losses or value impairment contingent upon restructuring, companies can do much to alleviate financial statement users' skepticism by providing timely
and informative disclosures. Additional disclosures help prevent financial statements from being misleading. Early disclosure of imminent losses may pacify statement users but it creates additional hardship for management in determining whether an impairment of value is temporary or permanent. Footnotes to the financial statements should explain in detail the nature and causes of the loss along with reasons for recognizing the loss when the company did and factors supporting the write-down.

An alternative method for handling impairment of value when measurement of the loss is easy, is to analyze the asset's useful life. "By shortening the asset's remaining service life, its carrying value is written off faster, and annual operations bear a greater charge." 7

III. DEBT RESTRUCTURING

Adding to the controversy under the topic of restructuring is another heated issue that is raising some eyebrows. The issue of concern is the method of accounting for the restructuring of debt, namely troubled debt, from both the debtor's and creditor's point of view. In this context FASB Statement 15, explains that a troubled debt restructuring occurs when "... the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider." 8 A troubled debt restructuring situation does not apply when a creditor merely makes
routine changes in the terms of debt.

FASB Statement 13 sets forth three possible faces of debt restructuring. The first is a "transfer from the
debtor to the creditor of receivables from third parties,
real estate, or other assets to satisfy fully or partially a
debt." In this case, the debtor faces the possibility
of recognizing two gains. The debtor should recognize a gain
or loss on the transfer of assets as the difference between
the fair market value and the book value of the assets. The
debtor shall also recognize a gain on the restructuring for
the excess of the carrying value of the debtor's payable
over the fair value of the transferred assets. On the flip
side, the creditor will record the assets at fair value and
recognize a loss for the amount of his/her investment in the
debt receivable in excess of the fair value of assets received.

The second possibility for a troubled debt
restructuring is the "granting of an equity interest to the
creditor by the debtor to fully or partially satisfy a debt
unless the equity interest is granted pursuant to existing
terms for convertibility of debt to equity interests."
FASB 13 sets forth that the debtor will recognize a gain for
the excess of carrying value of the payable over the fair
value of the equity interest. The creditor, on the other hand, accounts for the equity received in the same manner used for transferred assets.

A troubled debt restructuring may also include the third possibility: modification of debt terms, such as reducing the applicable interest rate over the remaining original debt term or extending the maturity date of debt obligations at an interest rate lower than the current market rate for like obligations. Modification of terms may also call for reducing the debt's face amount or reducing accrued interest. The creditor's motive is to actually recover his/her investment even if he/she has to reduce the effective interest rate or lengthen the maturity date. The debtor should account for this restructuring in three different manners contingent upon the circumstances involved. If the existing debt is less than or equal to total future payments of principle plus interest, the debt payable or receivable should be handled prospectively and not adjusted by either the debtor or creditor. No gain or loss should be recognized by either party to the extent that the debt recoverability is not affected.

On the other hand, if the existing debt is greater than the amount of future payments, FASB 15 states that the debtor shall recognize a gain equal to the excess of the payable's carrying value over the future payments, while the creditor reports a loss for the same amount.
IV. CONCLUSION

In the past few years there has been an outbreak of company restructuring that has demanded much attention. There are two broad bases that involve restructuring: 1) the write-down of assets, and 2) the restructure of debts. Both seem to work in the company's favor.

When a company writes down its assets, the company usually aggregates the losses and reports one great loss in the fourth quarter. Financial statement users believe this method is the "big bath accounting" phenomenon while management believes that delaying loss reporting until the fourth quarter is a function of identification. Delaying loss recognition is not consistent with the matching principle though because losses are not being recognized in the periods actually affected or when the losses are deemed measurable. Financial statement users demand more timely reporting and management can alleviate additional pressures by providing accurate and informative disclosures.

When a company partakes in debt restructuring a different set of boundaries are involved. Instead of reporting large losses, a company, as a debtor, will most likely report gains to the extent of its obligation discharged after the creditor agrees to make concessions that normally would not be made. Questions have arisen as to whether reporting a gain is justifiable. Gains are to be recognized when earned at the culmination of the earnings
process. In this situation debt is discharged but what is the earnings process? When has the gain been earned? Again, informative and complete footnotes to the financial statements may rid some doubt on the part of the financial statement readers. Readers of financial statements should take a closer look at income statement components and investigate gains and/or losses from restructurings. Readers should not rely solely on the Statement of Income but should also inspect the Balance Sheet and its components. Auditors do have the responsibility to determine that the financial statements of a company do present fairly the company's financial position, but it is left to the financial statement user to determine for himself/herself the company's actual financial health and its future prospects.
ENDNOTES

2 Ibid, p. 37
3 Ibid
4 Ibid, p. 38
5 Ibid
6 Ibid, p. 40
7 Ibid
8 Accounting Standards, Current Text, General Standards as of June 1, 1987
9 FASB, p. 11826
10 Ibid, pp. 11826-7
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