FUNDAMENTALS OF ACCOUNTING FOR DEBT MODIFICATIONS AND RESTRUCTURINGS
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A. INTRODUCTION

Borrowers may seek to renegotiate the terms of existing loans because they are not able to meet current loan covenants or cash flow requirements under their loans or because they want to increase the amount borrowed or obtain lower interest rates. Lenders may be willing to renegotiate the terms of existing loans because they realize that it may be in their best interests to reconsider the terms of a loan instead of: (a) losing the borrower to a competitor that is willing to provide a reduced interest rate because of an improvement in the borrower’s credit quality or a reduction in market interest rates, (b) forcing the borrower to find another lender or file for bankruptcy or (c) foreclosing on any collateralized assets. As a result of the renegotiations, the borrower and lender may agree to modify or restructure an existing loan or exchange one loan for another. The degree of change introduced by the modification, restructuring or exchange depends on any number of factors, first and foremost being the financial condition and prospects of the borrower.

Naturally, there are accounting implications when the borrower and lender agree to modify or restructure an existing loan or exchange one loan for another. The accounting implications differ depending on whether the borrower’s or lender’s accounting is being considered. This paper deals solely with the borrower’s accounting for a modification, restructuring or exchange. Depending on the facts and circumstances, a number of different accounting outcomes could result for the borrower. For example, the borrower may be required to recognize a gain or loss in the period of the modification, restructuring or exchange, or the borrower may be required to account for the effects of the modification, restructuring or exchange in future periods. A thorough analysis of the borrower’s facts and circumstances and the relevant authoritative accounting literature is required to ultimately determine how the borrower should account for a modification, restructuring or exchange. Oftentimes, a significant amount of professional judgment must be exercised in making this determination.

To identify the appropriate accounting model to apply to a modification, restructuring or exchange, the borrower must first determine whether it has met the criteria to remove a liability from its books (i.e., derecognize the liability and apply the extinguishment accounting model). Typically, these criteria are met when the modification, restructuring or exchange involves an old loan being paid off with proceeds from a new loan that is with a different (unrelated) lender (i.e., an unrelated party that was not considered a lender with respect to the old loan). In contrast, these criteria are not met just because the borrower and the same lender exchange cash to satisfy an existing loan and issue a new loan.

If the derecognition criteria have not been met, then the borrower must determine whether it should apply the accounting model for a troubled debt restructuring. In some cases, a troubled debt restructuring results from the full settlement of debt through the transfer of cash, noncash assets or equity (i.e., the debt is derecognized in the troubled debt restructuring). While the net effect on the income statement is the same regardless of whether the extinguishment or troubled debt restructuring accounting model is applied in these cases, there are additional disclosure requirements for a troubled debt restructuring. As such, consideration should be given to whether the derecognition of debt meets the conditions present in a troubled debt restructuring. If the derecognition criteria have not been met and the troubled debt restructuring accounting model does not apply to its facts and circumstances, then the borrower must determine whether it should apply the accounting model for a debt modification or extinguishment. The following illustrates this overall thought process:
[Note that many of the terms used in this decision tree (e.g., financial difficulties, concessions, substantially different) have specific meanings and implementation guidance attached to them. This paper explains and illustrates that guidance.]

The conclusions reached by a borrower in determining the appropriate accounting for a modification, restructuring or exchange of loans could significantly affect its financial statements. Depending on the facts and circumstances, one or more of the following may be required of the borrower:

- With respect to the loan itself:
  - Adjust the carrying amount of the loan
  - Make no adjustments to the carrying amount of the loan
  - Derecognize the old loan and recognize a new loan
- Change the amount of interest expense recognized in the income statement on a going forward basis or recognize a gain or loss in the income statement in the period of the modification, restructuring or exchange
- Expense some of the costs incurred to execute the modification, restructuring or exchange and (or) defer and amortize other costs

In addition, the borrower would also have to consider classification questions related to the old or pre-existing loan and the new or changed loan. Classification of debt is discussed in detail in our white paper, *Fundamentals of Debt Classification*. 
As mentioned earlier, this paper deals solely with the borrower’s accounting for a modification, restructuring or exchange of loans. The guidance that a lender would use to determine its accounting for a modification, restructuring or exchange of loans is not the same as that used by a borrower. In fact, there may be situations in which the borrower concludes it has entered into a troubled debt restructuring while the lender concludes it has not entered into a troubled debt restructuring (or vice versa). This paper also does not address the extinguishment, modification, exchange or conversion of convertible debt given the unique complexities involved in that accounting. However, there is limited discussion on how adding, changing or removing an embedded conversion option may affect a borrower’s determination as to the accounting model applied to the modification or exchange of the underlying debt.

Historically, entities have been required to present issuance costs related to term debt (e.g., legal and underwriting costs) as assets on the balance sheet and debt discounts (e.g., lenders’ fees) as a reduction of the related debt’s carrying amount. The requirement to present issuance costs related to term debt as assets was changed in April 2015 when the Financial Accounting Standards Board issued Accounting Standards Update (ASU) 2015-03, Interest—Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs. The change brought about by this ASU requires presentation of issuance costs related to term debt as a reduction of the related debt’s carrying amount on the balance sheet. For public business entities, the ASU is effective for financial statements issued for fiscal years beginning after December 15, 2015 and interim periods therein. For all other entities (e.g., private entities), the ASU is effective for financial statements issued for fiscal years beginning after December 15, 2015 and interim periods in fiscal years thereafter. All entities have the option to early adopt the ASU. Upon adoption, the new guidance must be applied retrospectively to all periods presented. For ease of discussion and illustration, this paper is written assuming that ASU 2015-03 is effective.

The relevant accounting literature on how to account for the modification, restructuring or exchange of loans is included in primarily two sections of the Financial Accounting Standards Board’s (FASB) Accounting Standards Codification (ASC):

- ASC 470-50, “Debt—Modifications and Extinguishments”
- ASC 470-60, “Debt—Troubled Debt Restructurings by Debtors”

The relevant guidance in these sections of the Codification has been summarized in this paper in Part B, Relevant literature and general concepts. Several examples of how to apply this guidance are included in this paper in Part C, Examples.
B. RELEVANT LITERATURE AND GENERAL CONCEPTS

B.1. Liability derecognition

Relevant Codification section(s): 405-20-40-1 and 2

General concepts
Extinguishment is the derecognition threshold for a liability. Derecognizing a liability simply means to take the liability off, or remove the liability from, the borrower’s books. The derecognition threshold is met only if: (a) the borrower pays the lender and is relieved of its obligation or (b) the borrower is legally released as the primary obligor. Payment to a lender may occur upon the delivery of cash, other financial assets or goods or services. Payment may also occur if the borrower reacquires its outstanding debt securities and cancels them or holds them as treasury bonds. Legal release as the primary obligor may be granted by the lender or may occur judicially. If the liability derecognition threshold has been met, then the borrower should apply extinguishment accounting (which is discussed in section B.3.3).

Questions arise regarding whether the following circumstances constitute an extinguishment: (a) the borrower is legally released by the lender as the primary obligor, (b) a third party agrees to assume the obligation and (c) the borrower agrees to become secondarily liable for the obligation. While the occurrence of all these circumstances extinguishes the borrower’s original obligation, it also creates a new obligation. This new obligation is a guarantee and must be accounted for as such (i.e., initially recognized and measured at fair value).

Commentary: Some troubled debt restructurings result in debt being fully settled either through the transfer of cash, noncash assets and (or) equity. In other words, in a situation where the debt is fully settled, the troubled debt restructuring would meet the liability derecognition criteria, which are generally considered first when accounting for debt that has been settled. When these criteria are met, the extinguishment accounting model is applied. While the net effect on the income statement is the same regardless of whether the extinguishment accounting model or troubled debt restructuring accounting model is applied in these situations, there are additional disclosure requirements for a troubled debt restructuring. As such, consideration should be given to whether the derecognition of debt meets the conditions present in a troubled debt restructuring.

The mere fact that the borrower and lender concurrently exchange cash to satisfy an existing loan (cash from borrower to lender) and issue a new loan (cash from the same lender to borrower) should not lead the borrower to conclude that the extinguishment accounting model should be applied. This exchange of cash and loans may need to be accounted for as a modification or troubled debt restructuring instead of an extinguishment.
B.2. Troubled debt restructuring accounting

B.2.1. Nature

Relevant Codification section(s): 470–60–10–1 and 2; 470–60–15–4 through 7; 470–60–15–9 through 11; 470–60–55–1 through 3

General concepts

The Master Glossary for the Codification defines a troubled debt restructuring as follows: “A restructuring of a debt constitutes a troubled debt restructuring if 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.” The concession granted by the lender will affect both the borrower’s and lender’s cash flows related to the debt. The cash flows may be affected by changing: (a) the amount or timing of cash flows paid by the borrower, (b) how much of the cash flows will be designated as interest and (c) how much of the cash flows will be designated as principal amounts.

A troubled debt restructuring may involve debt, bonds, notes or even accounts payable relating to purchasing goods or services on credit. In other words, it is not limited solely to loans or debt. The evaluation of whether a troubled debt restructuring has occurred should take place for each liability entered into with a specific lender. In some cases, the restructuring of a group of similar liabilities may be negotiated at the same time across a number of lenders. The fact that the restructuring is negotiated jointly does not change the fact that the accounting for the restructurings should take place separately for each individual liability. However, if bonds payable are part of a troubled debt restructuring, the bond is viewed as one liability for accounting purposes. In other words, each individual bond that makes up the bonds payable is not viewed as its own separate liability for accounting purposes.

A lender’s incentive in agreeing to a troubled debt restructuring rests on the theory that it is better to get something instead of nothing. In other words, if the only way a lender will get any payments from a borrower is if they agree to a concession, then they may be incented to agree to the troubled debt restructuring to get at least some of the amounts owed to them. Of course, the lender is motivated to grant a concession that still protects as much of its investment as possible. Any of the following could take place in a troubled debt restructuring:

- The lender agrees to settle the debt for less cash than the outstanding balance of the debt.
- The lender agrees to settle the debt by accepting assets from the borrower whose fair value is less than the carrying amount of the debt. The assets could be accounts receivable from routine sales made by the borrower, real estate or other assets. These assets may come to the lender as a result of foreclosure, repossession or other transfers.
- The lender agrees to settle the debt by accepting a grant of equity securities issued by the borrower, provided the grant is not occurring in accordance with pre-existing terms that would have permitted conversion of the debt to an equity interest.
- The borrower and lender agree to modify the terms of the debt and not transfer any assets or equity. The cash requirements under the debt may be reduced as a result of one or more of the following: (a) a reduction in the stated interest rate on the debt, (b) an extension of the maturity dates when the stated interest rate is lower than the market rate for comparable new debt, (c) a reduction in the face amount of the debt and (or) (d) a reduction in accrued interest owed on the debt.
- The borrower and lender agree to: (a) the partial settlement of the debt through the transfer of noncash assets or equity and (b) the modification of terms for the debt that remains.
The borrower and lender may initiate the discussions that lead to a troubled debt restructuring or those discussions may be forced by law or by a court. As such, a troubled debt restructuring may exist for accounting purposes if it was carried out under various provisions of the Federal Bankruptcy Act (e.g., reorganization) or other related federal statutes. When the borrower in a troubled debt restructuring is undergoing bankruptcy proceedings, a quasi-reorganization or corporate readjustment at the same time as the restructuring, it is important to understand whether such activities will result in a general restatement of the borrower's liabilities. If so, a troubled debt restructuring does not exist for accounting purposes.

The following situations are not in the scope of the troubled debt restructuring guidance:

- Changes to lease agreements
- Changes to employment-related agreements (e.g., pension plans, deferred compensation contracts)
- Failure by the borrower to pay its trade accounts according to their terms without reaching an agreement with its creditors to change the terms
- Deferral of legal action by the lender to collect past due amounts of interest and principal from the borrower
- Application of bankruptcy accounting by the borrower and a general restatement of its liabilities

**Commentary:** Some troubled debt restructurings result in debt being fully settled either through the transfer of cash, noncash assets and (or) equity. In other words, the troubled debt restructuring would meet the liability derecognition criteria, which are generally considered first when accounting for debt that has been settled. When these criteria are met, the extinguishment accounting model is applied. While the net effect on the income statement is the same regardless of whether the extinguishment accounting model or troubled debt restructuring accounting model is applied in these situations, there are additional disclosure requirements for a troubled debt restructuring. As such, consideration should be given to whether the derecognition of debt meets the conditions present in a troubled debt restructuring.

### B.2.2. Determining whether a troubled debt restructuring exists

**Relevant Codification section(s):** 470–60–15–8, 12 and 13; 470–60–55–4 through 13

**General concepts**

Determining whether the accounting for a troubled debt restructuring applies in a particular situation is a matter of professional judgment. An analysis of all the facts and circumstances must be performed and no one fact or circumstance would itself be considered determinative in the face of a preponderance of contrary evidence. The accounting literature provides guidelines that should be used in this analysis. These guidelines focus on the definition of a troubled debt restructuring (see section B.2.1). Based on that definition, the following two questions must be answered to determine whether the accounting for a troubled debt restructuring applies in a particular situation:

1. Is the borrower experiencing financial difficulties?
2. Has the lender granted a concession to the borrower?

If the answer to both of these questions is yes, then the restructuring of the debt should be accounted for as a troubled debt restructuring. If the answer to either of these questions is no, then the restructuring of the debt should not be treated as a troubled debt restructuring for accounting purposes. In those situations, the borrower must determine whether modification or extinguishment accounting is appropriate (see section B.3.2).

**Is the borrower experiencing financial difficulties?**

A borrower should evaluate whether it is experiencing financial difficulties if there has been deterioration in its creditworthiness since it originally issued the debt. For purposes of assessing whether the borrower’s creditworthiness has deteriorated:

- If the borrower’s credit–rating changes, but remains an investment–grade credit rating (e.g., Standard & Poor’s credit rating on the borrower drops from an A to a BBB), then its creditworthiness has not deteriorated.
- If the borrower’s credit–rating slips from investment grade to noninvestment grade (e.g., Standard & Poor’s credit rating on the borrower drops from a BBB to a BB), then its creditworthiness has deteriorated.

Refer to the commentary at the end of this topic for a discussion on other factors that can be assessed when determining if a borrower’s creditworthiness has deteriorated. These factors are particularly relevant when a borrower’s credit has not been formally rated by a recognized rating agency.
If the borrower’s credit rating has deteriorated, then a number of factors must be considered to determine whether the borrower is experiencing financial difficulties. Answering yes to any of the following questions would be an indicator that the borrower is experiencing financial difficulties:

- Is the borrower currently in default on any of its debt?
- Has the borrower declared bankruptcy or is the borrower in the process of declaring bankruptcy?
- Is there doubt about the borrower’s ability to continue as a going concern?
- Have any of the borrower’s securities been delisted from an exchange?
- Are any of the borrower’s securities in the process of being delisted from an exchange?
- Does the threat exist for any of the borrower’s securities to be delisted from an exchange?
- Are the borrower’s projected cash flows (based on current business capabilities) insufficient to cover payments required on the debt through maturity?
- Is the borrower unable to obtain debt from other lenders in which the effective interest rate charged by the lender is equal to the current market interest rate charged on comparable debt issued to a nontroubled borrower?

Answering yes to both of the following questions would be determinative evidence that the borrower is not experiencing financial difficulties:

- Has the borrower been servicing the debt and can the borrower obtain debt from other lenders in which the effective interest rate charged by the lender is equal to the current market interest rate charged on comparable debt issued to a nontroubled borrower?
- Has the lender agreed to restructure the debt only to take into consideration: (a) decreases in the current market interest rates at which the borrower could obtain funds or (b) improvements in the borrower’s creditworthiness since the debt was originally issued?

Answering yes to either, but not both, of these questions would be an indicator that the borrower is not experiencing financial difficulties.

**Commentary:** In many cases, a borrower’s credit has not been formally rated by a rating agency. This is particularly true of many privately held companies. Assessing whether a borrower’s creditworthiness has deteriorated in these cases requires the consideration of other factors in the context of the borrower’s specific facts and circumstances. Examples of other questions that should be considered in determining whether the borrower’s creditworthiness has deteriorated when the borrower’s credit has not been formally rated by a rating agency include the following:

- Is the borrower part of an industry whose sector risk has deteriorated?
- Is the borrower unable to obtain new debt at reasonable terms?
- Is the borrower unable to meet the debt covenants in its existing loan agreements?
- Is the borrower experiencing liquidity issues? For example, has its working capital ratio worsened?
- Has there been a general decline in the borrower’s financial performance? For example, has the borrower recently experienced recurring net losses?

Answering yes to any of these questions is an indicator that the borrower’s creditworthiness has deteriorated. The final assessment as to whether the borrower’s creditworthiness has deteriorated should take into consideration the responses to all of these questions as well as other relevant facts and circumstances specific to the borrower.

**Is lender granting a concession?**

A concession has been granted by the lender if the borrower’s effective (not stated) interest rate after the restructuring is less than its effective (not stated) interest rate prior to the restructuring. However, there may be rare situations in which a decrease in the effective interest rate is attributable to a factor not reflected in the mathematical calculation of the effective interest rate. Adding more collateral to the debt may give rise to this situation. Provided there is persuasive evidence in support of these rare situations, a concession may not have occurred even though there has been a decrease in the borrower’s effective interest rate. The accounting in such a situation should reflect the substance of the changes made to the debt.
The post-restructuring effective interest rate should give effect to all of the terms of the restructured debt, which would include any new or revised options, warrants, guarantees and letters of credit. The following steps should be taken when calculating the post-restructuring effective interest rate:

- Project all cash flows required under the post-restructuring debt
- Solve for the discount rate that makes the present value of the projected cash flows equal to the current carrying amount of the borrower’s pre-restructuring debt

Reflected in the carrying amount of the borrower’s pre-restructuring debt would be any unamortized premium, discount or issuance costs and any accrued interest payable. Hedging effects related to the pre-restructuring debt would not be included in its carrying amount. For example, the borrower may have previously elected fair-value hedge accounting for an interest rate derivative (such as an interest rate swap) related to the debt. Adjustments to the carrying amount of the debt to record changes in fair value associated with the hedging relationship should be excluded from the carrying amount of the pre-restructuring debt when calculating the post-restructuring effective interest rate.

Reflected in the projected cash flows required under the post-restructuring debt would be the effects of any new or revised enhancements (i.e., sweeteners) included in the debt. Examples of sweeteners include options, warrants, guarantees and letters of credit. One way in which adding a sweetener would directly affect cash flows is if the borrower added a new financially-sound guarantor to the debt and, as a result, the lender agreed to reduce the interest rate charged on the debt. Adding, deleting or changing a sweetener may not always have a direct effect on cash flows. Nonetheless, the standard-setters believed that adding, deleting or changing a sweetener should be taken into consideration when determining whether the lender has granted a concession. As such, the day-one projected cash flows required under the post-restructuring debt should include a new sweetener’s fair value or the change in a revised sweetener’s fair value. The length of time until a sweetener becomes exercisable would typically be taken into consideration in estimating its fair value on the date the restructuring occurs.

**Overall indicators that a troubled debt restructuring does or does not exist for accounting purposes**

Overall indicators that a troubled debt restructuring does not exist for accounting purposes include the following:

- Other lenders are willing to loan the borrower funds at market interest rates at or near the interest rates available for debt that is not troubled.
- The fair value of the assets (including cash) or equity interest: (a) accepted by the lender in full satisfaction of its receivable is equal to or more than the lender’s recorded investment in the receivable or (b) transferred by the borrower in full satisfaction of its debt is equal to or more than the carrying amount of the borrower’s debt.
- To maintain its relationship with the borrower, the lender agrees to reduce the effective interest rate on the debt solely because the borrower could go elsewhere to obtain funds at a current market interest rate that is less than the effective interest rate on the debt (such decrease in the current market interest rate could be due to the occurrence of a general decrease in market interest rates or a decrease in the risk being taken on by the lender with respect to the borrower).
- The new marketable debt issued by the borrower in exchange for its old debt has an effective interest rate that is at or near current market interest rates on comparable debt issued by nontroubled borrowers.

To the extent any of these indicators exist, it would take a preponderance of evidence to the contrary to conclude that a troubled debt restructuring does, in fact, exist for accounting purposes.

An overall indicator that a troubled debt restructuring does exist for accounting purposes is if other lenders are only willing to loan the borrower funds at effective interest rates that are so high that the borrower would not be able to make all the required payments under the debt. To the extent this indicator exists, it would take a preponderance of evidence to the contrary to conclude that a troubled debt restructuring does not, in fact, exist for accounting purposes.

Factors that should not enter into the determination as to whether a troubled debt restructuring exists for accounting purposes include:

- How much do the current lenders have invested in the pre-restructuring debt?
- What is the fair value of the debt immediately before and after the restructuring?
- What transactions have occurred among the lenders affected by the restructuring?

In general, how long the current lenders have held their investment in the pre-restructuring debt should also not enter into the determination as to whether a troubled debt restructuring exists for accounting purposes. However, a troubled debt restructuring could exist for accounting purposes if the lenders recently came to their current position through what was, in substance, a planned refinancing.
B.2.3. Series of restructurings on same debt

Relevant Codification section(s): 470–60–55–14

General concepts
Restructurings that occur in the same recent timeframe should be evaluated on a cumulative basis to determine whether a troubled debt restructuring occurred. There is no bright line for determining what is recent, unlike the one-year period prescribed for modifications and exchanges (see section B.3.2). In these situations, the borrower should solve for the discount rate that makes the present value of the projected cash flows required under the most recent restructured terms of the debt equal to the carrying amount of the borrower’s debt before the first restructuring occurred in the recent timeframe. In addition, for purposes of determining whether a concession was granted, the borrower should compare its effective interest rate after the most recent restructuring to the effective interest rate prior to the first restructuring that occurred in the recent timeframe. Analyzing the restructurings on a cumulative basis results in the borrower not getting a different accounting answer by executing the restructuring in stages.

B.2.4. Troubled debt restructuring accounting model

Relevant Codification section(s): 470–60–35–1 through 11

General concepts
How a borrower accounts for a troubled debt restructuring depends on whether the borrower: (a) transfers assets in the troubled debt restructuring, (b) transfers equity in the troubled debt restructuring and (or) (c) modifies the terms of the debt (e.g., the borrower and lender agree to modify the cash requirements under the debt on a going forward basis). The remaining discussion in this section focuses on the accounting when:

- Full settlement of the debt occurs through the borrower’s transfer of assets (which would include a repossession or foreclosure by the lender).
- Full settlement of the debt occurs through the borrower’s transfer of equity.
- Modification of the debt’s terms occurs with no assets or equity transferred in settlement.
- Partial settlement of the debt occurs through the borrower’s transfer of assets or equity and (or) modification of terms.

For purposes of this discussion, the carrying amount of the borrower’s pre-restructuring debt includes any unamortized premium, discount or issuance costs and any accrued interest payable.

Full settlement of debt—Borrower transfers assets

In a troubled debt restructuring in which the borrower agrees to transfer assets, the assets could be accounts receivable from routine sales made by the borrower, real estate or other assets (including cash). If the debt is fully settled by the transfer of assets:

- The borrower recognizes a gain on restructuring for the difference between the borrower’s carrying amount of the debt and the more clearly evident of: (a) the fair value of the transferred assets or (b) the fair value of the settled debt. The gain should typically be included with other financing income and expense.
- The borrower recognizes a gain or loss on the transfer of assets for any difference between the borrower’s carrying amount of the transferred assets and the fair value of the transferred assets. Whether the gain or loss affects operating income would depend on the nature of the assets transferred.

For these purposes, the carrying amount of the transferred assets should reflect any related valuation allowances (e.g., allowance for doubtful accounts) and any related unamortized premium, discount or acquisition costs. Consider a troubled debt restructuring in which accounts receivable are being transferred to settle outstanding debt. The carrying amount of the debt being settled is $1.2 million on the date of the restructuring. Information related to the accounts receivable being transferred on the date of the restructuring follows: (a) gross balance is $1 million, (b) related allowance for doubtful accounts is $100,000 and (c) fair value is $850,000. If the borrower concludes that this scenario represents a troubled debt restructuring, the borrower would recognize the following journal entry:
Debit | Credit
--- | ---
Debt | $1,200,000
Allowance for doubtful accounts | 100,000
Loss on transfer of assets | 50,000
Accounts receivable | $1,000,000
Gain on restructuring | 350,000

In this example, the gain on restructuring should be included with other financing income and expense. The loss on transfer of assets should be included in operating income given that the assets transferred (i.e., accounts receivable) are operating assets.

**Commentary:** Determining the gain on restructuring for the full settlement of debt through the borrower’s transfer of assets (see earlier discussion) or equity (see later discussion) might involve the fair value of the settled debt if that fair value is more clearly evident than the fair value of the transferred assets or equity. The fair value of a liability is based on its transfer price. It is not appropriate to assume that the price to transfer the liability is the same as the price to settle the liability or the same as the carrying amount of the liability. How a borrower would estimate the amount at which it would be able to transfer one of its liabilities presents unique challenges given the lack of market information on transfer prices for entity-specific liabilities. Oftentimes, there is little market information available because contractual or other legal restrictions prevent the transfer of such liabilities. Guidance on measuring the fair value of liabilities is included in ASC 820-10-35. When faced with the challenge of determining the fair value of the settled debt, the borrower should consider whether it would be beneficial to consult a qualified valuation specialist for assistance.

**Full settlement of debt—Borrower transfers equity**

In a troubled debt restructuring in which the borrower agrees to transfer equity to fully settle the debt, the borrower recognizes a gain for the difference between the borrower’s carrying amount of the debt and the more clearly evident of: (a) the fair value of the transferred equity and (b) the fair value of the settled debt. See earlier “Commentary” regarding determining the fair value of the settled debt.

**Borrower and lender only modify terms and do not transfer assets or equity in settlement**

In a troubled debt restructuring in which the borrower and lender agree to modify the terms of the debt (and not transfer assets or equity), the accounting depends on whether the total cash outflows required under the restructured debt are more or less than the carrying amount of the debt prior to the restructuring. In some cases, total cash outflows required under the restructured debt may fluctuate (e.g., the interest rate varies over time depending on changes in the prime rate). In these cases, total cash outflows required under the restructured debt should be based on the interest rate in effect at the time of the restructuring.

If total cash outflows required under the restructured debt are greater than the carrying amount of the debt prior to the restructuring, then no gain or loss is recognized and there is no adjustment to the carrying amount of the debt. The fact that no gain or loss is recognized and no adjustment is made to the carrying amount of the debt does not affect the conclusion that a troubled debt restructuring has occurred. The change in cash outflows resulting from the restructuring are accounted for on a prospective basis (i.e., the changes are recognized in future periods). A new effective interest rate on the restructured debt is calculated and used to record interest expense over its remaining term. The new effective interest rate is determined by finding the discount rate that results in:

\[
\text{Present value of restructured principal} + \text{Present value of restructured interest} = \text{Carrying amount of debt prior to restructuring}
\]

Future cash flows used in the present value calculations include any accrued but unpaid interest on the debt that continues to be payable after the restructuring.
If total cash outflows required under the restructured debt are less than the carrying amount of the debt prior to the restructuring, then a gain is recognized and there is an adjustment to the carrying amount of the debt. However, as explained later in this topic, gain recognition may not be appropriate when contingent payments are included in the terms of the restructured debt. If there are no contingent payments, the amount of the recognized gain and the adjustment to the carrying amount of the debt is determined as follows:

\[
\text{Carrying amount of debt prior to restructuring} = \text{Total cash outflows required under terms of restructured debt} = \text{Amount of recognized gain and adjustment to carrying amount of debt}
\]

Going forward, no interest expense is recorded on the debt. Payments of interest are reflected as a reduction of the debt’s carrying amount. More than one account (e.g., debt and the related unamortized debt discount and issuance costs) may be affected by the adjustment to the carrying amount of the debt. These accounts may either be retained or combined after the restructuring. If they are retained, the adjustment would need to be allocated among those accounts that remain after the restructuring using their previous balances for allocation purposes.

Contingent payments, or what are essentially contingent payments, may be included in the terms of the restructured debt. Examples of such contingent payments include: (a) amounts the borrower is required to pay if its financial condition improves (based on a specified, measurable metric) by a specific date and (b) the number of interest payments the borrower has to make is indeterminate because the restructured debt is due on demand. When contingent payments are included in the terms of the restructured debt and the total noncontingent cash outflows required under the restructured debt are less than the carrying amount of the debt prior to the restructuring, the borrower should not recognize a gain on the restructuring if the maximum total future cash payments (total noncontingent cash outflows plus all contingent amounts that could become payable) is greater than the carrying amount of the debt prior to the restructuring. If a gain is not recognized as a result of this guidance, a new effective interest rate must be calculated for purposes of recognizing interest expense in future periods. In some cases, this new effective interest rate may be at or near zero. When determining the new effective interest rate, only those contingent payments necessary to prevent gain recognition are included in the calculation. For example, assume in a troubled debt restructuring that: (a) the carrying amount of the debt prior to the restructuring is $1 million, (b) total noncontingent cash outflows required under the restructured debt are $900,000 and (c) maximum contingent payments that could be made under the restructured debt are $200,000 (two payments of $100,000 each). In this example, only $100,000 of the maximum contingent payments is included in calculating the new effective interest rate because that is the amount that would prevent gain recognition. The “probable” and “reasonably estimable” thresholds applied to the recognition of other contingent liabilities would be applied to determine if and when a liability should be recognized for the contingent payments included in the terms of the restructured debt. If a liability should be recognized, or when the contingent payments are actually made, consideration must be given to whether those amounts should serve to reduce the carrying amount of the restructured debt. This would be the case if those amounts were included in total future cash payments for purposes of preventing the recognition of a gain at the time of the restructuring.

As discussed earlier, when total cash outflows required under the restructured debt may fluctuate because the interest rate varies over time (e.g., based on changes in the prime rate), the total maximum cash outflows required under the restructured debt (which is used in determining the effects of the contingent payments on the accounting for the restructuring) should be based on the interest rate in effect at the time of the restructuring. If the effective interest rate changes in future periods, the effects of those changes should be accounted for as changes in estimates. However, consideration must be given to whether that accounting would result in a gain on the restructuring. A gain on the restructuring should only be recognized if it cannot be offset by future cash payments. Until then, the carrying amount of the debt is not adjusted and future cash payments reduce the carrying amount of the debt.

**Partial settlements**

The borrower and lender may agree to the partial settlement of debt in conjunction with a restructuring. For example, a troubled debt restructuring could result from any of the following:

- The borrower agrees to pay some cash to the lender and the borrower and lender agree to modify some of the remaining terms of the debt.
- The borrower agrees to transfer noncash assets to the lender and the borrower and lender agree to modify some of the remaining terms of the debt.
- The borrower agrees to transfer equity to the lender and the borrower and lender agree to modify some of the remaining terms of the debt.
- The borrower agrees to transfer cash, noncash assets or equity to the lender that partially settles the debt, but the terms of the debt that remain are unchanged.
When the troubled debt restructuring involves a partial settlement, the carrying amount of the debt is reduced by the fair value of the assets and (or) equity transferred in the partial settlement. Unlike the full settlement of debt through the borrower’s transfer of assets or equity in which the fair value of the settled debt (if it is more clearly evident) could be used in place of the fair value of the assets or equity to determine the gain on restructuring, the fair value of the partially-settled debt cannot be used to reduce the carrying amount of the debt. When noncash assets are involved, a gain or loss on the transfer of the assets is recognized for the difference between the carrying amount and fair value of the noncash assets transferred. This is similar to the approach taken when the troubled debt restructuring is a full settlement through the transfer of noncash assets, as discussed earlier in this section. After the carrying amount of the debt has been reduced and any gain or loss on the transfer of noncash assets recognized, the accounting for the restructuring follows the approach taken when the troubled debt restructuring involves only the modification of terms, as discussed earlier in this section.

When using this approach to account for a troubled debt restructuring that involves a partial settlement of the debt, the borrower’s analysis should use: (a) the carrying amount of the debt after reduction for the fair value of any assets or equity transferred and (b) the terms of the debt that remains after the partial settlement.

**Commentary:** A common related party relationship involving a borrower and a lender is when the lender is also an equity holder in the borrower. If the troubled debt restructuring accounting model is applied to changes in a loan with a lender that is also an equity holder, consideration must be given to whether any gain that results from applying that accounting model should be reflected in the income statement or in equity (i.e., additional paid-in capital). A key consideration in this regard is whether the lender is restructuring the loan to protect its equity investment in the borrower. If so, that would provide a strong indication that the effects of the restructuring should be reflected in equity.

When determining whether the lender is protecting its equity investment in the borrower, consideration should be given to the significance of the lender’s equity investment in the borrower. The Master Glossary of the Codification defines principal owners as those that own more than 10 percent of the voting interests (including direct and beneficial interests) of an investee. If the lender’s equity investment in the borrower would result in the lender being considered a principal owner, we believe the lender’s equity investment in the borrower is significant and indicates that the lender entered into the restructuring to protect its equity investment in the borrower. As a result, any gain on the restructuring should be reflected in equity. If the lender is not considered a principal owner, other relevant facts and circumstances should be considered to determine whether the lender entered into the restructuring to protect its equity investment in the borrower. Among those facts and circumstances are the significance of the lender’s debt and equity investments in the borrower relative to each other and relative to those held by other investors in the borrower.

**B.2.5. Accounting for fees and costs incurred**

**Relevant Codification section(s):** 470-60-35-12

**General concepts**

The borrower will likely incur direct costs in connection with executing a troubled debt restructuring. If these direct costs (including legal fees) relate to equity transferred from the borrower to the lender in the troubled debt restructuring, then those costs should reduce the amount that would otherwise have been recognized in equity. For all other direct costs incurred in executing a troubled debt restructuring, the accounting depends on whether a gain on restructuring has been recognized. If so, the amount of those costs should reduce the amount that would otherwise have been recognized as a gain. If not, the amount of those costs should typically be reflected as an expense within other financing income and expense.

**Commentary:** To the extent there are unamortized debt issuance costs on the debt prior to the restructuring and the debt is not fully settled in the restructuring, those costs would be included in the carrying amount of the debt prior to the restructuring. As discussed earlier, if total cash outflows required under the restructured debt are greater than the carrying amount of the debt prior to the restructuring (and, consequently, no gain or loss is recognized), the carrying amount of the debt is used in determining the new effective interest rate for the restructured debt. This new effective interest rate is used to calculate interest expense over the remaining term of the restructured debt. As such, the unamortized debt issuance costs on the debt prior to the restructuring continue to be recognized as interest expense over the remaining term of the restructured debt. However, in a troubled debt restructuring in which the total cash outflows required under the restructured debt (which does not include any contingent amounts) are less than the carrying amount of the debt prior to the restructuring, a gain is recognized. The calculation of the gain in this situation is based on the carrying amount of the debt prior to the restructuring less the total cash outflows required under the terms of the restructured debt. Because the unamortized debt issuance costs would be included in the carrying amount of the debt prior to the restructuring, they would effectively reduce the amount of gain recognized.

To the extent there are unamortized debt issuance costs on the debt prior to the restructuring and the debt is fully settled in the restructuring, those costs would serve to reduce any gain recognized on the restructuring.
B.2.6. Classification considerations

Relevant Codification section(s): 470–60–45–1 through 2

General concepts
When debt is restructured, consideration should be given to the current versus noncurrent classification of the debt that remains. Consideration should also be given to the current versus noncurrent classification of the debt that remains from a troubled debt restructuring that occurs after the borrower's balance sheet date but before the balance sheet is issued or available to be issued.

Commentary: While the classification of the debt may be affected by a troubled debt restructuring that occurs after the borrower’s balance sheet date but before the balance sheet is issued or available to be issued, the timing of the accounting for the troubled debt restructuring is not affected. In other words, any gain recognized in the accounting for the troubled debt restructuring cannot be pushed back to the balance sheet date. In addition, any equity grants that were part of the troubled debt restructuring cannot be pushed back to the balance sheet date.

For more information about the current versus noncurrent classification of debt, refer to our white paper, Fundamentals of Debt Classification.

B.2.7. Disclosures

Relevant Codification section(s): 470–60–50–1 through 2

General concepts
The borrower must disclose the following about a troubled debt restructuring that affected any of the financial statements presented:

- A description of how the terms of the debt changed and (or) the major features of settlement
- The amount of any gain recognized in connection with the restructuring as well as the gain per share
- The amount of any gain or loss recognized on the transfer of assets in connection with the restructuring

To the extent contingent payments are involved in the troubled debt restructuring, the borrower would disclose in periods after the restructuring the portion of the restructured debt’s carrying amount that reflects contingently payable amounts. In addition, with respect to the contingent payments, the borrower would also need to consider whether it should satisfy the general disclosure requirements applicable to contingent liabilities. If so, information such as the total amount contingently payable and the terms of the contingency would need to be disclosed.
B.3. Extinguishment and modification accounting

B.3.1. Scope

Relevant Codification section(s): 405–20–40–1; 470–50–05–1; 470–50–15–2 through 3; 470–50–55–8 through 9

General concepts
If the borrower concludes that it has not met the liability derecognition criteria or the troubled debt restructuring criteria, then it must determine whether the modification or exchange should be accounted for as an extinguishment or modification. This determination may be necessary when the borrower and lender agree to exchange loans or modify the terms of an existing loan. The determination must also be made when the borrower and lender agree to modify a loan to require its redemption at a future date for a specified amount.

The extinguishment and modification guidance discussed in this paper does not apply in any of the following circumstances:

- There is an in-substance defeasance, which occurs when the borrower establishes an irrevocable trust for the benefit of the lender and deposits in that trust the principal, interest and prepayment penalties applicable to the loan between the borrower and lender.
- The borrower announces its intention to call a loan at its first call date.
- The parties involved are: (a) the borrower or its agent and (b) a party that is not considered the lender (e.g., the borrower and lender reach an agreement that a loan between the borrower and a different lender will be redeemed).
- A loan is converted to the borrower’s equity securities in accordance with conversion privileges included in the loan at issuance.
- A loan is converted to the borrower’s equity securities in accordance with conversion privileges included in the loan that have been changed since issuance (including induced conversions).

B.3.2. Which model applies?

Relevant Codification section(s): 470–50–40–6 through 12

General concepts
If the borrower concludes that an exchange of loans or a modification to the terms of an existing loan do not meet the liability derecognition criteria or the troubled debt restructuring criteria, then it must determine whether the modification or exchange should be accounted for as an extinguishment, which could result in the borrower recognizing a gain or loss in its income statement (see section B.3.3). In making this determination, the mere fact that the borrower and lender concurrently exchange cash to satisfy an existing loan (cash from borrower to lender) and issue a new loan (cash from the same lender to borrower) should not automatically lead the borrower to conclude that the extinguishment accounting model should be applied. In these and other situations in which a loan is modified, the borrower must determine whether the new loan (the modified loan or the loan received in the exchange) is substantially different from the old loan (the loan before modification or the loan given up in the exchange).
The decision tree for determining whether a substantial difference exists because of a change in the loan’s cash flows follows:

**Diagram:**

1. **Question:** Is there at least a 10 percent difference between the present value of the new loan’s cash flows and the present value of the old loan’s remaining cash flows (i.e., the 10 percent cash flow test)?
   - **Yes:** Considered substantially different (i.e., apply extinguishment accounting).
   - **No:** (Less than 10 percent)

2. **Question:** Were embedded conversion options added, eliminated or changed in the modification or exchange?
   - **Yes:** Assess whether the addition of, elimination of or change in the embedded conversion option makes the new loan substantially different from the old loan.
   - **No:** Not considered substantially different (i.e., apply modification accounting).

When calculating the present value of cash flows referred to in the decision tree:

- The cash flows of the new loan should include any amounts exchanged by the borrower and lender in connection with the exchange or modification, which would include any fees charged by the lender to execute the modification or exchange, any incremental borrowings received by the borrower and any repayments of principal by the borrower.
- The cash flows for loans with floating interest rates should be based on the variable rate in effect when the exchange or modification occurs.
- For a loan that is callable or puttable, two sets of cash flows need to be considered: (1) cash flows assuming the call or put is exercised and (2) cash flows assuming the call or put is not exercised. The cash flows that should be used in the 10 percent cash flow test are those that result in the smallest change between the present value of the new loan’s cash flows and the present value of the original loan’s remaining cash flows. A loan is callable if the borrower has the right, but not the obligation, to redeem (i.e., repay) the loan before maturity on specified dates for a pre-determined call price. A loan is puttable if the lender has the right, but not the obligation, to require the borrower to repay the loan’s principal before its stated maturity date. Refer to section 3.2.1 for discussion about the applicability of this guidance to explicit and implicit prepayment options.
- Professional judgment should be exercised when determining the effects of contingent payment terms or unusual interest rate terms on a loan’s cash flows.
- The discount rate is the original loan’s effective interest rate (as determined for accounting purposes).
- If a less-than-substantially-different exchange or modification to the loan (first modification) occurred within a year of the current exchange or modification (second modification), the 10 percent cash flow test should compare: (a) the present value of the loan’s remaining cash flows as of the date of the first modification using the terms of the loan prior to the first modification and (b) the sum of (i) the present value of the loan’s cash flows from the date of the first modification to the date of the second modification using the terms of the loan after the first modification and (ii) the present value of the loan’s cash flows after the second modification using the terms of the loan after the second modification. In other words, the changes would be viewed cumulatively instead of separately. This requirement is so the borrower does not get a different accounting answer by executing the exchange or modification in stages.
- The significance of an exchange or modification to an embedded conversion option’s fair value is assessed separately and is not reflected in the 10 percent cash flow test (refer to the remaining content in this section for additional discussion).
The decision tree for determining whether a substantial difference exists because an embedded conversion option was added, eliminated or changed in the modification or exchange is captured below:

As noted in the decision tree, the significance of an exchange or modification to an embedded conversion option’s fair value is assessed separately and is not reflected in the 10 percent cash flow test discussed earlier in this section.

**Note 1:** For purposes of determining whether a conversion option is substantive, the guidance in ASC 470–20–40–7 through 9 would be used.

**Note 2:** To determine the change in the fair value of an embedded conversion option, compare the fair value of the option right before and right after the modification or exchange.
Commentary: In some situations, a warrant (or other sweetener or enhancement [such as a guarantee or letter of credit]) might be added to or removed from a loan agreement as a result of a modification or exchange of the loan. In other situations, the terms of a warrant included in the original terms of the loan agreement might be changed in a modification or exchange of the loan. The question that arises in these situations is how adding, changing or removing a warrant affects the conclusion about whether there is a substantial difference between the old loan and the new loan (and, therefore, whether the extinguishment or modification accounting model should be applied to account for the modification or exchange of the loan). The authoritative literature does not explicitly answer this question. However, when determining whether a concession has been granted in a troubled debt restructuring (see section 2.2), the authoritative literature requires the effects of any new, revised or removed sweeteners (including warrants) to be included in the projected cash flows required under the post-restructuring debt even though adding, revising or removing a sweetener may not always have a direct effect on cash flows. As such, when performing the analysis as to whether a concession has been granted, the day-one projected cash flows required under the post-restructuring debt includes the new sweetener’s fair value or the change in a revised sweetener’s fair value. Based on this guidance, we believe it would also be appropriate to take this approach when assessing whether there is a substantial difference between the old loan and new loan when a modification or exchange occurs. In other words, we believe that it would be appropriate to include a new warrant’s fair value in the cash flows of the new loan for purposes of the 10 percent cash flow test used to determine whether there is a substantial difference between the old loan and new loan. In addition, if the terms of a warrant have changed, we believe it would be appropriate to include the change in the warrant’s fair value in the new loan’s cash flows for purposes of the 10 percent cash flow test. The accounting for the fair value or the change in fair value of a warrant that is added, revised or removed would depend on whether the extinguishment or modification accounting model should be applied to the modification or exchange itself. For example, if a loan agreement is modified to include a warrant and the fair value of that warrant is $1 million, then $1 million would be included in the new loan’s cash flows for purposes of the 10 percent cash flow test. In addition, if the modification accounting model is applicable, the fair value of the warrant would be recognized as a debt discount. In contrast, if the extinguishment accounting model is applicable, the fair value of the warrant would be taken into consideration in determining the gain or loss on extinguishment (i.e., it would increase what would otherwise be a loss or decrease what would otherwise be a gain) (refer to section B.3.5 for additional discussion).

B.3.2.1. Prepayment options

Relevant Codification section(s): 470-50-40-12(c)

General concepts
For a loan that is callable or puttable, two sets of cash flows need to be considered for purposes of applying the 10 percent cash flow test: (1) cash flows assuming the call or put is exercised and (2) cash flows assuming the call or put is not exercised. The cash flows that should be used in the 10 percent cash flow test for purposes of reaching a decision about the accounting model that should be used are those that result in the smallest change between the present value of the new loan’s cash flows and the present value of the original loan’s remaining cash flows.

Commentary: A common form of call option present in a loan is a prepayment option. A prepayment option may be explicitly stated in the loan agreement or it may be implied when the loan agreement does not prohibit prepayment. Such an option allows the borrower to prepay (i.e., call) the debt before it otherwise matures, often subject to a penalty. If the new loan and/or the old loan are prepayable, the cash flows used in the 10 percent cash flow test may need to be calculated assuming both exercise and nonexercise of the prepayment option because the authoritative literature indicates that the assumption that results in the smaller change in cash flows is used for purposes of reaching a decision about the accounting model that should be used to account for the modification or exchange. This is the case regardless of the probability of prepayment and even if the borrower does not have the financial ability to prepay. Any prepayment penalties are considered part of the cash flows when assuming the prepayment option is exercised. The practical effect of applying this guidance is that if either assumption (i.e., exercise or nonexercise) results in a change of less than 10 percent, a substantial change has not occurred and modification accounting would be required. Said differently, both assumptions have to result in a change of more than 10 percent for a substantial change to have occurred and for extinguishment accounting to be required. The effects of applying this guidance in practice will typically result in modification accounting because the factors that cause a change in cash flows when assuming exercise of the prepayment option (e.g., fees charged by the lender to modify the loan, a change to the prepayment penalty) would rarely ever rise to the magnitude necessary to cause a change in cash flows of more than 10 percent. However, if an embedded conversion option was added, eliminated or changed in the modification or exchange, additional considerations apply (as illustrated in the second decision tree in section 3.2) that may be more likely to trigger extinguishment accounting depending on the facts and circumstances.

From an efficiency perspective, when the borrower has a loan with a prepayment option, it should start by performing the 10 percent cash flow test under the assumption that it expects would result in the smaller change in cash flows (which is typically the assumption that the prepayment option will be exercised). If the difference is less than 10 percent under that assumption, modification accounting would be required and it would not be necessary to perform the 10 percent cash flow test under the other assumption. However, if an embedded conversion option was added, eliminated or changed in the modification or exchange, additional considerations would apply that could result in extinguishment accounting. If the difference is more than 10 percent, the borrower would have to perform the 10 percent cash flow test under the other assumption to reach a final conclusion about whether modification or extinguishment accounting should be applied to the modification or exchange.
B.3.3. Extinguishment accounting model

Relevant Codification section(s): 470-50-40-1 through 3; 470-50-40-13

General concepts
The essence of extinguishment accounting is to remove the extinguished loan from the borrower’s books. However, extinguishment accounting might also apply when a loan is modified or exchanged (see section B.3.2). For the modification or exchange of a loan that qualifies for extinguishment accounting, a loan remains on the borrower’s books after the modification or exchange. In these cases, the original loan (the loan being modified or given up in the exchange) is effectively derecognized and a new loan (the modified loan or loan received in the exchange) is recognized. The remainder of this section discusses extinguishment accounting in general as well as the special consideration involved when extinguishment accounting is applied to the modification or exchange of a loan.

Extinguishment accounting in general

Depending on the facts and circumstances surrounding the extinguishment of a loan, the borrower may be required to separately recognize a gain or loss in the period of the extinguishment (i.e., recognition of these gains and losses are not deferred to future periods). The gain or loss is calculated as the difference between the loan’s reacquisition price and its net carrying amount. The loan’s reacquisition price is the amount paid to extinguish the loan, which includes any call premium or costs of reacquisition. If the loan is extinguished through the exchange of new securities, the loan’s reacquisition price is the total present value of the new securities (which should be equivalent to their fair value). If a loan is extinguished early through the issuance of common or preferred stock, the more clearly evident of the issued stock’s value or the loan’s value should be used as the reacquisition price.

The loan’s net carrying amount is: (a) the amount due at maturity (including any accrued but unpaid interest), (b) plus (minus) any related unamortized debt premium (discount) and (c) minus any related unamortized debt issuance costs. Typically, the gain or loss is included with other financing income and expense.

If a loan is extinguished at maturity under the terms and conditions agreed to at issuance (i.e., no early extinguishment, no modification of terms, etc.) and all accrued interest has been paid, the reacquisition price of the loan would typically be the amount of the principal repayment. In addition, a gain or loss on extinguishment would normally not exist in this situation because the principal repayment and the net carrying amount of the loan would be the same.

Prior to accounting for a loan extinguishment, the borrower should identify all of the rights and privileges being exchanged between the borrower and lender as part of the extinguishment. If more than just the extinguishment of a loan is occurring between the parties, then separate accounting recognition for any activities above and beyond the extinguishment would be required. In doing so, a portion of the consideration exchanged by the parties would need to be allocated to these additional activities.

To the extent the borrower and lender are related parties, consideration should be given to whether the extinguishment of a loan is effectively a capital transaction between the parties.
Commentary: A common related party relationship involving a borrower and a lender is when the lender is also an equity holder in the borrower. If extinguishment accounting is applied to changes in a loan with a lender that is also an equity holder, consideration must be given to whether any gain or loss that results from applying extinguishment accounting should be reflected in the income statement or whether the effects of the extinguishment should be reflected in equity (e.g., additional paid-in capital). A key consideration in this regard is whether the lender is modifying or exchanging the loan to protect its equity investment in the borrower. If so, that would provide a strong indication that the effects of the extinguishment should be reflected in equity.

When determining whether the lender is protecting its equity investment in the borrower, consideration should be given to the significance of the lender’s equity investment in the borrower. The Master Glossary of the Codification defines principal owners as those that own more than 10 percent of the voting interests (including direct and beneficial interests) of an investee. If the lender’s equity investment in the borrower would result in the lender being considered a principal owner, we believe the lender’s equity investment in the borrower is significant and indicates that the lender entered into the modification or exchange to protect its equity investment in the borrower. As a result, if the extinguishment accounting model is applied, any gain or loss that results should be reflected in equity. If the lender is not considered a principal owner, other relevant facts and circumstances should be considered to determine whether the lender entered into the modification or exchange to protect its equity investment in the borrower. Among those facts and circumstances are the significance of the lender’s debt and equity investments in the borrower relative to each other and relative to those held by other investors in the borrower.

Extinguishment accounting for a modification or exchange of loans

When extinguishment accounting is applied to a modification or exchange of loans, the loan that remains after the modification, or the loan received in the exchange, should be recognized at its fair value.

Commentary: Applying extinguishment accounting to the modification or exchange of loans requires the borrower to determine the fair value of the new loan (i.e., the loan that remains after the modification or the loan that is received in the exchange). The fair value of a liability is based on its transfer price. It is not appropriate to assume that the price to transfer the liability is the same as the price to settle the liability or the same as the carrying amount of the liability. Also, it is not appropriate to assume that the present value of the new loan’s cash flows calculated for purposes of the 10 percent cash flow test represents the fair value of that new loan because the discount rate used in the 10 percent cash flow test is the yield on the existing debt, and not the current market interest rate. How a borrower would estimate the amount at which it would be able to transfer one of its liabilities presents unique challenges given the lack of market information on transfer prices for entity-specific liabilities. Oftentimes, there is little market information available because contractual or other legal restrictions prevent the transfer of such liabilities. Guidance on measuring the fair value of liabilities is included in ASC 820-10-35. When faced with the challenge of determining the fair value of a new loan, the borrower should consider whether it would be beneficial to consult a qualified valuation specialist for assistance.

B.3.4. Modification accounting model

Relevant Codification section(s): 470-50-40-14 through 16

General concepts

There is no gain or loss recognized in the income statement under modification accounting. Instead, modification accounting requires the calculation of a new effective interest rate for the modified loan. In determining the new effective interest rate, the original loan’s carrying amount is adjusted for an increase in the fair value of an embedded conversion option. The adjustment increases any related debt discount or decreases any related debt premium. As a result, the carrying amount of the loan decreases and additional paid-in capital increases. Conversely, a decrease in the fair value of an embedded conversion option does not result in an adjustment to the loan’s carrying amount or additional paid-in capital. For purposes of determining whether the fair value of an embedded conversion option has increased or decreased, the fair values of the option right before and right after the modification or exchange are compared to each other.

A beneficial conversion feature is not recognized or reassessed when modification accounting is applied to an exchange or modification.
B.3.5. Accounting for fees and costs incurred

Relevant Codification section(s): 470-50-40-17 and 18

General concepts
How a borrower accounts for fees and costs involved in an exchange or modification of loans depends on: (a) whether the fees and costs are between the borrower and lender or between the borrower and a third party (e.g., the borrower’s legal counsel) and (b) whether extinguishment or modification accounting is applied to the exchange or modification:

| If borrower applies... | Fees between borrower and lender are... | Costs incurred with third parties are... | Unamortized debt discount, premium and issuance costs on old loan are...
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<tr>
<td>Extinguishment</td>
<td>Expensed</td>
<td>Reflected in debt issuance costs¹</td>
<td>Written-off</td>
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<tr>
<td>Modification accounting</td>
<td>Reflected in debt discount¹ and (or) debt premium (as appropriate)</td>
<td>Expensed</td>
<td>Left on books and continue to be amortized over the term of the modified loan</td>
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¹ Any unamortized debt discount and (or) debt issuance costs should be presented as a reduction of the related debt’s carrying amount on the balance sheet. For an example, refer to our article, Presentation of issuance costs related to term debt and lines of credit.

Fees between the borrower and lender when the borrower is required to apply extinguishment accounting are included in the calculation of the gain or loss on extinguishment. Such fees are deemed to be related to extinguishing the old loan. Fees between the borrower and lender when the borrower is required to apply modification accounting are not expensed. Such fees are deemed to be related to the modified loan and should be recognized in interest expense over the remaining term of the modified loan. If there is a debt premium for the loan at the time of the modification, then the fees between the borrower and lender reduce the debt premium. Otherwise (i.e., there is a debt discount or there is neither a debt premium nor a debt discount for the loan at the time of the modification), the fees between the borrower and lender are recorded as a debt discount. Debt waiver fees are an example of a fee paid by the borrower to the lender for which the accounting would depend on whether the borrower is required to apply extinguishment or modification accounting. Designation of fees by the lender as being related to the old loan or new loan does not influence the accounting for those fees. The model applied to the fees follows the accounting model used for the modification or exchange itself. As such, the accounting guidance on this subject determines whether the fees are in-substance related to the old loan or new loan.

Costs incurred with third parties when the borrower is required to apply extinguishment accounting are recognized as debt issuance costs and amortized to expense over the term of the new loan. Costs incurred with third parties when the borrower is required to apply modification accounting are expensed as incurred.

Commentary: In some cases, the borrower may agree to directly pay the lender’s third-party service providers (e.g., its external legal counsel) for the services provided to the lender in connection with the exchange or modification of a loan or the lender may agree to directly pay the borrower’s third-party service providers for services provided to the borrower in connection with the exchange or modification of a loan. The appropriate characterization of these payments by the borrower is important given the different accounting treatment afforded fees between the borrower and lender and costs incurred with third parties. If the third-party service provider’s fees are charges for services provided to the lender, we believe those fees should be characterized as fees between the borrower and lender for accounting purposes because that is consistent with their substance. We believe this is the appropriate characterization regardless of whether those fees are: (a) billed directly to the borrower by the third-party service provider or (b) billed to the lender by the third-party service provider and ultimately paid by the borrower based on payment instructions provided by the lender to the borrower. If the third-party service provider’s fees are charges for services provided to the borrower, we believe those fees should be characterized as third-party costs for accounting purposes because that is consistent with their substance. We believe this is the appropriate characterization regardless of whether those fees are paid directly by the borrower or paid by the lender on the borrower’s behalf.
Consider the following situation. The lender hires a law firm to provide the lender with legal counsel in connection with the modification of a loan between the lender and one of its borrowers. The lender instructs the law firm to bill the borrower directly for the legal services provided to the lender in connection with the modification. While the borrower agrees to pay the law firm directly, it is the lender that was provided the legal services. Based on these arrangements, the law firm bills the borrower $100,000. In addition, the lender charges the borrower a fee of $400,000 to execute the modification. In this situation, the question arises as to how the borrower should characterize, from an accounting perspective, the billings for the services provided by the law firm to the lender ($100,000). Should those billings be characterized as: (a) fees between the borrower and the lender or (b) costs incurred with third parties? Because the law firm’s fees are charged for services provided to the lender, we believe the law firm’s fees should be characterized as fees between the borrower and lender for accounting purposes. In other words, the total fees charged by the lender to the borrower in connection with the loan modification are $500,000, of which $400,000 is billed directly by the lender and $100,000 is billed by the law firm on the lender’s behalf. In this example, the borrower is essentially acting as the lender’s agent for purposes of paying the law firm for the legal services it provided to the lender. The same accounting treatment would result if $100,000 was billed to the lender by the third-party service provider and ultimately paid by the borrower (based on payment instructions provided by the lender to the borrower) rather than billed directly to the borrower by the third-party service provider.

As discussed further in section B.3.7, in a loan syndication, many lenders are individually loaning specific amounts to the borrower and the borrower is obligated to repay each individual lender. The guidance on how to account for the modification or exchange of loans would only apply to modifications or exchanges involving the borrower and the lenders taking part in the modification or exchange. In addition, the guidance would be applied separately to each loan in the syndication that is modified or exchanged. In some cases, one of the lenders in the syndicate will act in an investment banking or underwriting capacity for purposes of coordinating the modification or exchange across all the lenders participating in it (including itself). In those situations, the fees charged by the lender acting in that capacity need to be carefully analyzed to determine which portion represents a fee of that lender related to the modification or exchange of its own loan and which portion represents a third-party cost related to the underwriting or investment banking services it is providing to coordinate the modification or exchange across all lenders taking part in it. Treating the entire fee charged by the lender acting in the capacity of an underwriter or investment banker as a lender’s fee could result in reaching the wrong conclusions with respect to: (a) whether modification or extinguishment accounting should be applied to the changes made to that lender’s individual loan and (b) whether the appropriate amount of the fee is capitalized or expensed.
For purposes of the guidance on how to account for the extinguishment, modification or exchange of loans, the following should be kept in mind when identifying the borrower and lender(s):

- In a loan participation, one lender (i.e., the lead bank) makes a loan to the borrower and then transfers undivided interests in that loan to other banks (i.e., participating banks). For purposes of accounting for an extinguishment, modification or exchange of a loan in this situation, the lender is the lead bank and not the participating banks. As such, the guidance on how to account for the modification or exchange of loans would only apply to modifications or exchanges involving the borrower and the lead bank.

- In a loan syndication or public debt issuance, many lenders are individually loaning specific amounts to the borrower (the total of which is the full amount of financing sought by the borrower) and the borrower is obligated to repay each individual lender. Because there are multiple lenders, the borrower must identify which lenders are taking part in the modification or exchange. The guidance on how to account for the modification or exchange of loans would only apply to modifications or exchanges involving the borrower and the lenders taking part in the modification or exchange. In addition, the guidance would be applied separately to each loan in the syndication that is modified or exchanged. For those lenders not taking part in the modification or exchange, there is no accounting event.

A third-party intermediary may be involved in the efforts to modify or exchange loans. For example, an investment banker may buy back the borrower’s debt from its lenders and coordinate new debt agreements between the borrower and its lenders. Whenever a third-party intermediary is involved in a modification or exchange of loans, consideration should be given to whether the intermediary is acting as a principal or an agent. If the intermediary is acting as an agent of the borrower, then the intermediary’s involvement in the transaction would not affect the borrower’s accounting for the modification or exchange (other than needing to account for any fees paid to the intermediary). In other words, the borrower will not get different accounting treatment solely by involving an intermediary that is acting as its agent in the modification or exchange of loans. For accounting purposes, the borrower would effectively look through an intermediary that is acting as an agent and any actions of the intermediary would be considered actions of the borrower. Conversely, if the third-party intermediary is a principal in the modification or exchange of a loan, then the borrower would treat the intermediary as the lender and not look through it for accounting purposes.

Legal counsel may need to be consulted when analyzing whether a third-party intermediary is acting as a principal or an agent of the borrower in the exchange or modification of loans. In addition, a full analysis of the third-party intermediary’s role should be performed. Indicators to consider in this regard, and whether they point to the intermediary acting in the capacity of a principal or an agent of the borrower, are presented in the following table:

<table>
<thead>
<tr>
<th>Indicators</th>
<th>Principal</th>
<th>Agent of borrower</th>
</tr>
</thead>
<tbody>
<tr>
<td>intermediary places own funds at risk?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>basis of agreement with intermediary is...</td>
<td>Firmly committed</td>
<td>Best efforts</td>
</tr>
<tr>
<td>borrower directs intermediary’s activities and intermediary cannot act independently</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>intermediary is subject to loss on transactions entered into with lenders</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>intermediary’s income is based on...</td>
<td>Value of borrower’s security</td>
<td>Pre-established fee</td>
</tr>
</tbody>
</table>

B.3.8. Transactions between lenders

Relevant Codification section(s): 470-50-40-7; 470-50-55-6

General concepts
To the extent there are multiple lenders involved in a loan (e.g., bonds sold to several different parties, several banks in a loan syndicate), transfers or exchanges between the lenders would not result in a modification or exchange. The borrower would not be affected in this situation unless funds pass through the borrower or an agent of the borrower. To the extent an intermediary is involved in a transfer or exchange between lenders, consideration should be given to whether the intermediary is functioning as a principal or an agent in the transfer or exchange (see section B.3.7). If the intermediary is functioning as a principal in a transfer or exchange between lenders, it would also be considered a lender.
B.3.9. Line-of-credit arrangement or revolving debt

Relevant Codification section(s): 470-50-40-21 through 23; 470-50-45-2; 470-50-55-10 through 13

General concepts
A borrower often incurs costs (e.g., lender’s fee, legal costs) upon entering into a line-of-credit or revolving debt arrangement. It may be appropriate to defer and amortize some or all of these costs over the term of the arrangement. When there is a modification or exchange involving a line-of-credit or revolving debt arrangement, questions arise regarding the accounting for any related unamortized deferred costs as well as any costs incurred to execute the modification or exchange. To answer these questions, the borrower must compare the borrowing capacity of the old arrangement to the borrowing capacity of the new arrangement. The borrowing capacity of the old arrangement is determined by taking the arrangement’s commitment amount and multiplying it by the arrangement’s remaining term. The borrowing capacity of the new or modified arrangement is determined by taking the new or modified arrangement’s commitment amount and multiplying it by the term of the new or modified arrangement. For example, if the borrower has a line-of-credit arrangement whose remaining term is three years and the amount available under the line-of-credit arrangement (i.e., the commitment amount) is $10 million, the borrowing capacity of that old line-of-credit arrangement is $30 million ($10 million commitment amount * 3-year term). As illustrated in the table that follows, accounting for the unamortized deferred costs related to the line-of-credit or revolving debt arrangement prior to the modification or exchange and additional costs (e.g., lender’s fee, legal costs) incurred in conjunction with the modification or exchange may depend on whether there has been an increase or decrease in the line-of-credit or revolving debt arrangement’s borrowing capacity:

<table>
<thead>
<tr>
<th>Increase or decrease in borrowing capacity?</th>
<th>Unamortized deferred costs</th>
<th>Costs incurred in connection with modification</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase (borrowing capacity of new arrangement is greater than borrowing capacity of old arrangement)</td>
<td>Defer and amortize over term of new arrangement</td>
<td>Defer and amortize over term of new arrangement</td>
</tr>
<tr>
<td>Decrease (borrowing capacity of old arrangement is greater than borrowing capacity of new arrangement)</td>
<td>Write off in proportion to the decrease in borrowing capacity. For portion not written off, defer and amortize over term of new arrangement</td>
<td>Defer and amortize over term of new arrangement</td>
</tr>
</tbody>
</table>

Any unamortized deferred costs written off as a result of applying this guidance would typically be included with other financing income and expense. The amount of unamortized deferred costs at the balance sheet date may be presented in the balance sheet as either: (a) an asset or (b) a reduction of the carrying amount of debt, but only to the extent there is a debt balance. For additional information and an example, refer to our article, Presentation of issuance costs related to term debt and lines of credit.
B.4. Debt disclosures

Commentary: The Codification requires a relatively limited number of disclosures about the debt taken on by an entity. A few of these disclosure requirements have been noted in this paper. The SEC requires more disclosures about the debt taken on by public companies. In the absence of a specific disclosure requirement, a borrower should still consider whether the users of its financial statements would be interested in, or influenced by, information pertaining to the entity’s debts. For example, even though there is not a specific requirement that calls for the disclosure of changes to a loan and whether those changes resulted in modification or extinguishment accounting, the borrower should still consider whether the users of its financial statements would find information about the changes and related accounting helpful and relevant. In general, if the user of the financial statements would be influenced by such information, then it should be disclosed. The extent of the disclosures would vary depending on the facts and circumstances.
C. EXAMPLES

1. Troubled debt restructuring with no gain or loss

Facts: Borrower and Lender entered into a debt agreement on March 31, 20X1, with the following terms:

- Principal is $5 million.
- Stated rate of interest is 10 percent.
- Principal is payable in one lump sum on March 31, 20X6.
- Interest is payable annually (for ease of illustration) on March 31.
- Term is five years.

There was no discount or premium on the debt at issuance (i.e., the debt was issued at par and there were no lender’s fees) and there were no debt issuance costs (for ease of illustration). At the time the debt was issued, Borrower’s credit rating from Standard & Poor’s was BBB. During 20X2, Borrower begins to experience some financial difficulties. In February 20X3, Borrower’s credit rating from Standard & Poor’s was downgraded from BBB to BB. Similar downgrades from investment grade to noninvestment grade were made by other rating agencies. (Refer to the commentary in section B.2.2 for a discussion on other factors that can be assessed when determining if a borrower’s creditworthiness has deteriorated. These factors are particularly relevant when a borrower’s credit has not been formally rated by a recognized rating agency.) Borrower is not able to make the interest payment required ($500,000) on March 31, 20X3 and is not projecting sufficient cash flows in the remainder of 20X3 and beginning of 20X4 to support making the interest payment required on March 31, 20X4. Borrower attempts to identify other sources of financing and discovers that its financial situation severely hinders its ability to do so. In other words, other lenders are either not willing to lend to Borrower or are only willing to lend to Borrower at extremely disadvantageous terms.

On March 31, 20X3 (which is Borrower’s fiscal year-end), Borrower and Lender agree to change the terms of the debt agreement in the following ways:

- Principal amount is reduced to $4 million.
- Principal is payable in one lump sum on March 31, 20X8.
- Accrued and unpaid interest of $500,000 is forgiven.

In addition, the stated rate of interest remains 10 percent.

Borrower must first determine whether the liability derecognition threshold has been met in this situation. In making that determination, Borrower concludes that the threshold has not been met because Borrower has not been relieved of its obligation under the loan nor has it been legally released as the primary obligor under the loan. Borrower must next determine whether it should account for the changes to the loan as a troubled debt restructuring and, if so, the related accounting effects.

Analysis: Borrower concludes that the changes to the loan should be accounted for as a troubled debt restructuring because: (a) it is experiencing financial difficulties (as evidenced by, among other things, the deterioration in its credit rating) and (b) Lender has granted a concession.

When assessing whether it is experiencing financial difficulties, the first thing Borrower must determine is whether its credit rating has deteriorated. Borrower’s credit rating deteriorated because it has gone from investment grade to noninvestment grade. Because Borrower’s credit rating has deteriorated, it may be experiencing financial difficulties depending on its other facts and circumstances. Borrower assesses its other facts and circumstances and concludes that it is experiencing financial difficulties because it is not able to make the current or future interest payments required under the debt and because it is not able to secure a reasonable source of alternative financing.
Lender has granted a concession because the effective interest rate on the debt prior to the restructuring is more than the effective interest rate on the debt after the restructuring. To calculate the effective interest rate on the debt prior to the restructuring, Borrower must determine the discount rate that equates the present value of the amounts payable on the debt prior to the restructuring with the carrying amount of the debt prior to the restructuring. Borrower determines that discount rate to be 10 percent as illustrated in the table that follows:

<table>
<thead>
<tr>
<th>Present value (PV) of principal</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>PV factor [(\frac{1}{(1+i)^n}), where (i=10%) and (n=3)]</td>
<td>0.7513148</td>
</tr>
<tr>
<td></td>
<td>$3,756,574</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>PV of interest</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest payments ($5,000,000 * 10%)</td>
<td>$500,000</td>
</tr>
<tr>
<td>PV factor (\left[\frac{1-(1/(1+i)^n)}{i}\right],) where (i=10%) and (n=3)]</td>
<td>2.4868520</td>
</tr>
<tr>
<td></td>
<td>$1,243,426</td>
</tr>
<tr>
<td>PV of accrued and unpaid interest</td>
<td>$500,000</td>
</tr>
<tr>
<td><strong>Total of PVs, which equals the carrying amount of the debt prior to the restructuring</strong></td>
<td><strong>$5,500,000</strong></td>
</tr>
</tbody>
</table>

(Note that the effective interest rate on the debt prior to the restructuring is the same as the stated interest rate on the pre-restructured debt because there was no debt discount, debt premium or debt issuance costs assumed in this example.)

To calculate the effective interest rate on the debt after the restructuring, Borrower must determine the discount rate that equates the present value of the amounts payable on the debt after the restructuring with the carrying amount of the debt prior to the restructuring. Borrower determines that discount rate to be 2.04 percent (rounded from 2.035795 percent) as illustrated in the table that follows:

<table>
<thead>
<tr>
<th>PV of principal</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal</td>
<td>$4,000,000</td>
</tr>
<tr>
<td>PV factor (\frac{1}{(1+i)^n}), where (i=2.04%) and (n=5)]</td>
<td>0.9041432</td>
</tr>
<tr>
<td></td>
<td>$3,616,573</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>PV of interest</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest payments ($4,000,000 * 10%)</td>
<td>$400,000</td>
</tr>
<tr>
<td>PV factor (\left[\frac{1-(1/(1+i)^n)}{i}\right],) where (i=2.04%) and (n=5)]</td>
<td>4.7085667</td>
</tr>
<tr>
<td></td>
<td>$1,883,427</td>
</tr>
<tr>
<td><strong>Total of PVs, which equals the carrying amount of the debt prior to the restructuring</strong></td>
<td><strong>$5,500,000</strong></td>
</tr>
</tbody>
</table>

Total cash outflows required under the restructured debt are $6 million. This consists of repaying principal in the amount of $4 million and making five annual interest payments of $400,000 ($4 million * 10 percent). Because total cash outflows expected under the restructured debt ($6 million) are greater than the carrying amount of the debt prior to the restructuring ($5.5 million), no gain or loss is recognized as a result of the restructuring. In addition, there is no adjustment to the carrying amount of the debt. As such, there is no journal entry recorded on the date of the restructuring. On a going forward basis, Borrower would recognize interest expense using the effective interest rate on the debt after the restructuring. Information used in recording journal entries necessary on March 31 of each of the succeeding five years is presented in the table that follows:
2. Troubled debt restructuring with gain recognition

**Facts:** This example is based on the same facts as Example 1, except instead of the principal amount being reduced to $4 million, it is reduced to $3.6 million. For the same reasons discussed in Example 1, Borrower concludes that the liability derecognition threshold has not been met in this situation. Borrower must next determine whether it should account for the changes to the loan as a troubled debt restructuring and, if so, the related accounting effects.

**Analysis:** Borrower concludes that the restructuring is a troubled debt restructuring because: (a) it is experiencing financial difficulties for the same reasons discussed in Example 1 and (b) Lender has granted a concession because the effective interest rate on the debt prior to the restructuring is more than the effective interest rate on the debt after the restructuring. The effective interest rate on the debt prior to the restructuring is 10 percent as computed in Example 1.

To calculate the effective interest rate on the debt after the restructuring, Borrower must determine the discount rate that equates the present value of the amounts payable on the debt after the restructuring with the carrying amount of the debt prior to the restructuring. Total cash outflows required under the restructured debt are $5.4 million. This consists of repaying principal in the amount of $3.6 million and making five annual interest payments of $360,000 ($3.6 million * 10 percent). The carrying amount of the debt prior to the restructuring is $5.5 million ($5 million of principal plus $500,000 of accrued and unpaid interest). Because total cash outflows expected under the restructured debt are less than the carrying amount of the debt prior to the restructuring, the effective interest rate on the debt after the restructuring would be less than zero, which is less than the effective interest rate on the debt prior to the restructuring. As a result, Borrower concludes that Lender granted a concession. Given that Borrower is experiencing financial difficulties and Lender has granted a concession, Borrower concludes that a troubled debt restructuring has occurred.

When total cash outflows expected under the restructured debt are less than the carrying amount of the debt prior to the restructuring and there are no contingent payments, a gain on restructuring is recognized and an adjustment is made to the carrying amount of the debt. The amount of the gain and the net adjustment to the carrying amount of the debt recognized by Borrower is $100,000 (carrying amount of debt prior to restructuring [$5.5 million] less total cash outflows required under the terms of the restructured debt [$5.4 million]). Going forward, no interest expense is recorded on the debt and payments of interest are reflected as a reduction of the debt’s carrying amount.

The following is the journal entry recorded on the date the debt is restructured (March 31, 20X3):

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accrued interest (Note 1)</td>
<td>$500,000</td>
</tr>
<tr>
<td>Gain on restructuring of debt</td>
<td>$100,000</td>
</tr>
<tr>
<td>Debt (Note 1)</td>
<td>400,000</td>
</tr>
</tbody>
</table>

**Note 1:** The net effect on the carrying amount of the debt is a decrease of $100,000. After this journal entry, the carrying amount of the debt is $5.4 million. Because there is no interest expense recognized on a going forward basis when a gain is recognized on a troubled debt restructuring, the accrued interest account is reduced to zero and the entire carrying amount of the debt is included in the debt account.
Information used in recording the journal entries necessary on March 31 of each of the succeeding five years is presented in the table that follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>20X4</th>
<th>20X5</th>
<th>20X6</th>
<th>20X7</th>
<th>20X8</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning carrying amount of debt</td>
<td>$5,400,000</td>
<td>$5,040,000</td>
<td>$4,680,000</td>
<td>$4,320,000</td>
<td>$3,960,000</td>
</tr>
<tr>
<td>Interest payment ($3,600,000 * 10%)</td>
<td>360,000</td>
<td>360,000</td>
<td>360,000</td>
<td>360,000</td>
<td>360,000</td>
</tr>
<tr>
<td>Principal repayment</td>
<td>3,600,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ending carrying amount of debt</td>
<td>$5,040,000</td>
<td>$4,680,000</td>
<td>$4,320,000</td>
<td>$3,960,000</td>
<td>$0</td>
</tr>
</tbody>
</table>

3. Changes to prepayable loan and modification accounting

Facts: On June 30, 20X1, Borrower and Lender entered into a loan with the following terms:

- Principal borrowed = $5 million
- Term = Five years
- Maturity date = June 30, 20X6 (entire principal due at maturity)
- Interest payable at (i.e., stated interest rate) = 8.0 percent
- Interest paid = Annually (for ease of illustration)
- Prepayment penalty = $50,000

There was no discount or premium on the loan at issuance (i.e., the loan was issued at par and there were no lender’s fees). Debt issuance costs incurred with third parties (e.g., legal fees) related to entering into this loan amounted to $50,000. While the loan does not include any explicit prepayment terms, there is no prohibition against prepayment other than the requirement to pay a penalty upon prepayment. Borrower concludes this represents an implicit prepayment option. The following presents the journal entry Borrower makes in connection with the initial recognition of the loan on June 30, 20X1:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (receipt of principal from Lender)</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Debt issuance costs (Note 1)</td>
<td>50,000</td>
</tr>
<tr>
<td>Debt</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Cash (payment of legal fees)</td>
<td>50,000</td>
</tr>
</tbody>
</table>

Note 1: Unamortized debt issuance costs should be presented as a reduction of the related debt’s carrying amount on the balance sheet.

Borrower recognizes interest expense on the debt using the effective interest method. To do so, Borrower must determine the rate implicit in the loan or, said differently, the rate that would result in a constant rate of interest expense being recognized over the term of the loan. Given the net carrying amount of the loan of $4.95 million ($5 million of principal less $50,000 of debt issuance costs) and five annual interest payments in arrears of $400,000 ($5 million of principal multiplied by 8 percent interest rate), Borrower calculates the effective interest rate to be 8.25 percent (rounded from 8.252124 percent). If the loan had been issued at a premium or discount and (or) if there had been a lender’s fee, the determination of the effective interest rate would also have needed to take that premium or discount and (or) lender’s fee into consideration. The following presents the journal entry Borrower recognizes in connection with the interest payment it makes on June 30, 20X2:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense ($4,950,000 * 8.252124%)</td>
<td>$408,480</td>
</tr>
<tr>
<td>Cash ($5,000,000 * 8%)</td>
<td>$400,000</td>
</tr>
<tr>
<td>Debt issuance costs ($408,480 – $400,000)</td>
<td>8,480</td>
</tr>
</tbody>
</table>

After this journal entry, the unamortized debt issuance costs are $41,520 ($50,000 of debt issuance costs less amortization of $8,480) and the carrying amount of the debt is $4,958,480 ($5 million of principal less $41,520 of unamortized debt issuance costs).

The loan includes covenants that Borrower must comply with on a quarterly basis. Borrower determines that it will be in compliance with the debt covenants at June 30, 20X2, which is its year-end. However, Borrower does not expect to be in
compliance with the debt covenants as of September 30, 20X2. As such, Borrower negotiates with Lender to change the loan to reset the debt covenants so that Borrower is expected to be in compliance as of September 30, 20X2 and throughout the remaining term of the loan. In addition to resetting the debt covenants, Borrower and Lender also agree to the following changes on June 30, 20X2:

- Maturity date = June 30, 20X7
- Interest payable at (i.e., stated interest rate) = 12.0 percent

Borrower must pay a $100,000 fee to Lender as compensation for executing the changes to the loan. In essence, Borrower agreed to pay a higher rate of interest and a $100,000 fee in return for resetting the debt covenants and adding one year to the total term of the loan. Borrower incurs legal fees in the amount of $25,000 related to making these changes to the loan. The loan modification does not trigger the prepayment penalty provisions under the terms of the loan.

Before considering whether modification or extinguishment accounting should be applied in this situation, Borrower must first determine whether: (a) the liability derecognition threshold has been met and (b) whether a troubled debt restructuring has occurred. Borrower concludes that the liability derecognition threshold has not been met because Borrower has not been relieved of its obligation under the loan nor has it been legally released as the primary obligor under the loan. In addition, Borrower concludes that a troubled debt restructuring has not occurred because Lender is not granting a concession. Borrower must next determine whether it should account for the changes to the loan using modification or extinguishment accounting. In addition, Borrower also needs to determine how to account for the $100,000 fee paid to Lender and the $25,000 of legal fees incurred in connection with making changes to its loan.

Analysis: When considering whether modification or extinguishment accounting should be used to account for the changes to the loan, Borrower must determine the present value of the original loan’s remaining cash flows and the present value of the changed loan’s cash flows. Because the loan includes an implicit prepayment option, Borrower needs to consider the present value of these cash flows assuming both that the prepayment option is exercised and that the prepayment option is not exercised.

Borrower believes that the smaller change in cash flows will result when assuming that the prepayment option is exercised. As such, Borrower first applies the 10 percent cash flow test under that assumption. Assuming that the loan will be prepaid on June 30, 20X2, the date the loan was changed and the date as of which the 10 percent cash flow test is performed:

- Borrower determines that the present value of the original loan’s remaining cash flows is $5.05 million (principal prepayment of $5 million and the prepayment penalty of $50,000). While the carrying amount of the loan at June 30, 20X2 is $4,958,480, if Borrower exercised the prepayment option on the old loan, they would be required to pay the full principal amount plus the prepayment penalty. In other words, the original loan’s remaining cash flows do not take into consideration any unamortized debt issuance costs.

- Borrower determines that the present value of the changed loan’s cash flows is $5.15 million (principal prepayment of $5 million, the prepayment penalty of $50,000 and Lender’s fee of $100,000). Assuming prepayment, the difference between the present value of the original loan’s remaining cash flows and the present value of the changed loan’s cash flows is $100,000 or 2 percent of the present value of the original loan’s remaining cash flows. Because the difference is less than 10 percent (and an embedded conversion option is not part of the loan before or after the changes), the changes to the loan should be accounted for as a modification. Borrower does not need to perform the 10 percent cash flow test assuming that the prepayment option is not exercised, because only one of the 10 percent cash flow tests needs to have a change of less than 10 percent to result in modification accounting. The following presents journal entries related to the modified loan:
Accounting for modification of loan—June 30, 20X2 (Note 1)

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt discount and issuance costs (Note 2)</td>
<td>$100,000</td>
</tr>
<tr>
<td>Legal fees expense</td>
<td>25,000</td>
</tr>
<tr>
<td>Cash (fee paid to legal counsel)</td>
<td>$25,000</td>
</tr>
<tr>
<td>Cash (fee paid to Lender)</td>
<td>100,000</td>
</tr>
</tbody>
</table>

**Note 1:** Even though the prepayment penalty was included in the 10 percent cash flow test under the assumption that the prepayment option was exercised, the fee was not actually paid because the loan was not prepaid. As such, the fee is not included in this journal entry.

**Note 2:** Given that both the unamortized debt discount and unamortized debt issuance costs should be presented as a reduction of the related debt’s carrying amount on the balance sheet, Borrower reflects both amounts in the same account.

Accounting for first interest payment and amortization of debt discount and issuance costs on modified loan—June 30, 20X3

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense (Note 1)</td>
<td>$621,925</td>
</tr>
<tr>
<td>Debt discount and issuance costs (Note 1)</td>
<td>$21,925</td>
</tr>
<tr>
<td>Cash ($5,000,000 * 12%)</td>
<td>600,000</td>
</tr>
</tbody>
</table>

**Note 1:** Borrower recognizes interest expense and the amortization of debt discount and issuance costs using the effective interest method. Borrower determined that the effective interest rate on the modified loan is 12.8 percent (rounded from 12.800817 percent). Prior to making the first interest payment on the modified loan, the carrying amount of the modified loan is $4,858,480 ($5 million principal less $141,520 of unamortized debt discount and issuance costs). The amount of debt discount and issuance costs amortized is based on the difference between the interest payment and interest expense.

**Commentary:** If Borrower had not realized that it should consider the results of the 10 percent cash flow test under both the assumption that the loan is prepaid as well as the assumption that it is not prepaid, it may have reached an inappropriate conclusion that extinguishment accounting should be applied. As further illustrated in Example 4, which is based on the same facts as this example except prepayment is specifically prohibited by the loan both before and after the changes, the difference between the present value of the original loan’s remaining cash flows and the present value of the changed loan’s cash flows is $884,784 or 17.8 percent of the present value of the original loan’s remaining cash flows.

If the only change in cash flows in this example was due to Borrower paying Lender a fee solely to obtain a debt waiver letter for the expected noncompliance with the debt covenants as of September 30, 20X2 (i.e., no change to the interest rate or maturity date), that change in cash flows would still need to be evaluated to determine whether modification or extinguishment accounting for the change is appropriate. This determination then plays a part in how the fee itself should be treated from an accounting perspective. To the extent payment of a fee for a debt waiver letter is accounted for as a modification, the debt waiver fee paid to the bank is treated as a debt discount and any costs incurred with third parties (e.g., legal fees) to help obtain the debt waiver letter are expensed as incurred.

If Borrower received incremental borrowings from Lender in connection with making the changes to its loan, the present value of the changed loan’s cash flows would also include those incremental borrowings (refer to Example 5). If those incremental borrowings are not included in the changed loan’s cash flows, Borrower may inappropriately account for the changes to the loan.
4. Changes to loan agreement and extinguishment accounting

**Facts:** This example is based on the same facts as Example 3, except that prepayment of the loan is prohibited both in the original and changed loan (and, as such, there is no prepayment penalty). In addition, the fair value of the loan on June 30, 20X2 after the changes to the loan are executed is $5.4 million.

Before considering whether modification or extinguishment accounting should be applied in this situation, Borrower must first determine whether: (a) the liability derecognition threshold has been met and (b) whether a troubled debt restructuring has occurred. For the reasons given in Example 3, Borrower concludes that the liability derecognition threshold has not been met and a troubled debt restructuring has not occurred. As such, Borrower must next determine whether it should account for the changes to the loan using modification or extinguishment accounting. In addition, Borrower also needs to determine how to account for the $100,000 fee paid to Lender and the $25,000 of legal fees incurred in connection with making changes to its loan.

**Analysis:** When considering whether modification or extinguishment accounting should be used to account for the changes to the loan, Borrower must determine the present value of the original loan’s remaining cash flows and the present value of the changed loan’s cash flows. In making these determinations, Borrower must first calculate the original loan’s effective interest rate. To do so, Borrower must determine the rate implicit in the loan or, said differently, the rate that would result in a constant rate of interest expense being recognized over the term of the loan. As illustrated in the table that follows, Borrower determines that the effective interest rate on the original loan is 8.25 percent (rounded from 8.252124 percent):

<table>
<thead>
<tr>
<th>Date</th>
<th>20X2</th>
<th>20X3</th>
<th>20X4</th>
<th>20X5</th>
<th>20X6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan less unamortized debt issuance costs at beginning of period</td>
<td>$4,950,000</td>
<td>$4,958,480</td>
<td>$4,967,660</td>
<td>$4,977,597</td>
<td>$4,988,355</td>
</tr>
<tr>
<td>Interest expense (using effective interest rate of 8.25%)</td>
<td>408,480</td>
<td>409,180</td>
<td>409,937</td>
<td>410,758</td>
<td>411,645</td>
</tr>
<tr>
<td>Interest payment ($5,000,000 * 8%)</td>
<td>400,000</td>
<td>400,000</td>
<td>400,000</td>
<td>400,000</td>
<td>400,000</td>
</tr>
<tr>
<td>Reduction in unamortized debt issuance costs</td>
<td>8,480</td>
<td>9,180</td>
<td>9,937</td>
<td>10,758</td>
<td>11,645</td>
</tr>
<tr>
<td>Principal repayment</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Loan less unamortized debt issuance costs at end of period</td>
<td>$4,958,480</td>
<td>$4,967,660</td>
<td>$4,977,597</td>
<td>$4,988,355</td>
<td>(0)</td>
</tr>
</tbody>
</table>

If the loan had been issued at a premium or discount and (or) if there had been a lender’s fee, the determination of the effective interest rate would also have needed to take that premium or discount and (or) lender’s fee into consideration.

Using an effective interest rate of 8.25 percent, the present value of the original loan’s remaining cash flows on June 30, 20X2 (the date the changes were agreed to) is calculated as follows:

<table>
<thead>
<tr>
<th>PV of principal</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>PV factor [$1/(1+i)^n, where i = 8.25% and n = 4]</td>
<td>0.728206</td>
</tr>
<tr>
<td></td>
<td>$3,641,030</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>PV of interest</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual interest payment ($5,000,000 * 8%)</td>
<td>$400,000</td>
</tr>
<tr>
<td>PV factor [(1-(1/(1+i)^n))/i, where i = 8.25% and n = 4]</td>
<td>3.293624</td>
</tr>
<tr>
<td></td>
<td>$1,317,450</td>
</tr>
</tbody>
</table>

| PV of original loan’s remaining cash flows | $4,958,480 |

If Borrower had paid Lender a fee in conjunction with initially originating the loan, such fee would not be included in the cash flows used in this calculation because the calculation is focused on the original loan’s remaining cash flows. The debt issuance costs incurred with third parties upon entering into the original loan are not included in the cash flows reflected in the calculation because: (a) only amounts exchanged by Borrower and Lender are included in the original loan’s remaining cash flows and (b) such costs are not part of the remaining cash flows associated with the loan. In addition, the $100,000 fee paid to Lender for making changes to the loan is not included in this calculation because the calculation is focused on the original loan’s remaining cash flows.
For purposes of recognizing interest expense, Borrower can only use the straight-line method to amortize debt issuance costs if doing so would result in an immaterial difference from the effective interest method. While this may be an appropriate approach for purposes of recognizing interest expense, it is not appropriate to use the results of applying this approach for purposes of performing the 10 percent cash flow test when present value calculations are required (e.g., when the debt is not prepayable). In other words, the carrying amount of the old debt for purposes of the 10 percent cash flow test should be based on application of the effective interest method using the effective interest rate and, in doing so, the discount rate used in the present valuation calculations should be the effective interest rate of the old loan.

Using an effective interest rate of 8.25 percent, the present value of the changed loan’s cash flows is calculated as follows:

<table>
<thead>
<tr>
<th>PV of principal</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>PV factor [$1/(1+i)^n, \text{where } i = 8.25% \text{ and } n = 5]</td>
<td>0.6726945</td>
</tr>
<tr>
<td><strong>PV of principal</strong></td>
<td><strong>$3,363,473</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>PV of interest</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual interest payment ($5,000,000 * 12%)</td>
<td>$600,000</td>
</tr>
<tr>
<td>PV factor [\left(1-\left(1/(1+i)^n\right)\right)/i, \text{where } i = 8.25% \text{ and } n = 5]</td>
<td>3.966318</td>
</tr>
<tr>
<td>Lender’s fee for executing changes to the loan</td>
<td>100,000</td>
</tr>
<tr>
<td><strong>PV of changed loan’s cash flows</strong></td>
<td><strong>$5,843,264</strong></td>
</tr>
</tbody>
</table>

The legal fees incurred by Borrower in connection with making changes to the loan ($25,000) are not included in the present value of the changed loan’s cash flows because only amounts exchanged by Borrower and Lender are included in the changed loan’s cash flows.

The difference between the present value of the original loan’s remaining cash flows and the present value of the changed loan’s cash flows is $884,784 or 17.8 percent of the present value of the original loan’s remaining cash flows. Because the difference is greater than 10 percent, the changes to the loan should be accounted for as an extinguishment. The following presents journal entries related to the modified loan:

**Accounting for extinguishment of original loan and recognition of new loan—June 30, 20X2**

<table>
<thead>
<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss on extinguishment (Note 1)</td>
<td>$541,520</td>
<td></td>
</tr>
<tr>
<td>Debt (derecognition of original loan’s principal amount)</td>
<td>5,000,000</td>
<td></td>
</tr>
<tr>
<td>Debt premium and issuance costs (Note 2) (fee paid to legal counsel in connection with new loan)</td>
<td>25,000</td>
<td></td>
</tr>
<tr>
<td>Cash (fee paid to legal counsel)</td>
<td></td>
<td>$25,000</td>
</tr>
<tr>
<td>Cash (fee paid to Lender)</td>
<td></td>
<td>100,000</td>
</tr>
<tr>
<td>Debt (Note 3)</td>
<td></td>
<td>5,000,000</td>
</tr>
<tr>
<td>Debt premium and issuance costs (Notes 2, 3)</td>
<td>400,000</td>
<td></td>
</tr>
<tr>
<td>Debt issuance costs (write-off of unamortized debt issuance costs related to original loan)</td>
<td>41,520</td>
<td></td>
</tr>
</tbody>
</table>

**Note 1:** The loss on extinguishment is the difference between the reacquisition price of the original loan ($5.4 million (fair value of modified loan)) and the original loan’s net carrying amount ($5 million (face amount of loan) – $41,520 (unamortized debt issuance costs related to the original loan)) plus the fee paid to the lender ($100,000).

**Note 2:** Given that both the unamortized debt premium and unamortized debt issuance costs affect the carrying amount of the related debt on the balance sheet, Borrower accounts for both amounts in the same account.

**Note 3:** Of the $5.4 million fair value of the loan, $5 million represents the face amount of the loan, which is recorded in the Debt account, and $400,000 effectively represents a deemed premium on the loan, which is recorded in the Debt premium and issuance costs account (see Note 2).
**Accounting for first interest payment and amortization of debt premium and issuance costs on new loan—June 30, 20X3**

<table>
<thead>
<tr>
<th>Debit Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense (Note 1)</td>
<td>$538,601</td>
<td></td>
</tr>
<tr>
<td>Debt premium and issuance costs (Note 1)</td>
<td>61,399</td>
<td></td>
</tr>
<tr>
<td>Cash ($5,000,000 * 12%)</td>
<td>$600,000</td>
<td></td>
</tr>
</tbody>
</table>

**Note 1:** Interest expense and the amortization of debt premium and issuance costs on the new loan are determined using the effective interest method. Using the same approach that was used to determine the effective interest rate on the original loan, Borrower determined that the effective interest rate on the new loan is 10.02 percent (rounded from 10.020482 percent). Prior to making the first interest payment on the new loan, the carrying amount of the loan is $5,375,000 ($5 million principal plus $400,000 debt premium less $25,000 of unamortized debt issuance costs). The amount of debt premium and issuance costs amortized is based on the difference between the interest payment and interest expense.

**Commentary:** As illustrated in Example 3, if the loan was prepayable with a penalty of $50,000, Borrower would account for the changes to the loan as a modification instead of an extinguishment.

If Borrower received incremental borrowings from Lender in connection with making the changes to its loan, the present value of the changed loan's cash flows would also include those incremental borrowings (refer to Example 5). If those incremental borrowings are not included in the changed loan's cash flows, the borrower may inappropriately account for the changes to the loan.

### 5. Changes to loan agreement with incremental borrowings

**Facts:** This example is based on the same facts as Example 3, except: (a) prepayment of the loan is prohibited both in the original and changed loan (and, as such, there is no prepayment penalty), (b) the interest rate is changed from 8 percent to 9 percent on June 30, 20X2 and (c) Lender agrees to loan Borrower an additional $1 million, which increases the principal amount of the loan to $6 million. In essence, Borrower agreed to pay a higher rate of interest and a $100,000 fee to Lender in return for: (a) resetting the debt covenants, (b) increasing the amount borrowed and (c) adding one year to the total term of the loan.

Before considering whether modification or extinguishment accounting should be applied in this situation, Borrower must first determine whether: (a) the liability derecognition threshold has been met and (b) whether a troubled debt restructuring has occurred. For the reasons given in Example 3, Borrower concludes that the liability derecognition threshold has not been met and a troubled debt restructuring has not occurred. As such, Borrower must next determine whether it should account for the changes to the loan using modification or extinguishment accounting. In addition, Borrower also needs to determine how to account for the $100,000 fee paid to Lender and the $25,000 of legal fees incurred in connection with making changes to its loan.

**Analysis:** When considering whether modification or extinguishment accounting should be used to account for the changes to the loan, Borrower must determine the present value of the original loan’s remaining cash flows and the present value of the changed loan’s cash flows. In making these determinations, Borrower must first calculate the original loan’s effective interest rate. The terms of the original loan that affect its effective interest rate are the same in this example as they are in Example 4. As determined in Example 4, the effective interest rate on the original loan is 8.25 percent (rounded from 8.252124 percent) and the present value of the original loan’s remaining cash flows on June 30, 20X2 (the date the changes were agreed to) is $4,958,480.

Using an effective interest rate of 8.25 percent, the present value of the changed loan’s cash flows is calculated as follows:

<table>
<thead>
<tr>
<th>PV of principal</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal (including incremental borrowings of $1,000,000)</td>
<td>$6,000,000</td>
</tr>
<tr>
<td>PV factor [$1/(1 + i)^n; where i=8.25% and n=5]</td>
<td>0.6726945</td>
</tr>
<tr>
<td></td>
<td>$4,036,167</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>PV of interest</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual interest payment ($6,000,000 * 9%)</td>
<td>$540,000</td>
</tr>
<tr>
<td>PV factor [1-(1/(1 + i)^n)]/i, where i=8.25% and n=5]</td>
<td>3.966318</td>
</tr>
<tr>
<td></td>
<td>$2,141,812</td>
</tr>
<tr>
<td>Lender’s fee for executing changes to the loan</td>
<td>100,000</td>
</tr>
<tr>
<td>PV of changed loan’s cash outflows</td>
<td>$6,277,979</td>
</tr>
<tr>
<td>PV of changed loan’s cash inflows (i.e., incremental borrowings)</td>
<td>1,000,000</td>
</tr>
<tr>
<td><strong>PV of changed loan’s net cash flows</strong></td>
<td><strong>$5,277,979</strong></td>
</tr>
</tbody>
</table>
For purposes of determining the present value of the changed loan’s cash flows, Borrower should include any amounts exchanged by Borrower and Lender in connection with the changes to the loan. This would include both fees paid to Lender and incremental borrowings received by Borrower. It is critical that the incremental borrowings be included in the present value of the changed loan’s cash inflows and outflows. If they are not, Borrower would inappropriately account for the changes to the loan as an extinguishment instead of a modification as follows:

| PV of changed loan’s net cash flows (includes incremental borrowings of $1,000,000 in the changed loan’s cash outflows and the changed loan’s cash inflows) | $5,277,979 |
| PV of original loan’s remaining cash flows | 4,958,480 |
| Difference | $319,499 |
| % Difference (Correct) | 6.4% |

| PV of changed loan’s net cash flows if incremental borrowings received by Borrower (cash inflow) are incorrectly excluded from the PV calculation | $6,277,979 |
| PV of original loan’s remaining cash flows | 4,958,480 |
| Difference | $1,319,499 |
| % Difference (Incorrect) | 26.6% |

When Borrower correctly calculates the difference between the present value of the original loan’s remaining cash flows and the present value of the changed loan’s cash flows, Borrower concludes that the changes to the loan should be accounted for as a modification (because the difference is less than 10 percent of the present value of the original loan’s remaining cash flows and an embedded conversion option is not part of the loan before or after the changes). If Borrower incorrectly excluded the incremental borrowings it received from the present value of the changed loan’s cash flows, then Borrower would have incorrectly concluded that the changes to the loan should have been accounted for as an extinguishment (because the difference would have been more than 10 percent of the present value of the original loan’s remaining cash flows). Incorrectly accounting for the changes to the loan as an extinguishment would result in the inappropriate recognition of a gain or loss.

The following presents journal entries related to the modified loan:

**Accounting for modification of loan—June 30, 20X2**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (incremental borrowings)</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Debt discount and issuance costs (Note 1)</td>
<td>100,000</td>
</tr>
<tr>
<td>Legal fees expense</td>
<td>25,000</td>
</tr>
<tr>
<td>Debt (incremental borrowings)</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Cash (fee paid to legal counsel)</td>
<td>25,000</td>
</tr>
<tr>
<td>Cash (fee paid to Lender)</td>
<td>100,000</td>
</tr>
</tbody>
</table>

**Note 1:** Given that both the unamortized debt discount and unamortized debt issuance costs should be presented as a reduction of the related debt’s carrying amount on the balance sheet, Borrower reflects both amounts in the same account.

**Accounting for first interest payment and amortization of debt discount and issuance costs on modified loan—June 30, 20X3**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense (Note 1)</td>
<td>$563,358</td>
</tr>
<tr>
<td>Debt discount and issuance costs (Note 1)</td>
<td>$23,358</td>
</tr>
<tr>
<td>Cash ($6,000,000 * 9%)</td>
<td>$540,000</td>
</tr>
</tbody>
</table>

**Note 1:** Borrower recognizes interest expense and the amortization of the debt discount and issuance costs using the effective interest method. Using the same approach that was used to determine the effective interest rate on the original loan (see Example 4), Borrower determined that the effective interest rate on the modified loan is 9.62 percent (rounded from 9.61612 percent). Prior to making the first interest payment on the modified loan, the carrying amount of the modified loan is $5,858,480 ($6 million principal less $100,000 debt discount less $41,520 unamortized debt issuance costs). The amount of debt discount and issuance costs amortized is based on the difference between the interest payment and interest expense.
Commentary: As illustrated in Example 3, if the loan was prepayable, Borrower may have been able to avoid performing some of the calculations required by the 10 percent cash flow test.

If the only change in cash flows in this example was due to Borrower paying Lender a fee solely to obtain a debt waiver letter for the expected noncompliance with the debt covenants as of September 30, 20X2 (i.e., no change to the interest rate or maturity date and no incremental borrowings), that change in cash flows would still need to be evaluated to determine whether modification or extinguishment accounting for the change is appropriate. This determination then plays a part in how the fee itself should be treated from an accounting perspective. To the extent payment of a fee for a debt waiver letter is accounted for as a modification, the debt waiver fee paid to the bank is treated as a debt discount and any costs incurred with third parties (e.g., legal fees) to help obtain the debt waiver letter are expensed as incurred.

A less-than-substantially-different change in cash flows occurred in this example. As a result, if Borrower and Lender agreed to make additional changes to the loan on April 1, 20X3 (which is within a year of the changes agreed to on June 30, 20X2), the 10 percent cash flow test performed for the April 1, 20X3 changes to the loan should compare: (a) the present value of the original (i.e., unchanged) loan’s remaining cash flows on June 30, 20X2 (the date of the first modification) to (b) the sum of: (i) the present value of the changed loan’s cash flows from July 1, 20X2 through April 1, 20X3 using the terms of the loan after the first modification and (ii) the present value of the changed loan’s cash flows after April 1, 20X3 using the terms of the loan after the second modification. This requirement is so Borrower would not get a different accounting answer by executing changes to the loan in stages.

6. Changes to prepayable loans in a syndication

Facts: On January 1, 20X0, Borrower obtained $400 million of financing from a loan syndication in which four banks participated (Bank A, B, C and D). As part of the syndication, each bank entered into a loan with Borrower having the following terms:

- Principal borrowed = $100 million for each bank in the syndication ($400 million in total)
- Term = Ten years
- Maturity date = December 31, 20X9 (entire principal due at maturity)
- Interest payable at (i.e., stated interest rate) = 5.0 percent
- Interest paid = Annually (for ease of illustration)
- Prepayment terms = No prohibition against prepayment and no penalties assessed upon prepayment

Lenders’ fees and debt issuance costs incurred by Borrower in connection with obtaining the financing through the syndication were $4 million, which were recorded in an account titled “debt discount and issuance costs” that reduces the carrying amount of the loans.

In late 20X4, Borrower sold a plant for cash in the amount of $100 million. As a result, Borrower reassessed its financing needs and decided to modify the syndication on January 1, 20X5 as follows:

- Bank D’s loan was paid off in full and Bank D no longer participates in the syndication or provides any other financing to Borrower.
- Bank A, B and C remained in the syndication and continued to loan Borrower $100 million each.
- The interest rate of each loan was reduced from 5.0 percent to 4.75 percent.
- The total term of each loan was extended by five years.
- The maturity date of each loan was changed to December 31, 20Y4.

As a result of these changes, the total borrowings under the modified syndication were reduced from $400 million to $300 million. Prior to the modification, there were $2,278,143 in unamortized debt discount and issuance costs.

Bank A acted as the lead bank in modifying the syndication and received a fee of $1.5 million from Borrower, which consisted of the following:

- $750,000 lender’s fee for modifying the terms of its $100 million loan with Borrower
- $450,000 for underwriting services provided in connection with its role as the lead bank
- $300,000 for out-of-pocket lending costs, such as filing fees, attorney’s fees for the modifying the syndication and other direct expenses

Bank B and Bank C, who acted solely in the capacity of lenders, received fees of $750,000 each.
Before considering whether modification or extinguishment accounting should be applied in this situation, Borrower must first determine whether: (a) the liability derecognition threshold has been met and (b) whether a troubled debt restructuring has occurred. Borrower concludes that the liability derecognition threshold has been met with respect to Bank D’s loan because Borrower has been relieved of its obligation under the loan as a result having repaid the loan. However, with respect to its loans with Bank A, B and C, Borrower concludes that it has not been relieved of its obligation under any of those loans nor has it been legally released as the primary obligor under any of those loans. In addition, Borrower concludes that a troubled debt restructuring has not occurred because it is not experiencing financial difficulties. Borrower must next determine whether it should account for the changes to each loan in the modified syndication using modification or extinguishment accounting. In addition, Borrower also needs to determine how to account for the fees charged by each bank in connection with making changes to the remaining loans in the modified syndication.

**Analysis:** Given that the liability derecognition threshold was met with respect to Bank D’s loan when it was paid off in full and Bank D is no longer participating in the syndication or providing any other financing to Borrower, the extinguishment accounting model is applied to Bank D’s loan. Any unamortized debt discount and issuance costs related to Bank D’s loan should be derecognized when accounting for its extinguishment. Borrower allocates the total unamortized debt discount and issuance costs to each of the loans in the original syndication using the principal amount of each loan relative to the total principal amount of all the loans. Given that each of the four banks loaned Borrower the same amount in the original syndication, Borrower allocates 25 percent of the total unamortized debt discount and issuance costs ($2,278,143) to Bank D (which amounts to $569,536). None of the fees paid by Borrower to the banks that remained in the modified syndication should be allocated to the extinguishment of Bank D’s loan because the extinguishment took place in accordance with its original terms.

Application of the extinguishment model to Bank D’s loan has the following effects on Borrower’s financial statements:

<table>
<thead>
<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss on extinguishment of loan</td>
<td>$569,536</td>
<td></td>
</tr>
<tr>
<td>Debt</td>
<td>100,000,000</td>
<td>$100,000,000</td>
</tr>
<tr>
<td>Unamortized debt discount and issuance cost</td>
<td></td>
<td>569,536</td>
</tr>
</tbody>
</table>

The loss on extinguishment of the loan should be included in other financing income or expense on the income statement.

Borrower determines whether modification or extinguishment accounting should be used to account for the changes to the other loans in the modified syndication by applying the 10 percent cash flow test. For purposes of applying that test, Borrower must determine the lender’s fees paid to each bank because those fees should be included in the test. Given that Bank A is acting as the lead bank in the modification, it must determine: (a) how much of its fee should be treated as a lender’s fee versus a third-party cost for accounting purposes and (b) whether any of the fee it identifies as a lender’s fee represents a lender’s fee it incurred on behalf of all the lenders in the modified syndication. In analyzing the three components of Bank A’s fees, Borrower determines the following:

- The $750,000 component for modifying the terms of its $100 million loan with Borrower should be treated as a lender’s fee for accounting purposes. Characterizing this component as a lender’s fee is supported by the fact that Bank B and C were only acting in the capacity of lenders with respect to the modified syndication and also received lenders’ fees of $750,000 each.
- The $450,000 component for underwriting services provided in connection with its role as the lead bank should be treated as a third-party cost for accounting purposes. Bank A has two roles in the modified syndication. One role is that of a lender and the other is that of an underwriter. If Bank A had not acted in the capacity of an underwriter and Borrower instead hired a third party to act in that capacity, the fees paid to the third party would have been treated as third-party cost. As such, the fees paid to Bank A for the services provided in its capacity as an underwriter should be treated as a third-party cost for accounting purposes.
- The $300,000 component for out-of-pocket lending costs should be treated as a lender’s fee for accounting purposes. These are costs Bank A incurred in connection with the lending activities of all three banks in the modified syndication. Because the costs directly relate to lending activities, they should be treated as a lender’s fee. In addition, because the fees relate to the lending activities of all three banks, they should be allocated to each bank (for purposes of the 10 percent cash flow test performed for each loan with each bank) based on the principal amount of each loan remaining in the modified syndication relative to the total principal amount of all the loans remaining in the modified syndication. In other words, $100,000 ($100 million divided by $300 million multiplied by $300,000) of this fee should be allocated to each bank in the modified syndication for purposes of applying the 10 percent cash flow test.
Based on this analysis, the lender’s fees associated with Bank A’s loan for purposes of the 10 percent cash flow test is $850,000, which consists of the lender’s fee that is commensurate with the fees paid to the other lenders in the modified syndication ($750,000) plus its portion of the $300,000 reimbursement for the out–of–pocket lending costs it incurred in connection with the lending activities of all three banks remaining in the modified syndication ($100,000). In addition, the lenders’ fees associated with Bank B’s and Bank C’s loans for purposes of the 10 percent cash flow test are also $850,000 each, which consists of the fees they received directly from Borrower ($750,000 each) and their portion of the $300,000 reimbursed to Bank A for the out–of–pocket lending costs incurred in connection with the lending activities of all three banks remaining in the modified syndication ($100,000).

In applying the 10 percent cash flow test, Borrower must determine the present value of the original loan’s remaining cash flows and the present value of the changed loan’s cash flows. Because the loan includes an implicit prepayment option, Borrower needs to consider the present value of these cash flows assuming both that the prepayment option is exercised and that the prepayment option is not exercised.

Borrower believes that the smaller change in cash flows will result when assuming that the prepayment option is exercised. As such, Borrower first applies the 10 percent cash flow test under that assumption. Assuming that the loan will be prepaid on January 1, 20X5, the date the loan was changed and the date as of which the 10 percent cash flow test is performed, Borrower determines the following:

<table>
<thead>
<tr>
<th></th>
<th>Bank A</th>
<th>Bank B</th>
<th>Bank C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original loan’s remaining cash flows, consisting of principal repayment</td>
<td>$100,000,000</td>
<td>$100,000,000</td>
<td>$100,000,000</td>
</tr>
<tr>
<td>Changed loan’s remaining cash flows, consisting of:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Principal repayment</td>
<td>$100,000,000</td>
<td>$100,000,000</td>
<td>$100,000,000</td>
</tr>
<tr>
<td>Lender’s fees</td>
<td>850,000</td>
<td>850,000</td>
<td>850,000</td>
</tr>
<tr>
<td>Total</td>
<td>$100,850,000</td>
<td>$100,850,000</td>
<td>$100,850,000</td>
</tr>
<tr>
<td>Difference</td>
<td>$850,000</td>
<td>$850,000</td>
<td>$850,000</td>
</tr>
<tr>
<td>Percentage difference</td>
<td>0.85%</td>
<td>0.85%</td>
<td>0.85%</td>
</tr>
</tbody>
</table>

Assuming prepayment, the difference between the present value of each original loan’s remaining cash flows and the present value of each changed loan’s cash flows is $850,000, which is less than one percent of the present value of each original loan’s remaining cash flows. Because the difference is less than 10 percent (and an embedded conversion option is not part of the loan before or after the changes), the changes to each of the loans should be accounted for as a modification. Borrower does not need to perform the 10 percent cash flow test assuming that the prepayment option is not exercised, because only one of the 10 percent cash flow tests needs to have a change of less than 10 percent to result in modification accounting. The following presents journal entries related to modifying the loan syndication:

**Accounting for modification of loan syndication—January 1, 20X5**

<table>
<thead>
<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt discount and issuance costs (Note 1)</td>
<td>$2,550,000</td>
<td></td>
</tr>
<tr>
<td>Underwriting expenses</td>
<td>450,000</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$3,000,000</td>
<td></td>
</tr>
</tbody>
</table>

**Note 1:** The amount added to debt discount and issuance costs represents the lenders’ fees paid to each lender in the modified syndication ($750,000 per lender) as well as the $300,000 reimbursed to Bank A for the out–of–pocket lending costs incurred on behalf of all banks in the modified syndication.
Accounting for first interest payment and amortization of debt issuance costs on modified syndication—December 31, 20X5

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense (Note 1)</td>
<td>$14,554,706</td>
</tr>
<tr>
<td>Cash ($300,000,000 * 4.75%)</td>
<td>$14,250,000</td>
</tr>
<tr>
<td>Debt discount and issuance costs (Note 1)</td>
<td>304,706</td>
</tr>
</tbody>
</table>

Note 1: Borrower recognizes interest expense and the amortization of debt discount and issuance costs using the effective interest method. Borrower determined that the effective interest rate on the modified loans is 4.9 percent (rounded from 4.9214 percent) (see Note 2). Prior to making the first interest payments on the loans in the modified syndication, the total carrying amount of the modified loans is $300 million of principal less $4,258,607 of unamortized debt discount and issuance costs, which equals $295,741,393. The amount of unamortized debt discount and issuance costs represents the beginning balance of $2,278,143 less the $569,536 written off as a result of extinguishing the loan with Bank D plus the $2,550,000 of lenders’ fees incurred in connection with modifying the loans in the syndication.

Note 2: Given that the terms of each lender’s loan that remains in the syndication are the same before and after the syndication is modified, the effective interest rate and interest expense can be calculated on a syndication-wide basis. In situations where this is not the case, the effective interest rate and interest expense may need to be calculated individually for each loan.

Commentary: If Borrower had not appropriately considered the substance of the fees paid to Bank A, the cash flows used in the 10 percent cash flow test would have been misstated. In addition, the amount of those fees recognized as an expense versus additional debt discount and issuance costs would also have been incorrect. In other words, if Borrower assumed that all amounts paid to Bank A were a lender’s fee merely because Bank A was one of the lenders in the modified syndication, it would have overstated the debt discount and issuance costs and understated expenses by $450,000. This example further underscores the importance of understanding the substance of payments to lenders and third-party service providers and accounting for those payments based on their substance.

If Borrower had not realized that it should consider the results of the 10 percent cash flow test under both the assumption that the loan is prepaid as well as the assumption that it is not prepaid, it may have reached an inappropriate conclusion that extinguishment accounting should be applied. Examples 3 and 4 illustrate this potential outcome.

7. Line-of-credit modification

Facts: On January 1, 20X1, Borrower obtains a line-of-credit (LOC) arrangement from Lender. The LOC’s term is three years and the amount available under the LOC (i.e., the commitment amount) is $30 million. Borrower incurs $180,000 of costs (e.g., lender’s fee and legal costs) in connection with initiating the LOC and has an accounting policy to report these costs as an asset on the balance sheet. These costs will be amortized over the term of the LOC (i.e., three years). On January 1, 20X2, Borrower and Lender agree to modify the LOC. The term of the LOC is changed to three years from the date of the modification and the amount available under the LOC is changed to $15 million. To execute this change, Borrower paid Lender a fee of $100,000 and incurred legal costs of $40,000. Effectively, Borrower has received an additional year under the LOC in return for a decrease in borrowing capacity and a $100,000 fee.

On January 1, 20X2 (when Borrower and Lender agree to modify the LOC), there are $120,000 of unamortized deferred costs related to the old LOC. Borrower must determine how it should account for those remaining deferred costs upon modification of the LOC. In addition, Borrower must determine how it should account for the costs incurred to execute the changes to the LOC ($140,000 in lender’s fees and legal costs).
**Analysis:** The borrowing capacity of the old LOC is $60 million ($30 million commitment amount multiplied by 2-year remaining term). The borrowing capacity of the new LOC is $45 million ($15 million commitment amount multiplied by 3-year term). Borrowing capacity under the LOC has decreased by $15 million (or 25 percent) as a result of the changes agreed to by Borrower and Lender on January 1, 20X2. The unamortized deferred costs related to the old LOC would be written off in proportion to the decrease in the LOC’s borrowing capacity. As such, Borrower would write off $30,000 (or 25 percent) of the $120,000 of unamortized deferred costs related to the old LOC. Borrower defers and amortizes over three years (the term of the new LOC) the remaining amount of the unamortized deferred costs ($90,000) as well as the costs incurred to execute the changes to the LOC (i.e., $140,000 in lender’s fees and legal costs). The following represents the journal entry that would be recorded by Borrower on January 1, 20X2, to account for the unamortized deferred costs related to the old LOC and the costs incurred to execute the changes to the LOC:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unamortized deferred costs – Line of credit</td>
<td>$110,000</td>
</tr>
<tr>
<td>Interest expense (portion of unamortized deferred costs written off)</td>
<td>30,000</td>
</tr>
<tr>
<td>Cash</td>
<td>$140,000</td>
</tr>
</tbody>
</table>

After recording this entry, Borrower would have unamortized deferred costs on its books related to the LOC in the amount of $230,000 ($90,000 of remaining unamortized deferred costs from the original LOC and $140,000 of deferred costs related to the changed LOC).
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