EITF ABSTRACTS

Issue No. 96-19

Title: Debtor’s Accounting for a Modification or Exchange of Debt Instruments


References:
- FASB Statement No. 4, Reporting Gains and Losses from Extinguishment of Debt
- FASB Statement No. 76, Extinguishment of Debt
- FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities
- FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities
- FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities
- FASB Statement No. 145, Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections
- FASB Statement No. 166, Accounting for Transfers of Financial Assets
- APB Opinion No. 26, Early Extinguishment of Debt
- APB Opinion No. 30, Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions
- SEC Staff Accounting Bulletin No. 94, Recognition of a Gain or Loss on Early Extinguishment of Debt

ISSUE

Issue No. 86-18, “Debtor’s Accounting for a Modification of Debt Terms,” addresses circumstances under which existing debt should be considered extinguished, resulting in recognition by the debtor of an extraordinary gain or loss. [Note: See STATUS section.]

In that Issue, the Task Force reached a consensus that an exchange of a new noncallable debt instrument for an older callable debt instrument should be accounted for as an extinguishment by the debtor. Many Task Force members agreed that substantive modifications of debt (that is, modifications to principal, interest rate, maturity, or call provisions) should be accounted for as the extinguishment of that debt and the creation of
new debt, although no consensus was reached on that issue. Other Task Force members said that extinguishment accounting should be applied only to those debt instruments meeting the conditions for extinguishment under Statement 76.

Statement 125, which superseded Statement 76 on January 1, 1997, limits derecognition of a liability to extinguishments. It limits extinguishments to situations in which the debtor pays the creditor and is relieved of its obligation or is legally released as the primary obligor either judicially or by the creditor.

The issues are:

1. How a debtor should account for an exchange of debt instruments with substantially different terms
2. How a debtor should account for a substantial modification in the terms of an existing debt agreement (other than a troubled debt restructuring)
3. If a gain or loss is recognized from an exchange or modification, whether the gain or loss should be classified as extraordinary.

**EITF DISCUSSION**

The Task Force reached a consensus that an exchange of debt instruments with substantially different terms is a debt extinguishment and should be accounted for in accordance with paragraph 16 of Statement 125. The Task Force observed that a debtor could achieve the same economic effect by making a substantial modification of terms of an existing debt instrument. Accordingly, the Task Force reached a consensus that a substantial modification of terms should be accounted for like, and reported in the same manner as, an extinguishment.

The Task Force also reached the following consensuses regarding (1) when an exchange or modification is considered *substantial*, (2) how to account for fees paid or received by
a debtor and costs incurred by a debtor with third parties as part of an exchange or modification, and (3) the impact of the consensuses reached in this Issue on other related EITF Issues.

From the debtor’s perspective, an exchange of debt instruments between or a modification of a debt instrument by a debtor and a creditor in a nontroubled debt situation is deemed to have been accomplished with debt instruments that are 

\textit{substantially different} if any of the following three conditions are met:

1. The present value of the cash flows under the terms of the new debt instrument is at least 10 percent different from the present value of the remaining cash flows under the terms of the original instrument.

   For purposes of determining the change in the present value of the cash flows, the Task Force observed that the cash flows can be affected by changes in principal amounts, interest rates, or maturity. They can also be affected by fees exchanged between the debtor and creditor to effect changes in:

   - Recourse or nonrecourse features
   - Priority of the obligation
   - Collateralized (including changes in collateral) or noncollateralized features
   - Debt covenants and/or waivers
   - The guarantor (or elimination of the guarantor)
   - Option features.

   If the terms of a debt instrument are changed or modified in any of the ways described above and the cash flow effect (including changes in the fair value of an embedded conversion option) on a present value basis is less than 10 percent, the debt instruments are \textit{not} considered to be \textit{substantially different}, except as set forth by the following two conditions.

2. A modification or an exchange that affects the terms of an embedded conversion option, from which the change in the fair value of the embedded conversion option (calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification or exchange) is at least 10 percent of the carrying amount of the original debt instrument immediately prior to the modification or exchange.
3. A modification or an exchange of debt instruments that adds a substantive conversion option or eliminates a conversion option that was substantive at the date of the modification or exchange.¹

With respect to the second and third conditions, this guidance does not address modifications or exchanges of debt instruments in circumstances in which the embedded conversion option is separately accounted for as a derivative under Statement 133 prior to the modification, subsequent to the modification, or both prior and subsequent to the modification. [Note: See STATUS section.]

The following guidance is to be used to calculate the present value of the cash flows for purposes of applying the 10 percent cash flow test.

1. The cash flows of the new debt instrument include all cash flows specified by the terms of the new debt instrument plus any amounts paid by the debtor to the creditor less any amounts received by the debtor from the creditor as part of the exchange or modification.

2. If the original debt instrument and/or the new debt instrument has a floating interest rate, then the variable rate in effect at the date of the exchange or modification is to be used to calculate the cash flows of the variable-rate instrument.

3. If either the new debt instrument or the original debt instrument is callable or puttable, then separate cash flow analyses are to be performed assuming exercise and nonexercise of the call or put. The cash flow assumptions that generate the smaller change would be the basis for determining whether the 10 percent threshold is met.

4. If the debt instruments contain contingent payment terms or unusual interest rate terms, judgment should be used to determine the appropriate cash flows.

5. The discount rate to be used to calculate the present value of the cash flows is the effective interest rate, for accounting purposes, of the original debt instrument.

6. If within a year of the current transaction the debt has been exchanged or modified without being deemed to be substantially different, then the debt terms that existed a year ago should be used to determine whether the current exchange or modification is substantially different.

¹For purposes of evaluating whether an embedded conversion option was substantive on the date it was added to or eliminated from a debt instrument, the factors described in paragraphs 7–9 of Issue No. 05-1 "Accounting for the Conversion of an Instrument That Became Convertible upon the Issuer's Exercise of a Call Option," should be considered.
If it is determined that the original and new debt instruments are substantially different, then the calculation of the cash flows related to the new debt instrument at the effective interest rate of the original debt instrument is not used to determine the initial amount recorded for the new debt instrument or to determine the debt extinguishment gain or loss to be recognized. The new debt instrument should be initially recorded at fair value and that amount should be used to determine the debt extinguishment gain or loss to be recognized and the effective rate of the new instrument.

If it is determined that the original and new debt instruments are not substantially different, then a new effective interest rate is to be determined based on the carrying amount of the original debt instrument, adjusted for an increase (but not a decrease) in the fair value of an embedded conversion option (calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification or exchange) resulting from the modification, and the revised cash flows.

Fees paid by the debtor to the creditor or received by the debtor from the creditor (fees may be received by the debtor from the creditor to cancel a call option held by the debtor or to extend a no-call period) as part of the exchange or modification are to be accounted for as follows:

- If the exchange or modification is to be accounted for in the same manner as a debt extinguishment [Note: See STATUS section.] and the new debt instrument is initially recorded at fair value, then the fees paid or received are to be associated with the extinguishment of the old debt instrument and included in determining the debt extinguishment gain or loss to be recognized.
- If the exchange or modification is not to be accounted for in the same manner as a debt extinguishment, then the fees are to be associated with the replacement or modified debt instrument and, along with any existing unamortized premium or
discount, amortized as an adjustment of interest expense over the remaining term of the replacement or modified debt instrument using the interest method.

Costs incurred with third parties directly related to the exchange or modification (such as legal fees) are to be accounted for as follows:

- If the exchange or modification is to be accounted for in the same manner as a debt extinguishment [Note: See STATUS section.] and the new debt instrument is initially recorded at fair value, then the costs are to be associated with the new debt instrument and amortized over the term of the new debt instrument using the interest method in a manner similar to debt issue costs.
- If the exchange or modification is not to be accounted for in the same manner as a debt extinguishment, then the costs should be expensed as incurred.

The consensus in Issue No. 95-15, “Recognition of Gain or Loss When a Binding Contract Requires a Debt Extinguishment to Occur at a Future Date for a Specified Amount,” is superseded by the consensus in this Issue. The transaction described in Issue 95-15 deals with when a debtor enters into a binding contract with a holder of its debt obligation to redeem the debt security at a future date for a specified amount greater than (or less than) the debtor’s carrying amount of the debt for financial reporting purposes. The future date of the exchange specified in the contract will occur within one year of the date that the contract becomes binding to the parties. The debtor’s accounting for this transaction is to be accounted for based on the consensus in this Issue.

The guidance in Issue 86-18 for the transaction described below is not affected by the consensus reached in this Issue. In the context of its deliberations on Issue 86-18, the Task Force discussed a specific transaction in which a borrower, instead of acquiring debt securities directly, loans funds to a third party, who in turn acquires the borrower’s original debt securities. The borrower and third party agree that they may settle their respective receivables and obligations by right of setoff as payments become due,
contingent upon the third party’s continued retention of the borrower’s original debt. The
Task Force reached a consensus in Issue 86-18 that the borrower should not account for
the original debt securities as extinguished and that those securities should not be offset
against the receivable from the third party in the borrower’s financial statements.

Implementation Guidelines

The Task Force reached a consensus that:

1. The exchange of cash by the debtor or the debtor’s agent to acquire or settle debt is
   an extinguishment of debt under paragraph 16 of Statement 125. Therefore, such
   transactions involving the exchange of cash between a debtor and a creditor or
   creditors are not covered by the scope of this Issue. However, transactions
   involving contemporaneous exchanges of cash between the same debtor and
   creditor in connection with the issuance of a new debt obligation and satisfaction of
   an existing debt obligation by the debtor would only be accounted for as debt
   extinguishments if the debt instruments have substantially different terms, as
   defined in this Issue.

2. In transactions involving a third-party intermediary acting as agent on behalf of a
   debtor, the actions of the intermediary should be viewed as those of the debtor in
   order to determine whether there has been an exchange of debt instruments or a
   modification of terms between a debtor and a creditor. Stated another way, when a
   third-party intermediary acts as agent, the analysis should “look through” the
   intermediary.

3. In transactions involving a third-party intermediary acting as principal, the
   intermediary should be viewed as a third-party creditor similar to any other creditor
   in order to determine whether there has been an exchange of debt instruments or a
   modification of terms between a debtor and a creditor. Stated another way, when a
   third-party intermediary acts as principal, the analysis should not “look through” the
   intermediary.

4. Transactions among debt holders do not result in a modification of the original
debt’s terms or an exchange of debt instruments between the debtor and the debt
holders and do not impact the accounting by the debtor.

5. Transactions between a debtor and a third-party creditor should be analyzed based
on the guidance in paragraph 16 of Statement 125 and the consensus in this Issue to
determine whether gain or loss recognition is appropriate. Transactions entered
into between a debtor or a debtor’s agent and a third party that is not the creditor
are not included in the scope of this Issue.
The Task Force noted that application of those guidelines may require determination of whether a third-party intermediary is an agent or a principal and that consideration of legal definitions may be helpful in making that determination. The Task Force noted that, generally, an agent acts for and on behalf of another party. Therefore, a third-party intermediary is an agent of a debtor if it acts on behalf of the debtor. In addition, the Task Force noted that an evaluation of the facts and circumstances surrounding the involvement of the third-party intermediary should be performed. The Task Force observed that the following indicators should be considered in that evaluation:

1. If the intermediary’s role is restricted to placing or reacquiring debt for the debtor without placing its own funds at risk, that would indicate that the intermediary is an agent. For example, that may be the case if the intermediary’s own funds are committed and those funds are not truly at risk because the intermediary is made whole by the debtor (and therefore is indemnified against loss by the debtor). If the intermediary places and reacquires debt for the debtor by committing its funds and is subject to the risk of loss of those funds, that would indicate that the intermediary is acting as principal.

2. In an arrangement where an intermediary places notes issued by the debtor, if the placement is done under a best-efforts agreement, that would indicate that the intermediary is acting as agent. Under a best-efforts agreement, an agent agrees to buy only those securities that it is able to sell to others; if the agent is unable to remarket the debt, the issuer is obligated to pay off the debt. The intermediary may be acting as principal if the placement is done on a firmly committed basis, which requires the intermediary to hold any debt that it is unable to sell to others.

3. If the debtor directs the intermediary and the intermediary cannot independently initiate an exchange or modification of the debt instrument, that would indicate that the intermediary is an agent. The intermediary may be a principal if it acquires debt from or exchanges debt with another debt holder in the market and is subject to loss as a result of the transaction.

4. If the only compensation derived by an intermediary from its arrangement with the debtor is limited to a preestablished fee, that would indicate that the intermediary is an agent. If the intermediary derives gains based on the value of the security issued by the debtor, that would indicate that the intermediary is a principal.

The Task Force reached a consensus that transactions involving the modification or exchange of debt instruments can only result in gain or loss recognition by the debtor if
the conditions for extinguishment of debt described in paragraph 16 of Statement 125 are satisfied or if the consensus in this Issue requires that accounting. Accordingly, the guidance in Issue No. 87-20, “Offsetting Certificates of Deposit against High-Coupon Debt,” related to loss recognition is superseded by the consensus in this Issue. The general principles outlined above would apply to the transaction described in Issue 87-20.

The examples in Exhibit 96-19A illustrate the application of the above implementation guidelines.

**STATUS**

Statement 140 was issued in September 2000 and superseded Statement 125. Statement 140 does not change the guidance dealing with accounting for extinguishments of liabilities. Statement 166, which was issued in June 2009, amends Statement 140 without reconsideration of this matter.

Statement 145, issued in April 2002, supersedes Statement 4. Statement 4 required that all gains and losses from extinguishment of debt be classified as extraordinary items. Statement 145 removes the extraordinary item classification requirement but does not preclude gains and losses from extinguishment of debt that meet the criteria in Opinion 30 from being classified as extraordinary items.

Issue No. 06-6, "Debtor's Accounting for a Modification (or Exchange) of Convertible Debt Instruments," which was discussed at the September 7, 2006 and November 16, 2006 meetings, supersedes Issue No. 05-7, "Accounting for Modifications to Conversion Options Embedded in Debt Instruments and Related Issues," and amends the guidance in this Issue to clarify that the change in the fair value of an embedded conversion option
resulting from a modification in the terms of an existing debt instrument or an exchange of debt instruments should not be included in the cash flow test of whether the terms of the new debt instrument are substantially different from the terms of the original debt instrument under Issue 96-19. However, a separate analysis must be performed if the cash flow test under Issue 96-19 does not result in a conclusion that a substantial modification or exchange has occurred. Under that separate analysis, a substantial modification or exchange has occurred, and the issuer should apply extinguishment accounting if the change in the fair value of the embedded conversion option (calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification or exchange) is at least 10 percent of the carrying amount of the original debt instrument immediately prior to the modification or exchange. Additionally, a modification or an exchange of debt instruments that adds a substantive conversion option or eliminates a conversion option that was substantive at the date of the modification or exchange would always be considered substantial, and debt extinguishment accounting would be required in those circumstances. In addition, Issue 06-6 requires that when a convertible debt instrument is modified or exchanged in a transaction that is not accounted for as an extinguishment, an increase in the fair value of the embedded conversion option (calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification or exchange) should reduce the carrying amount of the debt instrument (increasing a debt discount or reducing a debt premium) with a corresponding increase in additional paid-in capital. However, a decrease in the fair value of an embedded conversion option resulting from a modification or an exchange should not be recognized. The issuer
should not recognize a beneficial conversion feature or reassess an existing beneficial conversion feature upon a modification or exchange of convertible debt instruments in a transaction that is not accounted for as an extinguishment. At its meeting on November 29, 2006, the Board ratified this amendment.

No further EITF discussion is planned.
Identification of Debtor and Creditor

Based on the definition of a loan participation in Statement 125, for purposes of applying the consensus in Issue 96-19, the debt instrument would be the contract between the debtor and the lead bank. Participating banks are not direct creditors but, rather, have an interest represented by a certificate of participation. In the event of a modification or exchange between the debtor and lead bank, the debtor would be required to apply the consensus in Issue 96-19.

Based on the definition of a loan syndication in Statement 125, for purposes of applying the consensus in Issue 96-19, separate debt instruments exist between the debtor and the individual creditors participating in the syndication. If an exchange or modification offer is made to all members of the syndicate and only some of the creditors agree to the exchange or modification, the consensus in Issue 96-19 would be applied to debt instruments held by those creditors who agree to the exchange or modification. Debt instruments held by those creditors who do not agree would not be affected.

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1Paragraph 74 of Statement 125 describes a loan participation as follows: “Groups of banks or other entities . . . may jointly fund large borrowings through loan participations in which a single lender makes a large loan to a borrower and subsequently transfers undivided interests in the loan to other entities.”

2Paragraph 72 of Statement 125 describes a loan syndication as follows: “Borrowers often borrow amounts greater than any one lender is willing to lend. Therefore, it is common for groups of lenders to jointly fund those loans. That may be accomplished by a syndication under which several lenders share in lending to a single borrower, but each lender loans a specific amount to the borrower and has the right to repayment from the borrower.”
In a public debt issuance,\(^3\) for purposes of applying the consensus in Issue 96-19, the debt instrument is the individual security held by an investor, and the creditor is the security holder. If an exchange or modification offer is made to all investors and only some agree to the exchange or modification, then the consensus would be applied to debt instruments held by those investors who agree to the exchange or modification. Debt instruments held by those investors who do not agree would not be affected.

**Exchanges or Modifications of Debt involving a Third-Party Intermediary**

In transactions involving a third-party investment banker acting as agent on behalf of the debtor, the activity of the investment banker is treated as if it were the activity of the debtor. Thus, if the investment banker acquires debt instruments from holders for cash, the debtor has an extinguishment even if the investment banker subsequently transfers a debt instrument with the same or different terms to the same or different investors. If the investment banker acting as agent on behalf of the debtor acquires instruments from holders by exchanging those instruments for new debt, the guidance in Issue 96-19 should be applied. If the investment banker acquires debt instruments from holders for cash and contemporaneously issues new debt instruments for cash, an extinguishment has occurred only if the two debt instruments have substantially different terms, as defined.

In transactions involving a third-party investment banker acting as principal, the investment banker is considered a debt holder like other debt holders. Thus, if the investment banker acting as principal acquires debt instruments from other parties, the

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\(^3\)A debtor issues a number of identical debt instruments to an underwriter who sells the debt instruments (in the form of securities) to various investors.
acquisition by the investment banker does not impact the accounting by the debtor, and exchanges or modifications between the debtor and the investment banker would follow the guidance in Issue 96-19.

**Transactions among Debt Holders**

If a debt instrument is transferred from one debt holder to another in connection with a modification or exchange, including transfers from an intermediary acting as principal to another debt holder, the debtor is not impacted by the exchange as long as the funds do not pass through the debtor or its agent.

**Gain or Loss Recognition**

The following scenarios do not result in an extinguishment and would not result in gain or loss recognition under either Statement 125 or Issue 96-19:

a. An announcement of intent by the debtor to call a debt instrument at the first call date
b. Placement by the debtor of amounts equal to the principal, interest, and prepayment penalties related to a debt instrument in an irrevocable trust established for the benefit of the creditor (that is, an in-substance defeasance)
c. An agreement with a creditor that a debt instrument issued by the debtor and held by a different party will be redeemed.
Index Entries for EITF Issue No. 96-19

DEBT
Exchange of Debt Instruments
   . . Debtor’s Accounting for a Modification or
   Exchange of Debt Instruments  96-19
Modification of Debt Terms
   . . Debtor’s Accounting for a Modification or
   Exchange of Debt Instruments  96-19

DEBT: EXTINGUISHMENTS
Modification of Debt Terms
   . . Debtor’s Accounting for a Modification or
   Exchange of Debt Instruments  96-19