APB 26: Early Extinguishment of Debt

APB 26 STATUS

Issued: October 1972
Effective Date: For transactions on or after January 1, 1973
Affects: Deletes ARB 43, Chapter 15
Deletes APB 6, paragraph 19

Affected by: 
Paragraph 2 amended by FAS 15, paragraph 10; FAS 71, paragraph 26(k); and FAS 84, paragraph 5
Paragraph 2 replaced by FAS 76, paragraph 7
Paragraph 3(a) amended by FAS 15, paragraph 10
Paragraph 3(a) replaced by FAS 76, paragraph 8; FAS 125, paragraph 234; and FAS140, paragraph 357
Paragraphs 3(c), 19, and 21 amended by FAS 76, paragraph 9
Paragraph 20 amended by APB 30, paragraph 7, and FAS 4, paragraph 10

Other Interpretive Pronouncements: AIN-APB 26, Interpretation No. 1
FTB 80-1

Issues Discussed by FASB Emerging Issues Task Force (EITF)

Affects: No EITF Issues
Interpreted by: No EITF Issues
Related Issues: EITF Issues No. 90-19, 96-19, 00-9, 02-15, and 03-7

INTRODUCTION

1. Debt is frequently extinguished in various ways before its scheduled maturity. Generally, the amount paid upon reacquisition of debt securities will differ from the net carrying amount of the debt at that time. This section expresses the views of the Accounting Principles Board regarding the appropriate accounting for that difference.

2. Applicability. This Opinion applies to all extinguishments of debt, whether early or not, except debt that is extinguished through a troubled debt restructuring and debt that is converted to equity securities of the debtor pursuant to conversion privileges provided in terms of the debt at issuance. It supersedes Chapter 15 of ARB No. 43, Restatement and Revision of Accounting Research Bulletins, and paragraph 19 of APB Opinion No. 6, Status of Accounting Research Bulletins. However, it does not alter the accounting for convertible debt securities described in APB Opinion No. 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants. Also, this Opinion does not apply to conversions of convertible debt when conversion privileges included in terms of the debt at issuance are changed, or additional consideration is paid, to induce conversion of the debt to equity securities as described in FASB Statement No. 84, Induced Conversions of Convertible Debt.

3. Definitions. Several terms are used in this Opinion as follows:

a. Extinguishment of liabilities. FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, defines transactions that the debtor shall
recognize as an extinguishment of a liability.

b. Net carrying amount of debt is the amount due at maturity, adjusted for unamortized premium, discount, and cost of issuance.

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

d. Difference as used in this section is the excess of the reacquisition price over the net carrying amount or the excess of the net carrying amount over the reacquisition price.

**DISCUSSION**

4. Current practice. Early extinguishment of debt is usually achieved in one of three ways: use of existing liquid assets, use of proceeds from issuance of equity securities, and use of proceeds from issuing other debt securities. The replacement of debt with other debt is frequently called refunding.

5. Differences on nonrefunding extinguishments are generally treated currently in income as losses or gains. Three basic methods are generally accepted to account for the differences on refunding transactions:

a. Amortization over the remaining original life of the extinguished issue

b. Amortization over the life of the new issue

c. Recognition currently in income as a loss or gain.

Each method has been supported in court decisions, in rulings of regulatory agencies, and in accounting literature.

6. Amortization over life of old issue. Some accountants believe that the difference on refunding should be amortized over the remaining original life of the extinguished issue. In effect, the difference is regarded as an adjustment of the cash cost of borrowing that arises from obtaining another arrangement for the unexpired term of the old agreement. Therefore, the cost of money over the remaining period of the original issue is affected by the difference that results upon extinguishment of the original contract. Early extinguishment occurs for various reasons, but usually because it is financially advantageous to the issuer, for example, if the periodic cash interest outlay can be reduced for future periods. Accordingly, under this view the difference should be spread over the unexpired term of the original issue to obtain the proper periodic cost of borrowed money. If the maturity date of the new issue precedes the maturity date of the original issue, a portion of the difference is amortized over the life of the new debt and the balance of the difference is recognized currently in income as a loss or gain.

7. Amortization over life of new issue. Some accountants believe that the difference on refunding should be amortized over the life of the new issue if refunding occurs because of lower current interest rates or anticipated higher interest rates in the future. Under this view, the principal motivation for refunding is to establish a more favorable interest rate over the term of the new issue. Therefore, the expected benefits to be obtained over the life of the new issue justify amortization of the difference over the life of the new issue.

8. Recognition currently in income. Some accountants believe a difference on refunding is similar to the difference on other early extinguishments and should be recognized currently in income in the period of the extinguishment. This view holds that the value of the old debt has changed over time and that paying the call price or current market value is the most favorable way to extinguish the debt. The change in the market value of the debt is caused by a change in the market rate of interest, but the change has not been reflected in the accounts. Therefore, the entire difference is recorded when the specific contract is terminated because it relates to the past periods when the contract was in effect. If the accountant had foreseen future events perfectly at the time of issuance, he would have based the accounting on the assumption that the maturity value of the debt would equal the reacquisition price. Thus, no difference upon early extinguishment would occur because previous periods would have borne the proper interest expense. Furthermore, a call premium necessary to eliminate an old contract and an unamortized discount
or premium relate to the old contract and cannot be a source of benefits from a new debt issue. For example, a larger (or smaller) coupon rate could have been set on the old issue to avoid an unamortized discount (or premium) at issuance. When such debt originally issued at par is refunded, few accountants maintain that some portion of past interest should be capitalized and written off over the remaining life of the old debt or over the life of the new debt.

9. Another argument in favor of current recognition of the difference as gain or loss is also related to market forces but is expressed differently. If debt is callable, the call privilege is frequently exercised when the market value of the bonds as determined by the current yield rate exceeds the call price. A loss or gain is recognized on extinguishing the debt because an exchange transaction occurs in which the call or current market value of the debt differs from its net carrying amount. For example, the market value of the debt ordinarily rises as the market rate of interest falls. If market values were recorded as the market rate of interest fluctuates, the changes in the market value of the debt would have been recorded periodically as losses or gains. The bond liability would not exceed the call price.

10. On the other hand, some accountants holding views opposing current recognition of the difference in income believe that recognizing the difference as gains or losses may induce a company to report income by borrowing money at high rates of interest in order to pay off discounted low-rate debt. Conversely, a large potential charge to income may discourage refunding even though it is economically desirable; the replacement of high cost debt with low cost debt may result in having to recognize a large loss. Thus, a company may show higher current income in the year of extinguishment while increasing its economic cost of debt and lower current income while decreasing its economic cost of debt. For these reasons, these accountants favor deferral.

11. **Extinguishment of convertible debt.** Accountants have expressed differing views regarding accounting for the extinguishment of convertible debt. In APB Opinion No. 14, which is directed in part to accounting for convertible debt at time of issue, the Board concluded that no portion of the proceeds from the issuance of the types of convertible debt securities defined in the Opinion should be accounted for as attributable to the conversion feature. In reaching that conclusion, the Board placed greater weight on the inseparability of the debt and conversion option and less weight on practical difficulties. The Board emphasized that a convertible debt security is a complex hybrid instrument bearing an option the alternative choices of which cannot exist independently of one another. The holder ordinarily does not sell one right and retain the other. Furthermore, the two choices are mutually exclusive; the holder cannot exercise the option to convert unless he foregoes the right to redemption, and vice versa. Therefore, APB Opinion No. 14 implies that (except for conversion) a difference on extinguishing convertible debt needs to be recognized in the same way as a difference on extinguishment of debt without conversion features.

12. The various views expressed on how to account for the extinguishment of convertible debt to some extent reflect the same attitudes as to the nature of the debt at time of issue as were considered in APB Opinion No. 14. Thus, some accountants believe that a portion of the proceeds at issuance is attributable to the conversion feature. If the convertible debt is later extinguished, the initial value of the conversion feature should then be recorded as an increase in stockholders' equity. The balance of the difference would, under that view of the transaction, be a gain or loss in income of the period of extinguishment.

13. Some accountants maintain that the intent of issuing convertible debt is to raise equity capital. A convertible debt is therefore in substance an equity security, and all the difference on extinguishing convertible debt should be an increase or decrease of paid-in capital.

14. Another view is that the market price that gives rise to the difference reflects both the level of interest rates on debt and the prices of the related common stock or both. Those expressing this view believe that if the effects of these factors can be identified at the time of extinguishment, the difference attributable to the interest rate should be accounted for as gain or loss in income, and that the difference attributable to the market price of the issuer's common stock should be accounted for as an increase or decrease in paid-in capital.

15. Some accountants believe that the accounting for a difference on extinguishment of convertible
debt depends on the nature of the security at the time of extinguishment. Events after time of issue may provide evidence that a convertible debt is either still debt in substance or equity in substance. Under this view the purchase price on extinguishment provides the best evidence as to whether the security is essentially debt or equity. Convertible debt that is selling below the call or redemption price at time of extinguishment is essentially debt; the difference should be a gain in current income. Moreover, if convertible debt has a coupon rate that exceeds the current market rate of interest and clearly causes the issue to trade at a premium as a debt instrument, the difference on extinguishment should be a loss in current income. On the other hand, if convertible debt is selling above the call or redemption price because of the conversion privilege, it is essentially a common stock. In effect, market forces have transformed a debt instrument into an equity security, and the extinguishment provides an explicit transaction to justify recognizing that the convertible debt is in substance a common stock equivalent. Those who hold this view believe that accounting should report the substance of the transaction rather than its form; convertible debt need not be converted into common stock to demonstrate that the extinguishment transaction is equivalent to a purchase of common stock for retirement.

16.  **Economic nature of extinguishment.** In many respects the essential economics of the decision leading to the early extinguishment of outstanding debt are the same, regardless of whether such debt is extinguished via the use of the existing liquid assets, new equity securities, or new debt. That is, the decision favoring early extinguishment usually implies that the net present value of future cash inflows and outflows is maximized by extinguishing the debt now rather than by letting it run to maturity. The savings may be in lower cash interest costs on a new debt issue, in increased earnings per share of common stock if the assets are not earning the interest rate on the outstanding debt, or in some other form. The essential event is early extinguishment. Under this view, the difference is associated with extinguishing the existing debt and is accounted for the same regardless of how extinguishment is accomplished.

17.  To illustrate that view, assume that three firms each have long-term debt outstanding with ten years remaining to maturity. The first firm may have excess cash and no investment opportunities that earn a rate of return higher than the cash savings that would ensue from immediately extinguishing the debt. The second firm may wish to replace the debt with a similar issue bearing a lower coupon rate. The third firm may have excessive debt and may want to replace the debt with a new issue of common stock. The underlying reason for the early extinguishment in all three cases is to obtain a perceived economic advantage. The relevant comparison in the replacement of debt with other debt is with the costs of other debt. The comparison in other cases is with other means of financing. The means by which the debt is extinguished have no bearing on how to account for the loss or gain.

**OPINION**

18.  The following conclusions of the Board are based primarily on the reasoning in paragraphs 8, 9, 11, 16, and 17.

19.  **Reduction of alternatives.** The Board concludes that all extinguishments of debt are fundamentally alike. The accounting for such transactions should be the same regardless of the means used to achieve the extinguishment.

20.  **Disposition of amounts.** A difference between the reacquisition price and the net carrying amount of the extinguished debt should be recognized currently in income of the period of extinguishment as losses or gains and identified as a separate item. Gains and losses should not be amortized to future periods.

21.  **Convertible debt.** The extinguishment of convertible debt does not change the character of the security as between debt and equity at that time. Therefore, a difference between the cash acquisition price of the debt and its net carrying amount should be recognized currently in income in the period of extinguishment as losses or gains.

**EFFECTIVE DATE**
22. This Opinion shall be effective for all extinguishments of debt occurring on or after January 1, 1973. Extinguishment transactions are considered to be terminated events similar to that set forth in paragraph 16 of APB Opinion No. 20 and as such, extinguishments that were previously recorded in fiscal years ending before January 1, 1973 should not be adjusted. However, the accounting for refunding transactions that have been previously reported in the fiscal year in which December 31, 1972 occurs may be retroactively restated to comply with the provisions of this Opinion.

The Opinion entitled "Early Extinguishment of Debt" was adopted by the assenting votes of fifteen members of the Board, of whom three, Messrs. Cummings, Ferst, and Gellein, assented with qualification. Messrs. Defliese, Watt, and Wear dissented.

Messrs. Cummings and Ferst assent to the issuance of this Opinion because it will reduce alternatives in accounting for extinguishments of long-term debt which are fundamentally alike. They object, however, to the conclusion in paragraph 21 that extinguishment of convertible debt gives rise to an income charge for the entire difference between the acquisition price and its carrying amount under all circumstances. In their view when convertible debt is traded at amounts which are clearly attributable to the value of the securities into which it is convertible, the acquisition of such debt by the issuing company is in substance an acquisition of its treasury stock. paragraph 21 mandates the unnecessary process of first converting the debt and then acquiring the stock in order to reflect the financial reality inherent in the transaction.

Mr. Gellein assents to issuance of the Opinion but disagrees with the conclusion expressed in paragraph 18 that all extinguishments of debt before scheduled maturities are fundamentally alike. He believes that some debt retirements which are accompanied by concurrent borrowings have economic purposes and results different from other debt retirements, and that the accounting should in these limited cases recognize these differences. Where a concurrent borrowing and retirement is planned, for example, to take advantage of a relatively low market rate of interest, or to avoid an anticipated increase, he believes that there is in substance a substitution of debt and the the "difference" between the reacquisition price and the net carrying amount of the retired debt should be charged or credited, as the case may be, to income over the remaining term of the retired debt. He believes that in such a situation the difference, whether charge or credit, arises from an economic circumstance and an action the result of which is to cause the periodic interest expense to be virtually unchanged during the remaining life of the retired debt. Amortizing the "difference" over the remaining life of the retired debt will show that result; the accounting recommended in paragraph 19 will not.

Mr. Defliese dissents to this Opinion because it fails to require recognition of the economic effects associated with an early extinguishment of debt designed to yield a profit. In his view such a payment, whether from borrowed funds (debt refunding) or from working capital (equity refunding), is essentially in every case a refunding at a higher cost of money (over the remaining original term) than that of the debt being prepaid, equivalent to an arbitrage with a predetermined net profit consisting of the difference between the discount from par and the future increased interest differential. He believes that omission of a provision for this added interest cost overstates the profit in the year of prepayment and shifts the interest burden to future periods. When the added cost is not known, or cannot be reasonably estimated, the entire discount should be allocated ratably over the remaining original term to offset such cost, in which case the net profit is spread over the remaining term. Similarly, when debt is refunded at a premium in order to take advantage of lower current or future rates, the premium should be deferred and charged appropriately to the periods benefited.

Mr. Watt dissents to this Opinion for the reasons set forth in paragraphs 6 and 10, because it requires gain or loss to be recognized currently in income of a difference between the reacquisition price and the net carrying amount of the extinguished debt in a refunding situation. He also dissents, for the reason set forth in paragraph 15, because it requires a loss to be recognized on the retirement of a convertible debt that is obviously trading on its common stock characteristics. To him this Opinion is a classic example of narrowing alternative accounting principles in a limited area to a point where the use of different accounting principles to accommodate entirely different circumstances calling for different results has now been proscribed.

Mr. Wear dissents to this Opinion because, in his view, it does not develop a persuasive and convincing argument that all extinguishments of debt before scheduled maturities are fundamentally alike.

He believes there are important differences in refunding situations, for the reasons described in
paragraph 6, and where convertible debt is involved, for the reasons set forth in paragraph 15.

APB 26 NOTES

Opinions of the Accounting Principles Board present the conclusions of at least two-thirds of the members of the Board, which is the senior technical body of the Institute authorized to issue pronouncements on accounting principles.

Board Opinions are considered appropriate in all circumstances covered but need not be applied to immaterial items.

Covering all possible conditions and circumstances in an Opinion of the Accounting Principles Board is usually impracticable. The substance of transactions and the principles, guides, rules and criteria described in Opinions should control the accounting for transactions not expressly covered.

Unless otherwise stated, Opinions of the Board are not intended to be retroactive.

Council of the Institute has resolved that Institute members should disclose departures from Board Opinions in their reports as independent auditors when the effect of the departures on the financial statements is material or see to it that such departures are disclosed in notes to the financial statements and, where practicable, should disclose their effects on the financial statements (Special Bulletin, Disclosures of Departures From Opinions of the Accounting Principles Board, October 1964.) Members of the Institute must assume the burden of justifying any such departures.

Accounting Principles Board (1972)

Philip L. Defliese, Chairman
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Joseph P. Cummings
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Robert Hampton, III
Donald J. Hayes

iAPB26, Footnote 1—If upon extinguishment of debt, the parties also exchange unstated (or stated) rights or privileges, the portion of the consideration exchanged allocable to such unstated (or stated) rights or privileges should be given appropriate accounting recognition. Moreover, extinguishment transactions between related entities may be in essence capital transactions.