TBH Consulting LLC

Debt Modifications

Executive Summary

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I. Introduction

Overview of debt modification

Borrowers may seek to renegotiate terms of existing loans due to reasons such as not being able to meet current loan covenants, insufficient cash flow, or wanting to increase borrowing capacity. For these, and other reasons, borrowers and lenders may agree to modify, restructure, or exchange the current loan for another with similar or modified terms.

A debt modification is defined as changes to the terms and conditions of the existing debt or replacing a debt arrangement with a new one. Examples may include modifications or exchanges of term loans or debt securities, modifications or exchanges to lines of credit or revolving-debt arrangements, or troubled debt restructurings ('TDR'). For accounting purposes, it is important to determine if the modification is an extinguishment of debt or not. If it is not an extinguishment of debt, or derecognition of a liability, the entity can continue to determine what kind of debt modification has occurred.

Introduction of ASC 470

ASC 470-50 Debt, Modifications and Extinguishments addresses the accounting for modifications of the terms of existing debt instruments and exchanges of debt instruments with the same creditor.

ASC 470-60 Debt, Troubled Debt Restructurings by Debtors addresses special accounting, presentation, and disclosure requirements related to troubled debt restructurings.

The guidance under these subtopics determines the accounting required for these specific types of debt modifications.

II. Analyzing a debt modification

Liability derecognition

In order to identify the appropriate treatment for changes to a loan, an entity must determine whether it has met the criteria to remove the liability from the books. If the criteria are met, the entity applies extinguishment accounting and derecognizes the extinguished loan from the books.

> The criteria are met in one of two ways: if the borrower pays the lender and is relieved of its obligation, or the borrower is legally released as a primary obligor.

Payments can be made with cash, other financial assets or goods and services. Legal release may be granted by the lender or may occur judicially.

Modification or exchange

If the liability derecognition threshold is not met and the TDR accounting model does not apply, then the entity must apply modification accounting. If determined to be a modification to a debt instrument, the entity must then determine if the accounting model for a debt modification or an extinguishment applies.

III. Modification or exchange

After determining that the debt modification is not a liability derecognition, the entity may determine it can utilize modification accounting. The accounting treatment is determined by whether the lender remains the same and if there is a substantial change in the debt terms.

Term loan or debt security

According to ASC 470-50, a 10% test is essential in determining if an entity must use modification or extinguishment accounting. The 10% test consists of determining if there is at least a 10% difference between the present value of the new loan's cash flows and the present value of the old loan's remaining cash flows. If the change in present value of cash flow is less than 10%, the change is considered a modification. If it is greater than 10%, it is considered an extinguishment. When performing this test, the cash flows of the new debt instrument and all of the amounts paid by the debtor to the lender should be a day one cash flow.

If a loan that is modified is callable or puttable, two sets of cash flows may need to be considered to apply the 10% test. One set is the cash flow assuming the call or put is exercised and the other assumes it is not. The set that is used for determining if modification accounting is utilized is the one that results in a smaller change between the present value of the new loan's cash flows and the present value of the original loan's remaining cash flows.

In the instance that multiple changes occur to the same debt in a one-year period, the entity should assess the changes cumulatively when applying the 10% test. The guidance requires this to avoid the debtor arriving at a different accounting answer when executing the modification in stages. The borrower should perform the 10% test to evaluate the changes by comparing the following two amounts:

1. The present value of the remaining cash flows for the debt as of the date the first changes were made

2. The present value of the cash flows for the modified debt as of the date the first changes were made, reflecting all the changes made within the one-year period

The discount rate used is the effective interest rate of the debt right before the first changes were made in the one-year period.

In some modifications, a warrant, guarantee, letter of credit, or other sweetener might be added to or removed from a loan agreement. Also, the original terms of these sweeteners could be changed. For an added warrant, when performing the 10% test, it is appropriate to include the new warrant's fair value in the cash flows of the new loan. This helps the borrower determine whether there is a substantial difference between the old loan and new loan and determine if the extinguishment or modification accounting model is applied.

There is no gain or loss recognized in the income statement under modification accounting. Modification accounting requires the calculation of a new effective interest rate for the modified loan. Once the new effective interest rate is determined, the old loan's carrying amount is adjusted for an increase in fair value of an embedded conversion option.

An embedded conversion option is a provision in a financial security that provides an issuer or holder of the security a certain right but not obligation to perform some actions at some point in the future.

The adjustment increases any related debt discount or decreases any related debt premium. This results in a decrease to the carrying amount of the loan and an increase to addition paid-in capital. If there is a decrease in the fair value of an embedded conversion option, there is no adjustment to the loan's carrying amount or additional paid-in capital. To determine if an embedded conversion options' fair value increased or decreased, an entity compares the fair values of the option right before and right after the modification or exchange.

Line of credit or revolving debt

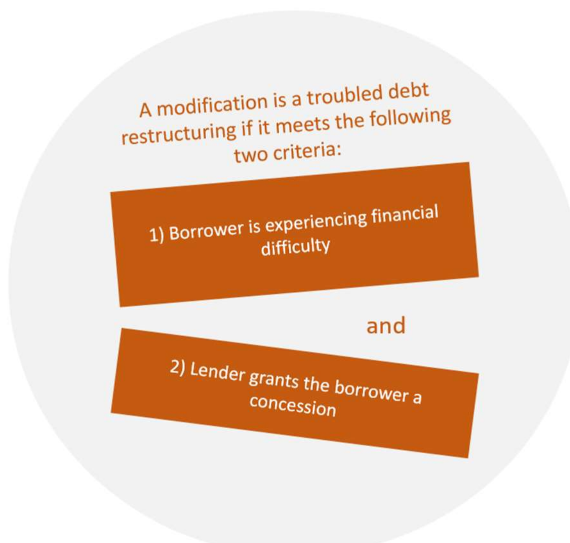
Upon entering a line of credit or revolving debt agreement, a borrower often incurs direct costs which should be deferred and amortized over the term of the arrangement. Once a modification or exchange involving one of these arrangements takes place, the borrower first determines if it is a TDR. If not, ASC 470-50-40-21 requires an entity to perform a borrowing capacity analysis to determine the appropriate accounting. The borrowing capacity of the old arrangement and the new arrangement must be compared. To determine the borrowing capacity of the old arrangement, the entity takes the arrangement's maximum commitment amount (not just the amount borrowed) and multiplies it by the arrangement's remaining term at the date of the modification. To determine the borrowing capacity of the new or modified arrangement, the entity takes the maximum commitment amount and multiplies it by the term of the new or modified arrangement. The difference in accounting treatment is if there is an increase or decrease in borrowing capacity.

ASC 470-50-40-21 provides guidance that states if the borrowing capacity of the new arrangement is greater than or equal to the borrowing capacity of the old arrangement, then any unamortized deferred costs, fees paid to the creditor, and any 3rd party costs shall be deferred and amortized over the term of the new arrangement. If the borrowing capacity of the new arrangement is less than the borrowing capacity of the old arrangement, then:

1. Any fees paid to the creditor and 3rd party costs shall be deferred and amortized over the term of the new arrangement
2. Any unamortized deferred costs relating to the old arrangement at the time of the change shall be written off in proportion to the decrease in borrowing capacity of the old arrangement. The remaining unamortized deferred costs shall be deferred and amortized over the term of the new arrangement.

IV. Troubled debt restructuring

If the liability derecognition threshold as described in Section II is not met, the entity must determine if it should apply the accounting model for a troubled debt restructuring ("TDR").



Subtopic 470-60 is applied by the entity to determine that the transaction is a TDR.

Does it exist?

According to ASC 470-60-55, for a debt restructuring to be considered troubled, the debtor must be experiencing financial difficulty and the lender must have granted a concession. In this situation, the objective of the lender is to maximize recovery of its investment by granting relief to the borrower.

To meet the first criteria for being considered a TDR, the guidance requires the debtor to evaluate whether it is experiencing financial difficulties. ASC 470-60-55-8 outlines the following scenarios for experiencing financial difficulties:

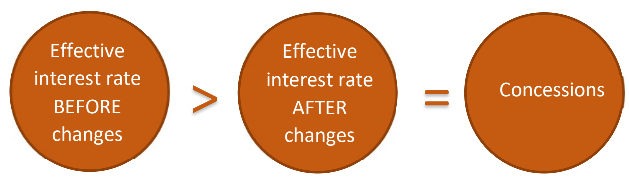
- In default on any debt
- Has declared or in the process of declaring bankruptcy
- Significant doubt as to whether the debtor will continue to be a going concern
- Debtor has securities that have been delisted, in the process of being delisted, or under threat of being delisted from an exchange
- The debtor forecasts that its cash flows will be insufficient to service the debt in accordance with the contractual terms of the existing agreement through maturity
- The debtor cannot obtain funds from sources other than the existing creditors

These examples of financial difficulties do not represent absolute indicators of whether the debtor is experiencing financial difficulties. All facts and circumstances should be considered when making the determination.

The second criterion that should be met is that the creditor grants a concession to the debtor. This can involve a reduction of the interest rate, forgiveness of principal or accrued interest, or a payment delay or deferral. The concession may result from an agreement between the debtor and creditor or imposed by law or court.

A concession may seem to make terms more favorable to the borrower, but the lender may have economic incentive to grant a concession during this time of financial difficulty for the borrower. An example is that the concession may benefit both parties in that the borrower avoids bankruptcy and other consequences of a default while the lender avoids the inability to recover borrowed amounts due to additional costs from a foreclosure or bankruptcy proceeding.

A concession is granted when the effective borrowing rate on the restructured debt is less than the effective borrowing rate on the original debt.



To calculate the effective borrowing rate after the changes, the entity should project all cash flows required under the changed debt and solve for the discount rate that makes the present value of the projected cash flows equal to the carrying amount of the borrower's debt before it was changed. ASC 470-60 provides further guidance on this determination by outlining that when determining the effect of any new or revised sweeteners (options, warrants, guarantees, etc.) the current fair value of the new sweetener or change in fair value of the revised sweetener would be included in day-one cash flows. In rare cases, if there is persuasive evidence that the decrease in effective borrowing rate is due to a factor not captured in the mathematical equation (ex. additional collateral) the creditor may not have granted a concession (ASC 470-60-55-13).

If a borrower is not experiencing financial difficulties nor granted a concession by the lender, the debt modification is not a TDR.

TDR Accounting

Accounting for a troubled debt restructuring depends on the type of restructuring. There are many different types that will be covered below.

One type is when a debtor transfers assets to the creditor in full satisfaction of its debt payable. The transaction is accounted for on the basis of the fair value of the assets transferred or equity interest issued (reduced by legal fees and other direct issuance costs). According to ASC 470-60, the excess of the carrying amount of the payable over the fair value of the assets transferred to the creditor is recognized as a gain. Additionally, the debtor recognizes a gain or loss from the difference between the fair value and carrying amount of the assets transferred. In accordance with ASC 820, the fair value of the assets transferred is the amount that the debtor would receive for them in a current sale between two willing parties.

Another type is a debt restructuring involving a modification of terms. Under ASC 470-60, the debtor is required to account for the modification on a prospective basis. The carrying amount of the payable is not changed unless its carrying amount exceeds the total undiscounted future cash payments (aggregate undiscounted future principal and interest payments) specified in the new terms. When this takes place, the debtor recognizes a gain equal to the carrying amount of the payable in excess of future cash payments. The interest expense for future periods is computed by the interest method. A constant effective interest rate is applied to the carrying amount of the payable at the beginning of each period between the restructuring and maturity. As mentioned previously, the effective interest rate is the discount rate where the present value of future cash payments according to the new terms equals the carrying amount of the payable.

A third type is a TDR involves a combination of term modifications, asset transfers, or a transfer of equity interests. The accounting for this type of modification is the same for a modification of terms, except that the transferred assets or equity are measured at fair value and reduces the carrying amount of the payable. The debtor recognizes a gain or loss based on the difference between the fair value of assets or equity transferred and the respective carrying amount. The remaining steps are similar to the other forms of modification.

Contingent payments and payments based on variable interest rates

Often times, TDRs include provisions that require additional payments if certain conditions are met in the future. Generally, these payments are based on the specified improvement of the debtor's financial condition or operating results within a period.

> According to ASC 470-60, these contingent payments should be included in the total future cash payments specified in the new terms to prevent improper recognition of a gain at the time of restructuring.

Also, in some cases, future payments are expected to fluctuate because the restructured debt includes a variable interest rate. While the cash flows could be viewed as indeterminate, the code requires the estimate of the total future cash payments for variable interest payments based on the variable interest rate at the time of restructuring. Since the interest rate can increase in the future, no gain should be recognized until the entire debt balance is paid off.

V. Presentation and Disclosure

Disclosure requirements

The disclosure requirements can be found in ASC 470. The debtor should include a general description of the transaction and the amount of debt considered to be extinguished at the end of each period that debt remains outstanding. An entity considers whether the users of its financial statements would be interested in information pertaining to the entity's debts and any modifications.

Troubled debt restructurings have additional required disclosures that the debtor must disclose either in the body of the financial statements or in the accompanying notes. The borrower must disclose a description of how the terms of the debt changed and the major features of settlement, the amount of any gain recognized in connection with the restructuring, and the amount of any gain or loss recognized on the transfer of assets in connection with the restructuring.

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TBH Consulting provides accounting and financial reporting services. We deliver Big 4 level of experience to our clients at competitive rates. We can mobilize the right resources at the right time to meet our clients' needs, whether such clients are Fortune 500, middle-market public companies or pre-IPO companies.

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