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THEORY AND PRACTICE

Current Studies and Concepts

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RETIREMENT OF DEBT

On June 15, 1972 the Accounting Principles Board of the American Institute of Certified Public Accountants issued an exposure draft entitled "Early Extinguishment of Debt." This proposed Opinion is to be effective for all debts retired before their maturity date on or after January 1, 1973.

In effect the proposed Opinion states that all debts retired before scheduled maturity date are fundamentally alike and that the gain or loss on such transactions should be recognized in income currently and identified as a separate item. No amortization over future accounting periods would be permitted.

Introduction

When debt is retired before maturity, the amount paid usually differs from the liability shown on the books at that time. This "difference" constitutes the subject for this proposed Opinion. This Opinion does ***not*** apply, however, to retirements under regular conversion privileges contained in the original issue.

Included are definitions of four of the terms used in the draft—(1) Early Extinguishment, (2) Net Carrying Amount, (3) Reacquisition Price, and (4) Difference. While many accountants would use different labels, the APB chooses to use these terms in the draft.

Discussion

Debt retirement before regular maturity date is usually achieved by:

(1) Use of existing liquid assets,
(2) Issuance of new equity securities, or
(3) Issuance of other debt securities.

Differences on the first two methods have generally been taken into income currently as a gain or loss. Differences on the last method (normally called refunding) have sometimes been amortized over the remaining life of the original issue, sometimes over the life of the new issue, or sometimes recognized currently in income as a gain or loss. Each method has some support in the accounting literature or in rulings of regulatory agencies or court decisions. The various arguments used to support these varying treatments are then listed in the proposed draft.

The Board next examined the "economic nature of extinguishment" and concluded that, regardless of whether the source of funds came from existing liquid assets, from new equity securities, or from new debt, the essential elements of the decision to retire the debt are the same. That is, the decision to retire current debt implies that an economic benefit will be derived from retiring the debt *now* rather than by letting it run to maturity. The benefit may be in lower interest costs, in greater earnings per share, or in some other form. But the essential event is the early extinguishment. And the difference is to be accounted for the same regardless of how such extinguishment is accomplished.

Opinion

The Board concluded in this exposure draft that:

(1) All extinguishments of debt before scheduled maturity date are fundamentally alike. The accounting should be the same regardless of the means used to achieve it.

(2) The difference between reacquisition cost and the net carrying amount should be recognized currently in income as a gain or loss and identified as a separate item. Gains and losses should not be amortized to future periods.

(3) The retirement of a convertible debt before maturity date does not change its character as between debt or equity. Therefore the difference should also be recognized currently in income.

LEASE TRANSACTIONS

On June 16, 1972 the Accounting Principles Board issued an exposure draft entitled "Accounting for Lease Transactions by Manufacturer or Dealer Lessors." It is effective for transactions on or after October 1, 1972. (Transactions entered into prior to that date may be adjusted to comply with its provisions.)

The draft specifies the criteria to determine when a lease should be accounted for as a sale by the manufacturer or dealer.

Introduction

APB No. 7 entitled "Accounting for Leases in Financial Statements of Lessors" deals with this subject, but many questions regarding its interpretation have arisen since it was adopted in 1966.

Discussion

Some of the circumstances which have arisen in which it is difficult to know if the transaction should be recorded as a lease or as a sale are:

(1) Where property is delivered under a cancellable lease, or
(2) Where property is delivered under a noncancellable lease which extends for only a portion of the useful life of the property.

Sometimes it was assumed that a cancellable lease would not actually be cancelled. And sometimes it was assumed that a noncancellable lease would be renewed when it was for a period of less than the useful life of the property. Such determinations are often extremely difficult, and some assumptions made that leases would continue even though not under legal obligation to do so were often not realized.

For this reason, the Board tentatively concluded that something more specific was needed to determine when a lease should be recorded as a sale. The Opinion is to supersede parts of the prior APB No. 7. However, the Opinion is not to apply to lease agreements of land or natural resources nor to financing transactions of financial institutions.

Opinion

The draft concludes that a lease should be recorded as a sale if collection of the payments is reasonably assured, no important uncertainties exist regarding costs yet to be incurred, ***and*** if any one of the following conditions is present:

(1) Title will be transferred without cost or only with nominal cost at the end of its noncancellable term,
(2) Similar property is available for sale and the present value of the lease together with any related investment credit equals or exceeds the usual selling price (or the fair value of the property in the absence of a normal selling price),
(3) If the selling price cannot be determined, the noncancellable term of the lease is substantially equal to the useful life of the property.

The draft goes on to point out that a high credit risk presents problems in determining the interest rate to be applied in computing present value of the lease payments. If the credit risk is so high as to preclude reasonable assurance of collection, it is then improper to record the lease as a sale.

When a lease is recorded as a sale, the amount recorded as revenue should be the present value of the payments (over the noncancellable term) and the amount charged against income should include the cost of the property plus the present value of any estimated future costs.

If important uncertainties exist (such as unusual guarantees of performance or protection from obsolescence), the maximum potential risks may be so great that the lease should be accounted for by the operating method.

Leases other than those meeting the criteria described above should be accounted for by the operating method as set forth in APB No. 7.

Third Parties

If the manufacturer or dealer sells or assigns the lease to an independent financial institution, the lease should be recorded as a sale where the usual risks of ownership are transferred. But where the risks and rewards of ownership are not transferred, the records should not reflect the transaction as a sale.

Leases sold or assigned to related companies should have the same considerations applied; in addition, it may be necessary to eliminate inter-company profits or loses.

Valuation of Capital Expenditures

(Continued from page 10)

[12]*Ibid.*, p 317

[13]Alfred Rappaport, "The Discounted Payback Period," *Management Services*, Vol. 2, No. 4 (July-August 1965) p 32

[14]*Ibid.*, p 35

[15]Bierman, Harold, Jr., and S. Smidt, *The Capital Budgeting Decision*, 2nd Edition, cited by Joseph L. Bower, *Managing the Resource Allocation Process*, (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1970) p 283

[16]Stewart C. Myers, "A Note on Linear Programming and Capital Budgeting," *The Journal of Finance*, Vol. XXVII, No. 1 (March 1972) p 92

[17]H. Russell Fogler, "Ranking Techniques and Capital Budgeting," *The Accounting Review*, Vol. XLVII, No. 1, (January 1972)

[18]Johnson, *Financial Management*, p 170