

The following examples illustrate creditor accounting for troubled debt restructurings.

Example 5. Receipt of Assets in Full Satisfaction

FACTS

Assume the following facts:

- Client Company, Inc. had a \$1 million note from the Hardtimes Company on its books due in equal annual principal installments of \$200,000 over five years. Interest was to be paid quarterly at a 12% rate.
- Hardtimes paid \$400,000 in principal payments during the first two years, as well as quarterly interest.
- Hard times cannot make the necessary future payments, but Client Company accepts equipment from Hardtimes with a market value of \$500,000 as full satisfaction.
- In previous years, Client Company, Inc. established a \$25,000 allowance for uncollectible amounts directly related to Hardtimes' note receivable.

SOLUTION

The entry to record the troubled debt restructuring is:

Equipment	500,000	
Allowance for uncollectible rates	25,000	
Loss in restructuring (\$600,000 - \$525,000)	75,000	
Note receivable		600,000

To record restructuring of note receivable from Hardtimes Company.

Example 6. Modification of Terms

FACTS

Assume that Client Company, Inc. has a \$1,000,000 10%, note from Contemporary Arts, Ltd. The note is due on December 31, 20X4. On January 1, 20X2, Client Company and Contemporary Arts agree that Client Company will forgive \$100,000 of the principal and accept a reduced interest rate of 8% over the remaining term of the note. On December 31, 20X1, Client Company has a \$30,000 allowance for future uncollectible amounts on its books related to the note from Contemporary Arts.

SOLUTION

The first step is to compare the present value of future cash receipts with the recorded investment in the note receivable as follows:

Face note of note	\$1,000,000
Less: Allowance for uncollectible amount	(30,000)
Recorded investment	<u>970,000</u>
Present value of future cash receipts:	
(Principal) × (PV at 10% for three years) \$900,000 × .751315	676,184
Interest	
(Revised principal × revised interest rate) × (PV of an annuity for three years at 10%) (\$900,000 × .08) × 2.486582	<u>179,034</u>
Present value of future cash receipts	<u>855,218</u>
Required adjustment	<u>\$114,782</u>

On January 1, 20X2, Client Company would make the following journal entry:

Bad debt expense	114,782	
Allowance for uncollectible accounts		114,782

Interest income will be recognized in each of the years 20X2, 20X3, and 20X4 based on the 10% effective rate as follows:

Year	Cash Interest ^(a)	Interest Income ^(b)	Adjustment To Note Receivable ^(c)	Present Value of Note Receivable ^(d)
1-1-X2				\$855,218
12-31-X2	\$72,000	\$85,522	\$13,522	868,740
12-31-X3	\$72,000	\$86,874	\$14,874	883,614
12-31-X4	<u>\$72,000</u>	<u>\$88,386 ^(e)</u>	<u>\$16,386 ^(e)</u>	900,000
	<u>\$126,000</u>	<u>\$260,782</u>	<u>\$44,782</u>	

^(a). $\$900,000 \times 8\%$

^(b). Present value $\times 10\%$

^(c). Interest income less cash interest

^(d). Present value plus receivable adjustment

^(e). Rounded

^(e).

The journal entry to be made in 20X2 to record interest income is:

Cash	72,000	
Note receivable	13,522	85,522

In subsequent years, the amounts for interest income and the adjustment to the note receivable will, of course, be different.

Assuming full collection on December 31, 20X4, the journal entry would be:

Cash	900,000	
Allowance for uncollectible account (\$30,000 + \$114,782)	144,782	
Note receivable (\$1,000,000 + \$13,522 + \$14,874 + \$16,386)		1,044,782

Example 7. Receipt of Assets in Partial Settlement and Modification of Terms

FACTS

Assume the same facts as in [Example 6](#) except that Client Company will forgive \$200,000 of principal and in partial settlement will accept equipment with a market value of \$70,000 on January 1, 20X2.

SOLUTION

The first step is to reduce the recorded investment in the receivable by the fair value of the equipment as follows:

Face value of note	\$1,000,000
Less: allowance for uncollectible amount	(30,000)
Recorded investment	970,000
Fair value of equipment	<u>(70,000)</u>
Revised investment	<u>\$ 900,000</u>

The journal entry to record the receivable reduction is:

Equipment	70,000	
Allowance for uncollectible accounts	30,000	
Note receivable		100,000

The required adjustment on the revised recorded investment in the note receivable is computed as follows:

Revised recorded investment	\$900,000
Present value of future cash receipts	
Principal (\$800,000 × .751315)	601,052
Interest (\$64,000 × 2.486582)	<u>159,141</u>
Present value of future cash receipts	<u>760,193</u>
Required adjustment	<u>\$139,087</u>

The journal entry on January 1, 20X2 would be:

Bad debt expense	139,807	
Allowance for uncollectible accounts		139,807

Interest income will be recognized in each of the years as follows:

<u>Year</u>	<u>Cash Interest</u> ^(a)	<u>Interest Income</u> ^(b)	<u>Adjustment to Note Receivable</u> ^(c)	<u>Present Value of Note Receivable</u> ^(d)
1-1-X2				\$760,193
12-31-X2	\$64,000	\$76,019	\$12,019	772,212
12-31-X3	\$64,000	\$77,221	\$13,221	785,433
12-31-X4	<u>\$64,000</u>	<u>\$78,567</u> ^(e)	<u>\$14,567</u> ^(e)	800,000
	<u>\$192,000</u>	<u>\$231,807</u>	<u>\$39,807</u>	

^(a) \$800,000 × 8%

^(b) Present value × 10%

^(c) Interest income less cash interest

^(d) Present value plus receivable adjustment

^(e) Rounded

^(e)

The journal entry to recognize interest income at December 31, 20X2 is

Cash	64,000	
Note receivable	12,019	
Interest income		76,019

Assuming full collection on December 31, 20X4, the journal entry would be:

Cash	800,000	
Allowance for uncollectible accounts	139,807	
Note receivable (\$900,000 + \$39,807)		939,807

Conversion of a loan to a debt security.

The FASB Emerging Issues Task Force reached the following consensus applicable to a situation in which the creditor receives a debt security in a restructuring that has a fair value that differs from the creditor's basis in the loan:

- The initial cost basis of a debt security of the original debtor received as part of a debt restructuring should be the security's fair value at the date of the restructuring. Any excess of the fair value of the security received over the net carrying amount of the loan should be recorded as a recovery of the loan. Any excess of the net carrying amount of the loan over the fair value of the security received should be recorded as a charge-off to the allowance for credit losses. Subsequent to the restructuring, the security should be accounted for according to the provisions of [SFAS No. 115](#), *Accounting for Certain Investments in Debt and Equity Securities* ([FASB ASC 320-10](#)).
- A security received in a restructuring in settlement of a claim for only the *past-due* interest on a loan should be measured at the security's fair value at the date of the restructuring and accounted for in a manner consistent with the creditor's policy for recognizing cash received for past-due interest. Subsequent to the restructuring, the security should be accounted for according to the provisions of [SFAS No. 115](#) ([FASB ASC 320-10](#)).

The following example illustrates how the foregoing consensus is applied.

Example 7A. Fair Value of Security Received Differs From Carrying Value of the Loan Facts

Assume that Client Company, Inc., the creditor, receives a debt security from the debtor in a debt restructuring. Before the restructuring, Client Company's carrying value of the loan was \$380,000, which includes a writedown of \$20,000.

The fair value of the debt security received is as follows in each of three separate cases:

Case 1: fair value equal to loan's carrying value	\$380,000
Case 2: fair value exceeds the loan's carrying value	\$390,000
Case 3: fair value is less than the loan's carrying value	\$370,000

Solution

At the date of the restructuring, the cost basis in the debt security is its fair value on that date. In each case, the loan itself must be removed from the accounts. In case 1, the journal entry is:

Investment in debt security	\$380,000
Loan receivable	380,000

In case 2, the fair value of the debt security is greater than the carrying value of the loan. The \$10,000 excess should be recorded as a recovery. The journal entry would thus be:

Investment in debt security	390,000	
Loan loss recovery		10,000
Loan receivable		380,000

In case 3, the \$10,000 excess of the carrying value of the loan over the fair value of the debt security is charged against the allowance for credit losses, as follows:

Investment in debt security	370,000	
Allowance for uncollectible loans		10,000
Loan receivable		380,000

Had Client Company not written down the loan directly before restructuring but had established a \$20,000 valuation allowance, the journal entries would have been as follows:

Case 1

Investment in debt security	380,000	
Valuation allowance	20,000	
Loan receivable		400,000

Case 2

Investment in debt security	390,000	
Valuation allowance	20,000	
Loan loss recovery		10,000
Loan receivable		400,000

Case 3

Investment in debt security	370,000	
Valuation allowance	20,000	
Allowance for uncollectible losses	10,000	
Loan receivable		400,000

Note that, in either situation, the debt security received should subsequently be accounted for in accordance with [SFAS No. 115](#) .