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A Study of the Accounting Impact of the New Standard on Debt Restructuring

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Author's contribution

The sole author designed, analyzed, interpreted and prepared the manuscript.

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Review Article

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ABSTRACT

After the introduction of the new standard on debt restructuring in 2019, this article analyzes the motivation of debt restructuring, compares the differences between the old and new standards on debt restructuring and analyzes the different effects of the new and old standards on the accounting treatment of creditors and debtors with case data, and finally proposes corresponding suggestions for some of the problems existing in the new standard.

Keywords: Debt restructuring; creditors; debtors.

1. INTRODUCTION

Analysis of the motivation for the revision of debt restructuring.

1.1 Limitations within the Original Accounting Standards

Under the previous accounting standards, debt restructuring could only be carried out when an enterprise was in financial difficulty, which made it difficult for many poorly run enterprises to prove that they were in financial difficulty and had to adopt alternative accounting treatment to resolve their financial problems, thus affecting their daily business activities and future development path. In the original accounting treatment, the debtor needs to distinguish between two major entries, namely the gain from debt restructuring and the gain or loss from the transfer of assets, while the four measurement methods in debt restructuring make the accounting treatment cumbersome and complicated, which greatly increases the workload of accountants in the accounting treatment of debt restructuring.

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1.2 Lower Quality of Information Disclosed in the Original Accounting Standards

Quality control in accounting is mainly controlled and disciplined under accounting standards and accounting systems, and therefore the level of quality of accounting information depends to a certain extent on the quality of accounting standards. In the former debt restructuring standard, creditors were recorded at the fair value of the non-cash assets transferred. When the non-cash assets were inventories, the accounting treatment was treated as a sale and the market price of the inventories was better determined; whereas when the non-cash assets were fixed assets, intangible assets and financial assets such as long-term equity investments, not all assets could be determined at fair value in the market, and therefore the reliability of the fair value obtained for the assets that an enterprise had under the previous accounting standards was still open to question. The difficulty in determining accurate and reliable fair values will have a significant impact on the accuracy of corporate financial reporting, which may result in misinformation to stakeholders and inaccurate investment judgments to investors and the general public, resulting in a detrimental impact on their interests.

1.3 Progressive Convergence of Accounting Standards with International Standards

Today's rapidly developing globalized economy and internationalized capital markets have led to more frequent international economic interactions and, as a result, more stringent requirements for the revision of accounting standards in the international economy. Moreover, since China acceded to the WTO, the scale of international trade and investment has been gradually expanding, and the trend for accounting standards to be in line with international standards has been highlighted.

2. ANALYSIS OF THE DIFFERENCES BETWEEN THE OLD AND NEW STANDARDS ON DEBT RESTRUCTURING

2.1 Different Definition Contents of the New Accounting Standards

The previous accounting standard on debt restructuring provided that a debtor could only restructure its debt in the event of financial difficulty. The new accounting standard on debt restructuring has changed the definition of debt restructuring and expanded the scope of application of the standard based on the previous accounting standard, with the new 2019 standard on debt restructuring emphasizing "renewed agreement". The newly revised standard removes the two prerequisites of "financial difficulty of the debtor" and "concessions by the debtor", making the recognition and measurement of restructured claims and debts converge with the standard for financial instruments, effectively avoiding the risk of "financial difficulty" or "concessions by the debtor" for the same type of debt restructuring. This effectively avoids the risk of the different accounting treatment for the same type of debt restructuring in terms of "financial difficulties" or "concessions by creditors" to solve financial problems, and also avoids the risk of transfer of benefits by some enterprises due to improper provisions of the standard. In addition, the new standard adds the prerequisite of "no change in counterparty", which allows creditors and debtors to offset each other's debts and revise their agreements.

2.2 Different Information Disclosure under the New Standard

Compared to the previous accounting standard on debt restructuring, under the new revised 2019 standard on debt restructuring, the disclosures emphasize how debt restructuring is carried out, as well as the mandatory disclosure of the carrying value of debt and gain or loss on disposal of assets, and the elimination of the disclosure of the total amount of debt restructuring. In addition to this, several changes have been made to the disclosure of the non-cash fair value when repaying debt with non-cash, and the fair value when converting debt into corporate capital. Also, new disclosures have been added for the increase in equity investment in a business resulting from a debt restructuring.

2.3 Different Accounting Treatment under the New Accounting Standards

In the repayment of the debt by non-cash assets and the conversion of debt to capital, the initial measurement of debt restructuring by creditors is changed. Under the old debt restructuring standard, assets or capital were recorded at fair value and the difference between the carrying value of the debt and the recorded value was included in non-operating expenses. In contrast, under the new standard for 2019, the determination of the recorded value and the difference is adjusted so that the fair value of the relinquished claim plus related taxes is used as the recorded value of the asset or capital, while the difference between the fair value and the carrying value of the relinquished claim is included in current profit or loss.

There are also changes in the way debtors are accounted for in the settlement of debts with non-cash assets. the 2006 standard on debt restructuring applies the fair value of assets and recognizes both gain or loss on disposal of assets and gain or loss on debt restructuring. In contrast, the new standard in 2019 eliminates the continued use of the fair value of assets and instead recognizes the difference between the carrying value of the debt and the carrying value of the disposal of non-cash assets as current profit or loss.

In respect of the conversion of debt to equity instruments, the accounting for debtors is supplemented by the previous standard: if the fair value of capital cannot be reliably measured at the time the debtor recognizes capital, the debtor should measure it at the fair value of the debt repaid.

3. REVIEW OF THE LITERATURE

Jin Xiaoyan (2017) [1] believes that there are certain loopholes under the new debt restructuring standard, mainly in three areas, the first of which is the unclear definition of financial difficulty. Financial difficulties are defined in two main ways: firstly, difficulties with liquidity. The second is operating in difficulty. There is no clear definition in the standard that, as a debtor, it should provide evidence that it is in financial difficulty, thus allowing some enterprises to abuse the new standard for unlawful transactions. The second is that the use of fair value for measurement tends to overestimate assets. The new debt standard provides that the assets received by creditors and debtors in a debt restructuring will be measured at fair value. In practice, the determination of fair value is highly arbitrary and prone to overestimation [2-5]. On the one hand, the parties to the restructuring are a community of interest; on the other hand, there is no active market for the non-cash assets used to offset the debt and the valuation agency lacks the independence it should have, making the valuation price difficult to be fair. Finally, the time value of money is not taken into account. Money has a time value, so usually the book value of a restructured claim is smaller than the future amount receivable. On the face of it, the creditor has not made concessions, but the creditor has made a deferral of the debtor's debt This reduces the financial pressure on the debtor to repay the debt immediately and gives it time to recover its business capacity and repay the debt over the long term. In fact, the creditor has made a concession and should be included in the debt restructuring. This is in effect a concession by the creditor and should be included in the debt restructuring.

Zheng Wei and Wu Yu（2019）[6] believe that the revised standard on debt restructuring by the Ministry of Finance has adapted to the needs of the market and the times, improved the definition of the standard on debt restructuring and the measurement of profit or loss under non-cash debt repayment, harmonised with the new standard on financial instruments and the new income standard, avoided misinterpretation between standards, and achieved convergence with international accounting standards [7,8]. The revised standard on debt restructuring facilitates the proper resolution of debt by listed companies, better recognition, measurement and disclosure, simplifies information disclosure, places higher demands on the professionalism of accountants and facilitates the protection of investors' interests by way of debt restructuring. However, due to the recognition of restructuring gains and losses as current profit or loss and the measurement of non-cash assets at fair value, there may still be surplus management by way of debt restructuring by some listed companies.

4. COMPARISON OF APPLICATION CASE STUDIES

Case Background: In March 202X, Company X originally held accounts receivable from Company Y with a carrying value of RMB 5 million. Of this, the original book value was RMB 6 million and Company X had made a bad debt provision of RMB 1 million. The fair value of the receivable was assessed to be RMB 5.5 million in that month. company X and company Y reached an agreement in that month for company Y to repay its debt to company X. Company Y's property was accounted for as a fixed asset with a carrying value of RMB 3.5 million in that month. Of this amount, the original book value was RMB5 million, and accumulated depreciation of RMB 1.5 million had been charged. The property was assessed to have a fair value of RMB 5.0 million for the month. The parties completed the transfer of title of the property in the same month. company X incurred taxes related to the transferred-in property of RMB 100,000 and company Y incurred taxes related to the transferred-out property of RMB 150,000.

4.1 Accounting Treatment of the Creditor (Company X) and Comparative Analysis

Accounting entries under the new standard: (In RMB million)

Debit: Fixed assets - property 560 (550 + 10)
Provision for bad debts 100
Credit: Accounts receivable - Company Y 600
Bank deposits 10
Investment income 50
Old standard accounting entries: (In RMB million)
Debit: Fixed assets - property 500
Provision for bad debts 100
Credit: Accounts receivable - Company Y 500
Loss on impairment of assets 100

Based on the above accounting entries, under the latest debt restructuring standard, Company X has incurred an "investment income" of $0.5 million as a result of the debt restructuring. Under the previous debt restructuring standard, if the debt was settled with non-cash assets, the creditor (Company X) was required to recognize the relevant gain or loss at the fair value of the non-cash assets. In this case, the creditor's (Company X) gain or loss under the original debt restructuring standard would be the fair value of non-cash assets transferred in exchange (property) - carrying amount of restructured debt = 500 - 500 = 0. As the creditor (Company X) has made an additional provision of $1 million for bad debts, it needs to be credited to the asset impairment loss account. In addition, the transaction resulted in a tax charge of RMB150,000, which was reported as "Taxes and surcharges". A comparison of the old and new standards shows that the creditor's (Company X) current profit or loss is increased by $0.5 million in the new standard compared to the old standard and is included in "investment income".

4.2 Accounting Treatment of the Debtor (Company Y) and Comparative Analysis

Accounting entries under the new standard: (In RMB million)

Debit: Accounts payable - Company X 600
Accumulated depreciation of fixed assets 150
Taxes and surcharges 15
Credit: Fixed Assets - Property 500
Bank deposits 15
Gain on disposal of assets 250
Old standard accounting entries: (In RMB million)
Debit: Accounts payable - Company X 600
Accumulated depreciation of fixed assets 150
Credit: Fixed Assets - Property 500
Gain or loss on disposal of assets 250

According to the above accounting entry, under the new debt restructuring standard, the debtor (Company Y) has generated $2.5 million as a result of the debt restructuring which is recorded as a "gain on disposal of assets". Under the previous debt restructuring standard, if the debt was settled with non-cash assets, the debtor should record the difference between the book value of the restructured debt and the fair value of the transferred non-cash assets as "non-operating income". In this case, the debtor (Company Y) calculated the gain or loss according to the original debt restructuring guidelines as the book value of debt - fair value of non-cash assets (property) = 600 - 500 = 1 million (yuan). In addition, the transaction will result in a tax charge of $150,000, which will be included in "Taxes and surcharges". A comparison of the old and new standards shows that the current profit and loss of the debtor (Company Y) has increased by $2.5 - 1.0 million = $1.5 million compared to the old standard.

5. PROBLEMS AND SUGGESTIONS OF THE NEW STANDARD ON DEBT RESTRUCTURING

5.1 Problems

5.1.1 There are disadvantages to the inclusion of gains and losses from debt restructuring in current profit and loss

All gains and losses arising from debt restructuring are included in current profit and loss, which enables enterprises to freely dispatch their profit margins. For example, if an enterprise generates a profit or loss in the process of debt restructuring, a company in poor financial condition can use the loopholes in the guidelines to regulate the scope of profit, such as increasing the enterprise's profit, thereby creating financial fraud and increasing the investment attractiveness of the enterprise itself to investors, to the detriment of stakeholders' interests.

5.1.2 Lack of market basis for fair value

In the 2019 Debt Restructuring Guidelines, gains and losses arising from debt restructuring assets are measured at fair value. However, in the actual operation of debt restructuring, the determination of fair value is less reliable and has a greater degree of arbitrariness. The lack of an active market for certain assets or capital makes it difficult to measure fair value accurately and quantitatively, resulting in a degree of possible overstatement of fair value.

5.1.3 The taxation system for debt restructuring needs to be improved

In the process of debt restructuring, the lack of tax credit by tax authorities still exists, which seriously undermines the normal operation of debt restructuring, and at the same time, the lack of tax credit of taxpayers also has a negative impact on debt restructuring. In addition, the taxation department's collection and control of tax owed by debtor enterprises are weak, and the phenomenon of tax evasion in the name of debt restructuring is more serious.

5.2 Recommendations

5.2.1 Reduce the impact of debt restructuring gains and losses on profits

Debt restructuring standards should be more stringent in regulating the disclosure system of debt restructuring and regulating the malpractices of enterprises in a poor financial condition to adjust the profit margin of the income statement to enhance the reliability of the financial statement data of enterprises.

5.2.2 Strengthen the control of financial personnel

Some companies do not have a strong monitoring mechanism, which makes some financial practitioners subject to weak control, to gain their interests, to make unethical behavior. Some financial personnel uses the loopholes of fair value in the debt restructuring guidelines to make false financial data that do not conform to the actual financial situation of the company, and the financial situation of the enterprise will become unreliable because of the whitewashing of financial personnel. To a certain extent, this affects the credibility of the company as well as its future development and also harms the interests of relevant stakeholders. As a result, companies should strengthen the control of their financial staff. In addition to this, the company should also strengthen the independence of the audit, to better play the supervisory role of the audit department and help prevent irregularities in the presentation of profits by the enterprise.

5.2.3 Strictly regulate the loan approval system of financial institutions

Financial institutions must strictly analyze the financial situation of enterprises and avoid excessive and unreasonable debt ratios in the process of lending to make the enterprise's debt structure deformed, so it is essential to strictly implement the loan approval procedure system. Enterprises must also do a good job of risk management control, not just the pursuit of scale while ignoring the quality of development.

5.2.4 Improve the debt restructuring credit system

In the debt restructuring taxation system, strengthen the taxation department in the taxpayer's tax collection and taxation construction, and at the same time improve the tax collection and management system, strengthen the strict law enforcement of the taxation department, regulate the taxpayer's taxation behavior, prevent illegal tax evasion in the debt restructuring process, and effectively reduce tax default behavior.

6. CONCLUSION

The implementation of the latest 2019 standard on debt restructuring has both advantages and disadvantages for the development of enterprises, the advantages include a deeper standardization of debt restructuring standards, but there are still loopholes that need to be improved. 2019 new standard on debt restructuring has a profound impact on enterprises. The new standard will guide the future direction of enterprises and help investors to make sound decisions. To promote the sustainable development of Chinese enterprises, to regulate China's socialist market economy, and to keep in line with international standards, China's debt restructuring standards still need to be constantly innovated and improved.

COMPETING INTERESTS

Author has declared that no competing interests exist.

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