WOODBURY
SCHOOL *of* BUSINESS

Early Bond Repurchases Without Retirement

Sheldon R. Smith
Marty D. Van Wagoner
Accounting Department
Woodbury School of Business
Utah Valley University

ENGAGE:OPPORTUNITY

INTRODUCTION

- Stock repurchases
  - Retired or held as treasury stock
- Companies can also buy and retire their own bonds before maturity

- What happens if repurchased bonds are not retired but held for possible resale?
  - How would the gain/loss be treated?
  - How would the transaction be reflected in the balance sheet?
  - How would the resale of these bonds be recorded?
- This paper provides a conceptual exploration of bonds repurchased before maturity by the issuing company without a corresponding early retirement of these bonds

WOODBURY SCHOOL of BUSINESS

BACKGROUND

- Company may retire some or all its bonds before they mature
- May have been issued for 20, 30, 40+ years, but the company's economic situation may have changed, making early retirement advantageous
- Can either pay the call price (if callable) or buy in the open market for the current market price

- Reasons for early retirement
  - Avoid continued cash interest payments
  - Use excess cash if no better alternative
  - Call price is less than current market price
  - May improve debt ratio or debt-to-equity ratio for various reasons, including the need to meet or maintain debt covenant requirements

WOODBURY SCHOOL of BUSINESS

- Implications
  - Very unlikely the purchase price equals the book value of the bonds
  - Leads to a gain or loss at the time of retirement; equity transactions cannot lead to gains/losses, but the elimination of a liability can

- If the market interest rate has increased since issuance, the market price will have dropped, leading to a gain on repurchased bonds
- While it seems that any company would like a gain, the gain is only achieved by giving up something
- In this case the company gives up the ability to continue to pay the below-current-market interest rate that would otherwise be locked in

- If the market interest rate has decreased since issuance, the market price will have increased, leading to a loss on repurchased bonds
- While a company might not like a loss, it can get something through its willingness to take a loss
  - May be able to refinance with lower-rate bonds
  - May be willing to bear the loss to quit paying interest at the higher-than-current-market rate
    - This may especially be true if the company thinks market rates will continue to decline, causing the price to increase further

- Changes in market rates can be a result of changes in company-specific risk or changes in the general economy
- These changes can easily occur over a several-decade period in the life of a bond issue

- If company-specific risk increases, the market rate demanded for these bonds would also increase, driving down the market value of the bonds
- While this might be an ideal time for a company to buy back its own bonds, the increased risk might also indicate financial distress and an inability to buy back bonds

- If company-specific risk decreases, the market value of the bonds will increase
- In this case, the company might not be in financial distress but would then need to weigh the loss it would incur to retire the bonds with the benefit of either refinancing with lower-market-rate bonds or simply eliminating the interest at the original higher rate

- If the market rates change in the general economy, independent of the risk of the specific company, market rate increases (decreases) will lead to market value decreases (increases) for the bonds
- As the market value decreases (increases), a repurchase of the bonds would lead to a gain (loss)
- In this case, a decrease may not be a sign of financial distress, so the company may be in a position to repurchase bonds

- It appears that most companies repurchasing bonds retire them upon repurchase
  - Remove the bond liability from the balance sheet
  - “Repayment of debt” on the statement of cash flows
    - Example: ams AG (Austria)
    - GE (U.S.) and Vale (Brazil) announced in September 2019 plans to repurchase bonds

- Though we were able to find examples of bond repurchases for retirement, we have not been able to identify bond repurchases without retirement
- However, there are reasons such transactions could take place
- The next section explores these reasons and possible accounting for such transactions

EARLY DEBT REPURCHASES WITHOUT RETIREMENT

- What if a company repurchased its own bonds but held them for possible resale prior to maturity, especially if the maturity date is still many years in the future?
- Why might a company choose this option?

Reasons for Repurchase

- Reconsider reasons above for early retirement
  - "Invest" excess cash temporarily in case cash is needed again in the future through resale
  - Improve the company's debt ratio or debt-to-equity ratio temporarily
  - Avoid cash interest payments temporarily

- Future resale would not require a new bond contract or additional issuance costs
- If a company had expectations of which way market interest rates would move in the future, it might be able to take advantage of potential changes in these market rates

- If the market interest rate has changed since the bonds were issued, a company might want to record a gain or loss on the repurchase and then immediately resell those bonds in the market
- Why?

WOODBURY SCHOOL of BUSINESS

- If the market rate had increased, causing the value of the bonds to drop below book value, a gain could be recognized at the time of the repurchase, but that gain would be recorded at the cost of a higher interest rate for the remaining life of the bonds
- However, some companies might be interested in this type of earnings management to recognize a gain in the short run even if it means less income in the future due to the higher interest cost

- If the market rate had decreased, causing the value of the bonds to rise above book value, a loss could be recognized at the time of repurchase but lead to a lower interest expense in the future
- This type of earnings management might be appealing to companies who are taking the “big bath” now in order to reduce expenses and increase income in the future

- In these cases, the quality of earnings could be questioned
- In fact, these possibilities raise the question about whether this is a situation where the gain or loss should be deferred in order to avoid the manipulation of net income
- A company might argue that this is simply a “refinancing” arrangement for its bonds and that the gain/loss should be recognized immediately

- Does it make sense to allow a company to record a gain or loss for a repurchase with a simultaneous reissuance?
- These scenarios may just be a ploy to manage earnings
- However, if a company repurchases its bonds with the possible intent to resell them in the future, perhaps after several years, mostly to avoid interest payments or temporarily use excess cash, this may be considered a legitimate corporate strategy and not earnings management

- Market rate increases after issuance
    - (This slide and the next two opposite if rate decreases)
- Bond value drops
- Bonds can be repurchased at a gain
- In the interim holding period, the market rate can either increase further or decrease

- If the market rate increases further, the gain would be offset by an even higher interest rate to be paid once the bonds are reissued
- However, the company could avoid the payment of interest during the period the bonds are not outstanding

- If the market rate decreases after the repurchase before the bonds are resold, the gain would still be calculated at the time of the repurchase, and the interest payments would stop
- Depending on how low the market rate goes by the reissuance date
  - the company might still pay a market rate above the original rate, or
  - the company might be able to pay a market rate below the original rate

WOODBURY SCHOOL of BUSINESS

Treatment of Gain or Loss

- The repurchase of bonds for retirement results in a gain or loss in the income statement
- This is true even if the bonds are refinanced with newly issued bonds
- Should the gain/loss on repurchase be treated differently if the bonds are held for possible resale?

- Does that answer depend on any specific holding period for these bonds before they are resold?
- An argument can be made for the immediate recognition of the gain/loss if bonds are repurchased and held for resale
- Other alternatives could be considered

- Alternative #1
  - Recognize the gain/loss immediately, but reverse it out if the bonds are resold later before maturity
    - No satisfactory way to account for the reversal
      - If the gain/loss was reversed at the time of bond reissuance, it seems that the reversal would need to be an adjustment to the discount or premium at the time of reissuance, but that would then change the market rate at reissuance, perhaps significantly, such that the rate implicit in the bond reissuance would have no relationship to the actual market rate on that date

- Alternative #2
  - Defer the gain/loss until the bonds are retired, mature, or are reissued
    - Deferred gain (liability) or deferred loss (asset) does not make much sense
    - Unrealized holding gains/losses on available-for-sale security investments are deferred from the income statement until the actual sale of the security; these amounts go to OCI (AOCI) until the security is sold, at which time the gain/loss is moved to income

- It is possible that the deferred gain/loss on repurchased bonds held for resale could also be considered “unrealized” and stored in AOCI until the later disposition of those bonds
- Such deferral may better represent the intent of the organization to hold the bond for resale or later retirement so the final disposition of the gain/loss more closely matches the final disposition of the instrument
- One potential drawback is that a company could arbitrarily choose when to declare the bonds retired, thus allowing earnings management in recognizing the gain/loss on the income statement

- Alternative #3
  - Defer the gain/loss and recognize it over the remaining (original) life of the bonds
    - Deferred through AOCI
    - Transfer to income systematically
    - Would still need to recognize any remaining gain/loss at the time of retirement, as the future life would have no meaning if the bonds were truly retired
    - Again, a deferral with later recognition over time might more closely match the final disposition of the instrument

Treatment of Repurchased Bonds

- Alternative #1
  - If the debt is retired, the actual liability is reduced
  - An argument can be made for the same treatment for bonds repurchased and held for resale, as they are not outstanding
  - Perhaps argue that the bonds which can be resold should at least be disclosed in the footnotes, similar to the disclosure of unused credit lines

- Alternative #2
  - The repurchased bonds could be held in a contra liability account
  - Would recognize that the bonds are not outstanding but that they could be resold later
  - Would show a difference between retired bonds and those held for possible resale
  - Similar to treasury stock as a contra equity
  - Could be confusing to refer to them as treasury bonds (U.S. Treasury bonds)

- Alternative #3
  - Classify as an investment asset
    - While treasury stock is not an asset, might a company's own bonds be an investment asset?
    - Difficult to argue that you can invest in your own bonds and treat it as an asset
    - Defined as something that provides future economic benefit
      - A company would not pay itself interest
      - Could the savings of interest to otherwise be paid be a future economic benefit

- When a parent purchases bonds of its own subsidiary, the consolidated entity has to eliminate the effects of any intercompany bonds during the consolidation process
- Might also make sense then that a single company could not show both a liability owed to itself with a corresponding investment asset in that liability
- Could also cause problems in calculating financial ratios that involve assets or liabilities
- Deferred bond issuance costs used to be an asset, but these costs are not now treated as assets, so it might also make sense that an investment in one's own bonds could not be classified as an asset

WOODBURY SCHOOL of BUSINESS

DISCUSSION

- The Financial Accounting Standards Board (FASB) actually provides some guidance for bonds repurchased and not retired.
- Accounting Standards Codification (ASC) 405-20-40-1 refers to the derecognition of a liability

A debtor shall derecognize a liability if and only if it has been extinguished. A liability has been extinguished if either of the following conditions is met:

a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes the following:
    1. Delivery of cash
    2. Delivery of other financial assets
    3. Delivery of goods or services
    4. Reacquisition by the debtor of its outstanding debt securities whether the securities are cancelled or held as so-called treasury bonds.

b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor. For purposes of applying this Subtopic, a sale and related assumption effectively accomplish a legal release if nonrecourse debt (such as certain mortgage loans) is assumed by a third party in conjunction with the sale of an asset that serves as sole collateral for that debt.

- This standard lacks clarity, as the terms "treasury bond" or "treasury bonds" do not appear any other time in the ASC except in reference to U.S. Treasury bonds
- Although it seems that the FASB intended this usage to refer to a company's bonds that are repurchased and held for possible resale, that meaning is not clarified elsewhere by the codification

- In addition, the term “so-called” can be ambiguous
- Merriam-Webster includes two definitions, almost the opposite of each other
  - “Commonly named” with an example of “the so-called pocket veto”
  - “Falsely or improperly so named” with an example of “deceived by a so-called friend”

- Therefore, it is not obvious whether the FASB is implying that “treasury bonds” is an improper name for repurchased bonds held for resale or if it is a common name for such bonds
  – The term is not otherwise used in the codification, so it may not be common
  – However, since “treasury stock” is in common usage, perhaps “treasury bonds” can be common usage, even though these bonds may be so rare as to infrequently be referred to at all

- Another interesting factor may be the use of the term “held as”
- In legal writing such as the tax code, every word or phrase may have a very concrete meaning or definition, used to determine legislative intent
- Is there a specific holding period required such that a bond would be “held as” a so-called treasury bond?

LEGAL CONCERNS

- Just as with treasury stock, an entity needs to be cautious with repurchases of bonds and watch for potential legal pitfalls
- Insider trading accusations are of great concern
- An entity, its directors, officers, and certain shareholders are subject to Section 16 of the Securities and Exchange Act of 1934, Rule 10b-18, also know as the “safe harbor” rule, and Regulation FD

- In addition, care must be taken to avoid classification of the repurchase as a “tender offer” unless tender offer rules are followed
- U.S. securities law regulates tender offers but provides no definition, so understanding comes mostly from case law
- Organizations also want to avoid accusations of earnings management or manipulation

IMPLICATIONS AND LIMITATIONS

- While the ASC cited indicates that bonds repurchased and held or resale are derecognized and that any resulting gains or losses are immediately recognized, consideration should be given to treating these bonds as a contra liability, recognizing that they are not outstanding but that the bonds have not yet been retired

- Deferral of the gains/losses through AOCI should also be considered, with future recognition on the income statement as appropriate
- In comparing alternatives, possible earnings management implications should be considered

- The implications of the paper may be limited, as we have yet to find a specific example of a company that has disclosed a bond repurchase without a corresponding retirement
- However, companies are increasingly looking for legitimate methods to improve financial performance, and the temporary reduction in interest payments along with the possibility of reselling repurchased bonds before they mature may be of interest to select companies

FURTHER RESEARCH

- Tax implications of repurchased bonds held for resale
  - How should gains/losses be treated for taxation?
- Empirical evidence about companies repurchasing their own bonds, either for retirement or resale
  - Why do companies buy back their own debt?
  - What distinguishes these companies from others that do not repurchase their own debt?
- Case writeup on this topic for a graduate-level financial accounting/research course; separate case for a graduate-level tax class

CONCLUSION

- Companies may not frequently repurchase and retire their own bonds before maturity; even less likely is a bond repurchase held for resale
- The ASC seems to have a definitive treatment for bonds repurchased and not retired
- However, this paper has raised conceptual questions about whether this is the best possible method of accounting for this type of transaction
- Alternatives are presented for consideration