

EARLY BOND REPURCHASES WITHOUT RETIREMENT

*Sheldon R. Smith, Woodbury School of Business, Utah Valley University, 800 W. University Parkway,
Orem, UT 84058, 801-863-6153, smithsh@uvu.edu*

*Marty D. Van Wagoner, Woodbury School of Business, Utah Valley University, 800 W. University
Parkway, Orem, UT 84058, 801-863-5913, MartyV@uvu.edu*

ABSTRACT

Companies can buy back and retire their own bonds before maturity, resulting in a possible gain or loss on the extinguishment of debt. What would happen if a company repurchased its own bonds before maturity but did not retire them, potentially holding them for resale later before the bonds mature? This paper provides a conceptual exploration of the early repurchase of bonds without a corresponding retirement.

Keywords: Bonds, Bond Repurchases, Bond Retirement, Treasury Stock

INTRODUCTION

Companies often repurchase shares of their own stock. These repurchases can happen for a number of different reasons. Repurchased stock can either be retired or held as treasury stock. Retired shares are treated as authorized but unissued shares and can be sold again later. Treasury stock is held in a contra equity account; these shares can also be resold later. Transactions involving a company's own equity cannot result in gains or losses [2, 505-30-25-7]. They also cannot result in an increase in retained earnings but sometimes result in a reduction of retained earnings [2, 505-30-30-10].

Companies can also buy back and retire their own bonds before the bonds mature. Because bonds are a liability, the early retirement of bonds can result in a gain or loss. What would happen if a company repurchased its own bonds before maturity but did not retire them, potentially holding them for resale later before the bonds mature? How would the gain/loss be treated at the time of repurchase? How would this 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 those bonds.

BACKGROUND

A review of the repurchase of stock and the repurchase and retirement of bonds will be provided first. This review provides a foundation for the discussion of bonds that are repurchased and held for future resale.

Stock Repurchases

Companies buy back shares of their own stock for many different reasons. Intermediate accounting textbooks list some of these reasons. In general terms, a company may buy back shares if it feels the stock is undervalued in the market. If shares are undervalued, the company may "get a good deal" if it can buy back shares at the undervalued amount and later reissue these shares at a higher value. The result of buying back shares and reducing the number of shares in the market may be an increased market price

because the supply of those shares has been reduced. If a stock repurchase increases the earnings per share, the stock price, and/or the return on equity ratio for remaining stockholders, they can benefit from the stock repurchase, at least temporarily [4][10][12]. Meanwhile, the company can use a stock repurchase as a way to use cash to pay out company earnings without paying a dividend. This can be advantageous also to those who sell their shares back, as the sale of stock back to the company may result in lower capital gains tax rates than the ordinary income tax rates that would be required for dividends [10][12].

Shares may be repurchased to make them available to issue in a stock option or stock award plan for employees, or at least in an attempt to offset the number of shares issued through these plans [4][12][13]. They may also be repurchased to be available to distribute for anticipated stock dividends [12] or to be used for a forthcoming business combination [10][12]. In some cases, shares of stock are repurchased from dissident stockholders or outside stockholders to reduce the likelihood of a successful takeover attempt [4][10][21][13]. A related reason not necessarily tied to a takeover attempt might be simply to result in antidilution—to increase the value or percent ownership of each share and/or to aggregate ownership among fewer shareholders. Shares may also be repurchased if they are needed to satisfy demand by holders of convertible bonds or convertible preferred stock [13].

While it is feasible that a company could repurchase shares of its own preferred stock, either through a call provision or on the open market, it is unusual for a company to hold preferred stock as treasury stock [10]. This discussion will focus on the repurchase of common shares, either for retirement or to be held as treasury stock. For successful companies, it is expected that, over time, the market price of the common shares would exceed the original sales price. Therefore, in many cases when a company wants to repurchase shares of its own stock, it will need to pay more than the original capital invested. In less common cases, the market price of the stock might be lower than its original sales price, allowing a company to repurchase shares at an amount lower than what was originally received from investors.

If repurchased shares are retired, the capital accounts credited upon the original issuance (Common Stock and maybe Additional Paid-in Capital) are reduced for the amounts related to the shares retired. As stock may have originally been issued at different prices, a cost flow assumption may need to be used—specific identification, FIFO, or average cost—to determine the amounts to be removed from the original capital accounts. Any stock issuance costs for the original issuance would have reduced the paid-in capital recorded and would therefore affect the amount removed from the accounts when stock is retired.

As transactions in a company's own equity cannot result in gains or increases to Retained Earnings, if shares are repurchased and retired at an amount below the original sales price, the balancing credit is made to a paid-in capital account (such as Paid-in Capital—Retired Stock). An argument for using this account is that the excess of the original sales price over the repurchase price is not an amount due to anyone, so it is capital that simply remains in the company. However, as it no longer represents Paid-in Capital in Excess of Par for the retired shares, it does not remain in that account. Of course, by the time balance sheets are presented, most or all of the paid-in capital accounts other than the specific accounts for Common Stock and Preferred Stock are aggregated, so this distinction is not usually presented on the balance sheet even though it may still be represented in the specific company accounts.

As transactions in a company's own equity also cannot result in losses, if shares are repurchased and retired at an amount above the original sales price, the balancing debit depends on prior transactions and the company's preference. If a credit balance exists in the Paid-in Capital—Retired Stock account, it could first be used up to the extent it exists [2, 505-30-30-8]. If that account has no balance from prior transactions or an inadequate credit balance, then any remaining debit could come from Retained Earnings.

An argument for debiting Retained Earnings is that the reason the repurchase price exceeds the stock's original selling price relates to appreciation in the value of the stock since dividends were not declared and paid previously to keep the stock's market price at its original sales price. So, although the excess paid to retire the stock is not technically a dividend, it can be considered a payment in lieu of unpaid dividends, which would have reduced Retained Earnings had they been declared previously.

Because the capital accounts from the original issuance of stock are derecognized for retired stock, these shares, once retired, are simply considered authorized but unissued shares. If these retired shares are later sold again, the journal entry would simply follow the convention for the original issuance of stock.

Spiceland et al. [12] indicate that *The Revised Model Business Corporation Act* no longer recognizes the concept of treasury shares. As many state laws have followed this revision, treasury stock may not be recognized as frequently now as in the past. However, repurchased shares are still recognized as treasury stock in some cases. Two different methods used to be discussed in intermediate accounting textbooks with respect to treasury stock—the par value method and the cost method. More recent editions of intermediate accounting textbooks seem to focus only on the cost method. Spiceland et al. [12] indicate that *The Revised Model Business Corporation Act* eliminated the concept of par value in 1980. Many states may have updated their laws to reflect this change. If the concept of par value is less common, the par value method for treasury stock may also be less common, making it irrelevant for discussion in these intermediate textbooks. However, if this is the case, it is interesting that these same textbooks continue to teach about par value in the chapter on equity. However, Spiceland et al. [12] indicate that it is still necessary to teach about par value in textbooks, as many established companies issued shares prior to the change in state statutes and these same companies may still sell shares that were previously authorized with a par value.

Under the par value method, the Treasury Stock account is debited for the par value of the shares repurchased. The original Paid-in Capital in Excess of Par account is also reduced for the amount originally credited to that account when the stock was sold, again perhaps needing to assume some cost flow assumption—specific identification, FIFO, or average cost. This method essentially mirrors the retirement method discussed above except that the Common Stock account is not reduced, but instead the Treasury Stock account is debited. In this case, the Treasury Stock account is treated as a contra account to the Common Stock account, as they are both recorded at par value. Because the Common Stock account is not reduced, the stock is still considered to be issued, but because it is held as treasury stock, it is not considered to be outstanding. If treasury stock accounted for using the par value method is resold, the journal entry looks like the original issuance of stock except that Treasury Stock is credited rather than Common Stock. If this treasury stock is later retired, the related Common Stock and Treasury Stock accounts, both recorded at par value, are derecognized by debiting Common Stock and crediting Treasury Stock.

Under the cost method, the Treasury Stock account is debited for the cost paid for the stock. No paid-in capital accounts from the original issuance are derecognized. The Treasury Stock account in this case is a contra-equity account and is subtracted from total stockholders' equity, as it would not make sense in this case to subtract it directly from the Common Stock account since it is not recorded at par value. If some or all of this treasury stock is later resold, the Treasury Stock account will be reduced for a proportionate amount of the cost of the treasury stock (perhaps again needing a cost flow assumption—specific identification, FIFO, or average cost—if treasury shares were purchased in multiple transactions at different per share costs). If the amount received for the sale of the treasury stock exceeds the cost removed from the Treasury Stock account, another paid-in capital account (such as Paid-in Capital-

Treasury Stock) would be credited. If the proceeds from the sale of the treasury stock are less than the cost of that treasury stock, Retained Earnings could be debited, possibly after using up any credit balance in the Paid-in Capital-Treasury Stock account from previous treasury stock transactions [2, 505-30-30-8 to 30-10].

Specific equity account balances may differ depending on which of these methods—Retirement, Treasury Stock (par value method), or Treasury Stock (cost method)—is used. However, the total stockholders' equity will remain the same. Other similarities between retired shares and treasury shares are that (1) no cash dividends are paid on these shares, either because they are not considered issued, or if considered issued, they are not outstanding, and (2) no preemptive right exists for retired or treasury shares.

Early Retirement of Debt

A company may want to retire some or all of its bonds before they mature. Although the bonds may initially have been issued for 20, 30, 40, or more years, the company's economic situation may have changed over time, and early retirement may now be advantageous. A company can retire its bonds early either by paying the call price for callable bonds or by purchasing its own bonds in the open market at the current market price.

One reason for retiring bonds early would be to avoid the continued interest payments over time that would no longer be required if the bonds were retired. If a company has some excess cash, retiring bonds may be a good use of this cash, although that might be an admission by the company that it has no better investment use for the funds. On the other hand, if the company truly has no current potential asset investments that can earn a greater return than the interest saved by retiring the bonds, this use of cash might be optimal.

Another situation for which a company may want to retire its bonds early could occur if callable bonds have a call price less than the current market price of the bonds. Additionally, a company may want to retire bonds if it will improve its debt ratio or its debt-to-equity ratio, which could be desirable for varying reasons, including the need to meet or maintain debt covenant requirements.

What are the implications of early bond retirements? Because it is very unlikely that the amount paid to repurchase the bonds (call price or market price) will exactly equal the book value of the bonds, early bond retirements will most often result in a gain or a loss being recorded. Any bond issuance costs incurred to issue the bonds would increase the discount or decrease the premium recorded at the initial issuance, resulting in a higher market rate to be used by the issuing company. We will assume any bond issuance costs have been netted with the premium or discount account, thus implying that any unamortized bond issuance costs will also affect the gain or loss recorded at the time of the repurchase.

If the market interest rate has increased since the bonds were issued, the market price will have dropped below the book value of the bonds. In this case, a gain would be recognized if the bonds are repurchased. While it seems that any company would like a gain, a company actually gives something up to achieve this gain. It gives up the ability to continue to pay the below-current-market interest rate that would otherwise be locked in if the company continued to make the interest payments on the bonds.

If the market interest rate has decreased since the bonds were issued, the market price will have increased above the book value of the bonds. In this case, a loss would be recognized if the bonds are repurchased and retired. Why might a company be willing to buy back its bonds if it will have to record a loss? One

reason is that it might be able to refinance those bonds with bonds that are sold based on the lower current market interest rate. The loss may be worth bearing to lower the effective interest rate paid in the future. Or if the company no longer needs the money from the bonds, it might simply be willing to bear the loss to quit paying interest at the higher-than-current market rate that it is locked into if it continues to make interest payments over the remaining life of the bonds until they mature. This may be especially true if the company thinks market rates will continue to decline, causing the price of the bonds to increase even further.

As an example, suppose a company issues \$100,000,000 of 5%, 30-year bonds when the market interest rate is 6%. If interest payments are made semiannually under the bond contract, the bonds will initially sell for \$86,162,218, a discount of \$13,837,782. After ten years, the unamortized discount will have decreased to \$11,557,386, leaving the book value of the bonds at \$88,442,614. If, during that ten-year period, the market rate for these bonds has increased to 7%, the bonds would then have a fair value of \$78,544,928. If the issuing company repurchased and retired its bonds at that price, it would record a gain of \$9,797,686, the difference between the amount paid and the book value of the bonds. On the other hand, if the market rate had decreased to 5% over that ten-year period, the bonds would have a fair value of \$100,000,000. If the issuing company repurchased the bonds for this amount, it would record a loss of \$11,557,386, as it paid that much more to retire the bonds than the book value of the liability removed from its books.

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 the 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 the ideal time for a company to purchase its own bonds, it might also signal financial distress for the company. If the company is distressed, it may not have the ability to buy back any of its bonds. If the company-specific risk decreases, the market rate demanded for these bonds would also decrease, causing the market value of the bonds to increase. In this case, the company may not be in financial distress but would then have to weigh the loss it would incur in retiring its bonds with the benefit of either refinancing with lower-market-rate bonds or simply eliminating the continued interest at the original higher interest rate.

If 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 company's bonds. As the market value decreases (increases), a repurchase of the bonds would lead to a gain (loss). However, in this case, the market value decrease for the bonds may not be a sign of financial distress for the company, so the company may be in a position to repurchase bonds.

If the bonds are repurchased through a call provision, this would normally take place on an interest payment date, requiring no further updating of premium or discount amortization before recording the retirement. However, if the bonds are repurchased through the open market, these retirements could take place at any point in time, requiring an adjusting entry to amortize the discount or premium from the last interest payment date to the date of repurchase before the entry for the bond repurchase/retirement is recorded [10].

If a company repurchases and retires its own bonds, it will need to debit Bonds Payable for the face value of the bonds retired. It will also need to eliminate any related contra or adjunct accounts for unamortized discounts/premiums. After crediting Cash for the purchase price, any remaining debit (credit) needed to make the entry balance would be recorded to a loss (gain) account. The effect of any transaction cost to

buy back the bonds would be an increase in the cash paid, resulting in a larger loss or a smaller gain than would otherwise be recorded.

Currently, it appears most companies repurchasing bonds retire the bonds upon repurchase and, therefore, remove the bond liability from the balance sheet and present it as a “repayment of debt” in the statement of cash flows. A recent example of this is the 2019 Half Year Report of ams AG, located in Austria [5][6]. Similarly, GE, in the US, and Vale, in Brazil, announced in September 2019 plans to enter into bond repurchases [1][14].

Though we were able to find examples of bond repurchases for retirement, we have not been able to identify examples of bond repurchases without retirement. There are reasons that such transactions could take place, however, and the next section explores these reasons, as well as the possible accounting for such transactions.

EARLY DEBT REPURCHASE WITHOUT RETIREMENT

Intermediate accounting textbooks briefly cover the early retirement of debt, typically in a few short paragraphs, perhaps with an example to illustrate the journal entry [4][10][12][13]. However, these books do not discuss or illustrate the repurchase of debt before maturity without a corresponding 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

The reasons given above for an early retirement of debt can be reconsidered for the early purchase of bonds without retirement. This type of transaction might be a way to “invest” excess cash temporarily in case this cash is needed again later through the resale of the bonds. The effect of this transaction could also improve the company’s debt ratio or debt-to-equity ratio temporarily or allow the avoidance of interest payments temporarily, as a company would not pay itself interest on its holdings of its own bonds which are not outstanding. In addition, the future resale of these bonds would not require a new bond contract or additional issuance costs as might be required if the bonds were refinanced immediately or if new bonds were issued later. 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.

Presumably, a company’s bond price could be driven down by a decreased credit rating due to a public expectation that the company will have difficulty repaying the bonds. If the company can raise the cash to buy back all or some of the bonds, contrary to expectation, it could possibly do so at a significantly reduced price. The buyback of those bonds could demonstrate to the public that it is financially stronger than presumed so its credit rating might increase. It could then reissue those bonds, without the issuance price associated with a new issuance, at a much higher price than that at which it repurchased them. Such a scenario would result in very positive cash flows for an entity. However, it could also result in accusations of improper behavior, as addressed below under legal concerns.

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 of the bonds and then immediately resell those bonds in the market. Why might a company do this? 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, might some companies 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 the repurchase, but the loss would provide lower interest expense in the future. Again, this type of earnings management might be appealing to companies who are taking a “big bath” now in order to reduce expenses and increase income in the future. Of course, 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. However, a company might argue that this is simply a “refinancing” arrangement for its bonds and that the gain or loss should be recognized immediately in the income statement.

As was mentioned before, any transaction costs to repurchase bonds would reduce the gain or increase the loss recorded at the time of repurchase. In addition, transaction costs to resell these bonds, even if done essentially simultaneous with the repurchase, will increase the effective rate on the reissuance, meaning that the market rate for the bonds resold will increase slightly.

Ignoring the transaction costs and using the same example introduced previously, the bonds would have a book value of \$88,442,614 after ten years. If the market rate had increased from 6% to 7% during that ten-year period, the bonds could be repurchased for \$78,644,928, with a calculated gain of \$9,797,686. However, the immediate resale of these bonds would then mean the issuing company would now have an effective rate of 7% for the remaining life of the bonds rather than the original 6% rate. On the other hand, if the market rate had decreased from 6% to 5% during that ten-year period, repurchase of the bonds would require \$100,000,000, leading to a calculated loss of \$11,557,386. However, the immediate reissuance of the bonds would lead to a lower effective rate of 5% for the remaining life of the bonds compared to the original 6% effective rate. Would it make sense to allow a company to record a gain or loss on this repurchase/resale transaction if the repurchase and resale were to happen essentially simultaneously?

So far, the scenarios mentioned may just be a ploy to manage earnings. However, if a company buys back its bonds to hold them 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 instead of simple earnings management.

If the bonds were repurchased at a gain because the market rate had increased since the bonds were originally issued, the bonds could be held for resale in the future. However, in the interim holding period, the market rate could either increase further or decrease. If the market rate increased further, the gain would be offset by an even higher interest rate to be paid once the bonds are reissued. However, during this interim period, the company would also avoid the payment of interest on the bonds that are not outstanding.

To illustrate this scenario, the example given above will be extended. After ten years if the market rate had increased to 7%, the bonds could be repurchased for \$78,644,928, a calculated gain of \$9,797,686. Suppose the company held these bonds without retiring them and resold them in the market after five additional years. During this period of time, the company would save \$25,000,000 that would not be paid in cash at the stated interest rate. If, during that five-year period, the market rate increased further to 8%, the company could resell the bonds for \$74,061,950, obviously less than was paid to repurchase the bonds earlier. The company would then be paying an effective rate of 8% for the remaining life of the bonds.

If the market rate decreased after the bonds were repurchased but by the time the bonds are resold, the gain would still have been calculated at the time of the repurchase, and the interest payments would not be made on those bonds. However, depending on how low the market rate had dropped, the company might resell the bonds and pay a rate that is higher than the original rate (if the rate decreased from the repurchase date but is still higher than the original rate) or be able to pay a rate lower than the original rate (if the market rate drops below the original rate).

Returning to the example, if the bonds were resold after five years, the company would still save \$25,000,000 that would not need to be paid in interest. Assuming the market rate decreased to 6½%, lower than the rate at the time of repurchase but higher than the original market rate, the bonds could be resold for \$85,763,562, an amount higher than what was paid to repurchase the bonds five years earlier, and the issuing company would then have an effective rate of 6½% for the remaining life of the bonds. If the market rate decreased even further during this five-year period, to 5½%, lower than the original market rate, the company could resell the bonds for \$94,937,675, an amount higher than the original issue price, and pay an effective rate of 5½% for the remaining life of the bonds.

If the bonds were repurchased at a loss because the market rate had decreased since the bonds were originally issued, the bonds could be held for resale in the future. However, in the interim holding period, the market rate could either decrease further or increase. If the market rate decreased further, the loss would be offset by an even lower interest to be paid once the bonds are reissued. However, during this interim period, the company would also avoid the payment of interest on the bonds that are not outstanding.

Using the same example, if the market rate had decreased to 5% during the ten-year period before the bonds were repurchased, they could be repurchased for \$100,000,000, a calculated loss of \$11,557,386. If the effective rate decreased even further to 4% over the next five years before the bonds were resold, they could be resold for \$111,198,228, significantly more than either the original issue price or the repurchase cost, and the company would then pay an effective rate of 4% until the bonds mature.

If the market rate increased after the bonds were repurchased but by the time the bonds are resold, the loss would still have been calculated at the time of the repurchase, and the interest payments would not be made on those bonds. However, depending on how high the market rate had increased, the company might resell the bonds and pay a rate that is lower than the original rate (if the rate increased from the repurchase date but is still lower than the original rate) or pay a rate higher than the original rate (if the market rate rises above the original rate).

Again, from the prior example, if the market rate went up from 5% at the date of repurchase to 5½% by the time the bonds were resold five years after the repurchase, the bonds would then be resold for \$94,937,675. Although this would be less than the amount paid to buy back the bonds, the company would have avoided \$25,000,000 of cash interest at the stated rate during that five years. If the market rate went up even higher to a rate above the original market rate, say 6½%, the reissue price would be only \$85,763,562, and the company would now pay an effective rate of 6½% until maturity. However, the company would still have saved \$25,000,000 of cash interest during the five years when the bonds were not outstanding.

Of course, a company would not necessarily need to repurchase all of its bonds, nor would it necessarily need to resell all of its repurchased bonds. Although the examples given above illustrate the entire face

value being repurchased or resold, any portion of the bonds could actually have been repurchased or resold, resulting in proportionate gains/losses and proportionate savings of cash interest at the stated rate.

Treatment of Gain or Loss

The repurchase of bonds for retirement results in the recognition of a gain or a loss in the income statement. This is true even if the bonds are repurchased through refinancing with newly issued bonds. Should the gain or loss on the repurchase of bonds be treated differently if the bonds are held for possible resale? And does the answer to that question depend on any specific holding period for these bonds before they are resold? For example, if they are resold immediately (or very soon after repurchase), would this be considered just an inappropriate earnings management effort, changing when or how the gain or loss should be recorded?

As with bonds repurchased for retirement, an argument can be made for the immediate recognition of the gain or loss if bonds are repurchased and held for resale. This assumption was applied in the examples given above. Other methods of accounting for the gain or loss could also be considered.

We wondered about recognizing the gain/loss immediately but reversing it out if the bonds are resold later before maturity. However, we found no satisfactory way to account for any reversal. If the gain or loss were reversed out later at the time of the reissuance, it seems that the reversal would need to be an adjustment to the discount or premium at the time of reissuance of the bonds. However, 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 for that company's bonds on that date.

Another idea is to defer the recognition of the gain/loss until the bonds are actually retired early, mature, or are reissued. Deferring the gain/loss in a Deferred Gain account (liability) or a Deferred Loss account (asset) also does not make much sense. However, unrealized holding gains on available-for-sale security investments are deferred from the income statement until the actual sale of the investment by including the deferred amount in other comprehensive income (OCI), which is closed into accumulated other comprehensive income (AOCI) in the stockholders' equity section of the balance sheet. 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, either through retirement, maturity, or reissuance. A deferral may better represent the intent of the organization to hold the bond for resale or later retirement, so that the recognition of the gain or loss more closely matches the final disposition of the instrument. One potential drawback of this method is that a company could arbitrarily choose when to declare the bonds retired, thus allowing earnings management at its discretion when it seemed most beneficial to recognize that gain or loss in the income statement.

Another idea is to defer the gain or loss and recognize it over the remaining (original) life of the bonds. This could again be done by putting the "unrealized" gain or loss in AOCI and gradually transferring it to the income statement over the remaining original life of the bonds. However, it again might make sense to recognize any remaining gain or loss at the time of retirement if the company formally retires its repurchased bonds, as the future life of the bonds would no longer have 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 the Repurchased Bonds

How should the repurchased bonds be treated on the balance sheet if they are held for possible resale? If the debt is retired, the actual liability is reduced, so an argument could be made that the debt should be reduced similarly for bonds repurchased but held for resale. After all, they are not currently outstanding.

Perhaps the repurchased bonds should be held in a contra liability account. This treatment would recognize that they are not currently outstanding but that they could possibly be resold later. This treatment would be similar to how treasury stock is presented in a contra equity account. However, it might be confusing to refer to these bonds as “treasury bonds,” as they could then be confused with (U.S.) Treasury bonds. On the other hand, it would also indicate a difference between bonds that are retired and derecognized compared to repurchased bonds that are held for possible resale.

Another possible way to classify these repurchased bonds would be in an investment asset account. While U.S. GAAP does not recognize treasury stock as an asset, might a company’s investment in its own bonds be recognized as an investment asset? It may be difficult to argue that you can invest in your own bonds and treat it as an asset. An asset is defined as something that provides future economic benefit. A company certainly would not pay itself interest. Perhaps the savings of interest to otherwise be paid could be considered a future economic benefit. However, 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. It would then make sense that a single company could not show both a liability owed to itself with a corresponding investment asset in that liability. In addition, if the bonds were still shown as a liability and also shown as investment assets on the same balance sheet, that could cause problems in the calculation of any financial ratios that use debt or assets as a factor in the ratio. Another argument against treating repurchased bonds as an asset is that deferred bond issuance costs used to be treated as an asset and written off over time, but now, these costs cannot be treated as an asset but are instead netted against the proceeds from the bonds, adjusting the premium or discount and the effective rate paid on the bonds.

DISCUSSION

The Financial Accounting Standards Board actually provides some guidance for bonds repurchased and not retired. Accounting Standards Codification 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.

However, ASC 405-20-41-1-a-4 lacks clarity, as the terms “treasury bond” or “treasury bonds” do not appear any other time in the Accounting Standards Codification except in reference to U.S. Treasury bonds. Therefore, 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 as well. Merriam-Webster includes two definitions of that term, with the two definitions being almost the opposite of each other. One definition is “commonly named,” with an example of “the so-called pocket veto.” The other definition is “falsely or improperly so named,” with an example of “deceived by a so-called friend” [7]. Therefore, it is not obvious whether the FASB is implying that “treasury bonds” is an improper name for a company’s bonds repurchased and held for resale or it is implying that it is a common name for such bonds. Since the term is not otherwise used in the codification, that may imply it is not a common name. However, since the term “treasury stock” is in common usage, it might be assumed that a company’s own bonds that are repurchased and held for resale could also be commonly called “treasury bonds,” even though they 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, and the specific way the tax code is worded often is used to determine legislative intent. Is the wording of the Accounting Standards Codification subject to the same careful look at definitions? For example, if a bond is repurchased to recognize a gain or loss and immediately resold, does that bond qualify as one that has been “held as” a so-called treasury bond? If not, is there any specific period of time that it would need to be held in order to qualify as having been held?

LEGAL CONCERNS

Just as with treasury stock, an entity needs to be cautious with the repurchase of bonds and watch for potential legal pitfalls. Insider trading accusations are of great concern, of course. An entity and its directors, officers, and certain shareholders are subject to Section 16 of the Securities and Exchange Act of 1934, Rule 10b-18, also known as the “safe harbor” rule, and Regulation FD [8][9]. In addition, care must be taken to avoid classification of the repurchase as a “tender offer” unless the tender offer rules are followed. U.S. securities law regulates tender offers but provides no definition of a tender offer, so our understanding of tender offers largely results from case law [3][11][15]. In addition to insider trading and tender offer issues, an organization must further be careful in order to not be accused of any other type of earnings management or earnings manipulations.

IMPLICATIONS AND LIMITATIONS

While it seems that the ASC cited above indicates that bonds repurchased and held for resale are derecognized and that any resulting gains or losses are immediately recognized, we think that 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. In addition, we feel that deferral of the gain/loss through AOCI should also be considered, with future recognition on the income statement as appropriate.

In comparing alternatives, possible earnings management opportunities should be considered, determining if they are appropriate or inappropriate. However, the implications of this paper may be limited, as we have yet to find a specific example of a company that has disclosed the repurchase of its own bonds without a corresponding retirement. On the other hand, companies have increasingly been looking for

legitimate methods to improve performance over time, 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 over time.

FURTHER RESEARCH

This paper has not covered the tax implications of repurchased bonds held for resale. An extension of this paper would be to investigate these tax implications. How should the gains/losses be treated for tax purposes if the bonds are held for resale rather than being retired?

This paper has also not looked at any empirical evidence about companies repurchasing their own bonds, either for retirement or for resale. Empirical research could investigate why companies buy back their own debt. What distinguishes these companies from other companies that do not buy back their own debt?

Another avenue for future pedagogical research is to write up a case on this topic for a graduate-level financial accounting/research course. This case could require the students to search the Accounting Standards Codification to find how repurchased bonds are handled if they are not retired. It could also require the students to present arguments for or against any other alternative accounting treatments that are presented in this paper. A separate case could be used in a graduate-level tax course to allow the students to research current tax law and argue the tax implications of bonds that have been repurchased but are not retired.

CONCLUSION

Companies may not frequently repurchase and retire their own bonds before maturity, but if they do, the concept of how to account for this early extinguishment is typically covered in intermediate accounting textbooks. However, these same textbooks do not discuss the treatment for bonds repurchased before maturity that are held for possible resale rather than being retired. Perhaps this type of transaction takes place so infrequently as to be unimportant to an already full topical coverage in the intermediate accounting sequence.

Even though accounting textbooks do not cover this type of treasury bond, the Accounting Standards Codification seems to have a definitive treatment for bonds repurchased and not retired. These bonds are derecognized in the financial statements, with a corresponding gain or loss recognized in the income statement. However, this paper has raised conceptual questions about whether this is the best possible method of accounting for this type of transaction, especially if the bonds are immediately or fairly immediately resold. Other accounting methods are presented that could be considered as alternatives to derecognition which might provide better information to financial statement users.

REFERENCES

[1] Boston, Claire and Black, Thomas (2019). GE Plans \$5 Billion Debt Buyback to Help Tame Balance Sheet, Bloomberg, September 12, <https://www.bloomberg.com/news/articles/2019-09-12/ge-plans-5-billion-debt-buyback-to-help-tame-balance-sheet>

[2] Financial Accounting Standards Board (FASB). Accounting Standards Codification (ASC).

- [3] Girouard, John E., Are Corporate Buybacks Basically Just Insider Trading? (And Other Questions You're Afraid To Ask) Forbes.com May 11, 2018, [Intelligent Investing](https://www.forbes.com/sites/investor/2018/05/11/are-corporate-buybacks-basically-just-insider-trading-and-other-questions-youre-afraid-to-ask/#4718deede16f) Contributor Group, <https://www.forbes.com/sites/investor/2018/05/11/are-corporate-buybacks-basically-just-insider-trading-and-other-questions-youre-afraid-to-ask/#4718deede16f>
- [4] Hanlon, Michelle, Leslie Hodder, Karen Nelson, Darren Roulstone, and Amie Drago (2020). *Intermediate Accounting*, 2nd ed., Westmont, IL: Cambridge Business Publishers.
- [5] <https://ams.com/-/03-12-2019-repurchase-of-convertible-bonds>
- [6] <https://ams.com/documents/20143/2234347/Q2+2019+ams+report+english+f.pdf/b9d63624-1d24-f12a-ccf8-0d0e84eae080?t=1563856181228>
- [7] <https://www.merriam-webster.com/dictionary/>
- [8] <https://www.sec.gov/rules/final/33-8335.htm>
- [9] <https://www.sec.gov/smallbusiness/goingpublic/officersanddirectors>
- [10] Kieso, Donald E., Jerry J. Weygandt, and Terry D. Warfield, (2019). *Intermediate Accounting*, 17th ed., Hoboken, NJ: John Wiley & Sons, Inc.
- [11] [Schulte Roth & Zabel LLP](https://www.lexology.com/library/detail.aspx?g=1f26932c-9366-4119-a9b9-9551ffe6374a), Making lemonade from lemons: issuer bond repurchases, [USA](https://www.lexology.com/library/detail.aspx?g=1f26932c-9366-4119-a9b9-9551ffe6374a) April 7 2009, <https://www.lexology.com/library/detail.aspx?g=1f26932c-9366-4119-a9b9-9551ffe6374a>
- [12] Spiceland, J. David, Mark W. Nelson, and Wayne B. Thomas (2020). *Intermediate Accounting* 10th ed., New York, NY: McGraw-Hill Education.
- [13] Stice, James D and Earl K. Stice (2014). *Intermediate Accounting*, 19th ed., Mason, OH: South-Western Cengage.
- [14] Vale unveils bond buyback (2019). September 13, <https://www.latinfinance.com/daily-briefs/2019/9/13/vale-unveils-bond-buyback>
- [15] White & Case, Bond Repurchases – An Issuer’s Guide to Questions to Ask and Points to Consider, 25 Oct 2018, <https://www.whitecase.com/publications/alert/bond-repurchases-issuers-guide-questions-ask-and-points-consider>