

RECAPITALIZATION ACCOUNTING IN COMPANIES

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Financial reconstruction, or reorganization, made its appearance in Vietnam in 1992 after the policy on privatization (or equitization) was adopted. This policy, at first, aimed at altering ownership, from public to private one, of companies. After 13 years, this project only made poor progress because of insolvable financial problems in state-owned companies. In 2002, to support this project, the Government established DATC (Debt and Asset Trading Corporation), a financial intermediary whose main function is to trade in debt and asset of companies through direct agreements, tendering or decisions by authorities. In 2004, the NA passed the Bankruptcy Law and Chapter 6 of the law states that companies that lose their solvency and go bankrupt are allowed to carry out recapitalization and operate again after reaching agreement with creditors in a maximum period of three years. Although this operation has existed for a long time, record and presentation of financial information of such transactions have not been mentioned fully and timely in the accounting system, which makes it difficult for companies to present such transactions in their ledgers. By analyzing financial nature of the recapitalization, this article tries to offer measures to perfect methods of recording and presenting information about recapitalization in companies to serve the State control.

1. Recapitalization: a financial solution of companies in periods of recession

In operation process, when companies reach their peak, a period of recession may appear before a new stage starts. At the bottom of the recession period is beginning of a new stage of development when important reform takes place. If the reform brings about breakthrough in expansion of business operation and major changes in strategy, human resource and finance, it can be called recapitalization. The recapitalization takes place in all operations and departments of the company, from administrative, finance, distribution network and personnel to merger, division, or transfer of ownership. The recapitalization may be financial or operational. The operational recapitalization includes revolutions in strategy, market and products that change radically organization and management in the company. Financial recapitalization comprises basic changes in capital structure and owners taking place during processes of improving the debt-to-equity ratio, acquisition, merger, division, or changing into public or private companies. Because of complexity of the problem, this article only aims at analyzing the financial recapitalization in aspects of reconstruction of capital structure, record and presentation of information about the recapitalization in financial statement in a transparent and lawful manner.

Capital structure is the relation between debt

and capital in a company. Ways of using owner's equity and debt affect risks and profit the company receives in future. When the company finances its capital with debt it may enjoy two benefits: saving taxes by gaining interest deductibility, and avoiding division of profit when earned because income from debts is fixed. Using the debt, however, may increase risks and lead to disadvantages when profit earned is not big enough to pay interest with the result that shareholders should cover this loss to save the company from bankruptcy.

According to this requirement, the recapitalization takes place when the company takes action to change the proportion of equity capital to debt capital to gain an optimal capital structure or maintain survival of the company. The optimal capital structure here is the one that maximizes the price of shares of the company. Identifying an optimal structure of capital for a company, in fact, is very difficult, therefore companies tend to set a target structure of capital at a fixed ratio, and when the real capital structure move away from this ratio to a certain extent it may affect the price of shares or profit of the company. Recession of the company shows itself in falls in the price of shares on the market or in its profit. These falls are partly affected by the capital structure, which encourages the corporate management to adopt the recapitalization to bring the capital structure back to the target one with a view to bringing its shares back to their inner value by issuing more shares to pay some debts and starting using owner's equity.

If debt represents a large share in the capital structure, the company may meet with difficulties dealing with business risks and it may fall into recession quickly if its cash flow is reduced to so a low level that it can't repay debts when due and it may be on the brink of bankruptcy then. Deciding to recapitalize the company or have it declared bankrupt depends on whether its value after the recapitalization is bigger than the liquidation value. If recession of the company is independent, creditors will negotiate with the management about programs and terms of recapitalization, including changes in debt agreements, such as grace period, reduced interest rate, longer term of repayment, cuts in principal, change from debt into capital or repayment of debt by transferring as-

sets whose value is lower than the debt. If the company suffers effects of the economic recession at regional or global level and it needs governmental intervention, the government can establish a recapitalization board inside or outside the banking system specializing in buying bad debts from commercial banks, transferring debts into owner's equity and then participating in the recapitalization of the company (debtor) and retrieving its investment buy selling their equity when the recapitalization is successful.

2. Legal regulations and recapitalization in Vietnam

Because of lack of statistics of losses caused by the 2008 crisis, the article can only analyze the recapitalization in the wake of the Asian financial crisis in 1997-98. This crisis caused a lot of damage for Asian economies and left huge bad debts in banking systems because a series of companies might go bankrupt without help from governments. Data about doubtful debt in major Asian economies according to Ernst & Young are as follows:

Table 1: Doubtful debt in major Asian economies

	Debt sold after Asian financial crisis	Debt unsolved in government's debt management corporations	Debt in financial institutions
Japan	600	112	330
China	200	107	307.0*
Taiwan	50	n/a	19.1
Thailand	95	5	18.8
Indonesia	37	5	16.9
South Korea	125	45	15.0

* Reorganized, reclassified, returned, transferred or written-off

Source: Ernst & Young

Total bad debt of major economies was estimated roughly at US\$2,000 billion and it would be difficult to recover from the crisis if this huge debt were not solved. Realizing this, the preferred solution taken by Asian governments in 1997-98 was to establish debt management agencies, such as IBRA (Indonesian Bank Restructuring Agency), AMC (Asset Management Company) in Malaysia, and KAMCO (KIPCO Asset Management Com-

pany) in South Korea, etc. Reorganization agencies buy bad debts of companies from banking systems to save commercial banks. When banks are unburdened of doubtful debts, they can finance recapitalization projects of companies to help them recover from the economic recession. Other policies of governments also help companies to recover. Reorganization agencies carry out recapitalization in companies, turn debts into owner's equity and resell them when companies recover successfully. Up to 2005, most reorganization agencies stopped operating with some US\$1,000 billion worth of bad debt sold. For example, IBRA went out of in 2005 after settling 95% of bad debt.

Vietnam was affected more by the privatization than by the Asian financial crisis. The privatization is a policy to reorganize most of state-owned companies to generate a new dynamic of development and provide more commodities for the stock market. From 1990, the market economy was adopted in Vietnam when most companies were owned by the State and suffered from poor performance. To develop the economy according to economic laws and secure support from such financial institutions as IMF, WB and ADB, Vietnam should carry out some reforms as suggested by donors; and the privatization is one of such reforms.

Up to 2008, some 3,000 companies of small and medium sizes have been privatized and some 2,000 others were in the waiting list for 2010. The privatization was slow and met with difficulties because of losses, doubtful debts, poor performance and unsolvable financial problems. To accelerate this program, the Government established the

DATC in 2003. Up to 2009, DATC took over VND2,944.2 billion worth of debt and excluded assets (assets excluded from the value of the company) from 2,284 companies comprising VND1,293.5 billion worth of debt and 1,659.7 billion of assets. At present, DATC has finished taking over debts and assets excluded from the privatized company's value. In 2009, DATC signed 56 contracts to buy VND694.38 billion worth of debts and earned VND370.2 billion from settlement of these debts and assets. Taking its operations up to 2009 into account, DATC has bought VND6,577.38 billion worth of debt and asset from commercial banks and other creditors. Most of its buying contracts are associated with plans to settle the debt by reorganization and transfer of ownership. Main measures taken by DATC are to rearrange the term of repayment, write off part of debts owed by the companies, recapitalize, and persuade strategic investors who invest in the companies after privatization and turn the company into a joint-stock one as a major shareholders. After the recapitalization and turning the privatized company into a joint-stock one, DATC, as a creditor and owner, starts reorganize the company. All successfully reorganized companies, such as SADICO Cần Thơ, Procimex Vietnam, Sơn La Sugar Joint Stock Company, and Kon Tum Sugar Joint Stock Company, have come into operation and gained enough profit to repay debts (including repayment of debt to DATC).

Thus, financial reconstruction has become common in Vietnam since 1992 after the policy to privatize the state-owned companies was introduced. The reorganization at first concentrated on change in the ownership, and then complicated financial

problems in the company to be privatized required the recapitalization because many of them were insolvent and burdened with so huge losses or bad debts that they couldn't be privatized. That is why they need recapitalization before reorganization and change in ownership. Realizing this, 13 years after the first decision on the privatization, the Government made the Decision 109/2003/ QĐ-TTg on June 5, 2003 to establish DATC – a financial intermediary that helps state-owned companies deal with their financial problems. DATC handling of such problems is carried out according to Circular TT39/2004/TT-BTC issued on May 11, 2004 by Ministry of Finance, and after six years, purchase of debt linked with reorganization of companies carried out by DATC proved effective. Many corporate debtors after the reorganization have improved remarkably, gain better performance and accumulated enough profit to repay all their debts to DATC before their maturity.

As for the reorganization because of bankruptcy declared by court, it is carried out according to decisions of creditors as stipulated by Section 1, Chapter 6 of the Bankruptcy Law (No 21QH/2004 passed on June 5, 2004) that allows the company to recapitalize and return to operation after necessary agreement with creditors in a maximum period of three years. This is a legal basis for the recapitalization under supervision of the court.

In addition, when the company notices that its capital structure deviates from its target structure to such an extent that it reduces its profit or prices of its shares, it can alter its capital structure in order to maintain a suitable financial state to maximize the value of its shares.

Regarding the legal infrastructure of the recapitalization, many pieces of subordinate legislation have come into effect but they are not sufficient and consistent. They are limited to regulations about the state control and implementation of the recapitalization and while one of important problems - record, presentation and disclosure of the recapitalization process – is not included in regulations of the accounting system. Companies when carrying out transactions of this kind have to work out their own criteria for recording and presenting such information in their financial statement because of lack of standard regulations, which affects negatively rationality and honesty of information in the financial statement after the recapitaliza-

tion. Disclosure of information about the recapitalization is not mentioned, which damages transparency of reorganized companies. This is also one of causes that hinders the privatization. Companies face many obstacles when dealing with financial problems and they usually have to wait for a long time for decisions or approvals from authorities. Thus, perfecting mechanisms and legal infrastructure is an urgent task now.

3. Recapitalization accounting

While necessary pieces of subordinate legislation about the recapitalization accounting are still lacking, the article wants to suggest criteria for recording and presenting information about the recapitalization based on current regulations on financial management and realities of the recapitalization with a view to helping companies record and present their recapitalization in the financial statement.

a. Recapitalization method:

If the capital structure is unreasonable, the company can issue more shares to settle bonds and repay debts, or issue bonds to repurchase its shares.

When the recapitalization takes place because of need for special financial handling in order to maintain corporate operations, the company should value debts and its resources used for repayment of debts, and agree with creditors about the reorganization according to the following methods:

- Settling debts using cash or assets whose value is smaller than the debt.
- Turning debts into owner's equity.
- Changing debt agreements, such as prolonging the term of payment, and/or reducing the interest rate and principal, etc.
- Combining the said methods.

b. Accounting principles:

Recapitalization accounting records reasonable value of altered capital and debts or value agreed upon by debtor and creditor (or debt buyer or reorganization agency). Difference between reorganized capital and debts could be recorded in item "owner's equity" on the balance sheet or in income or expense on the business result report. Because the recapitalization is not a business transaction but a process of altering rights and obligations of the company towards owners and creditors, bene-

fits received must be treated as owner's equity (positive variance is recorded under premium on capital stock) while negative variance is a loss caused by the reorganization, therefore it is not added to the owner's equity and should be recorded in the present period (that is, period expense) according to the following rules:

- Recapitalization as part of the development strategy of the company in future by issue of bonds, repurchase of shares, or settlement of bonds by issuing more shares is recorded according to fair value of debt or issued capital.

- When the recapitalization is carried out by turning a debt into owner's equity, this increase will be registered in the "owner's equity" item and a corresponding decrease must be recorded in liability item, and difference between reorganized debt and total debt on the ledger is considered as premium on capital stock.

- When reorganizing the company by restructuring debt-related items, if the reorganized debt is greater than future payment, decrease in the debt may be recorded as a sum payable, the difference as premium on capital stock. If the reorganized debt is smaller than the future payment no adjustment is necessary. Expenses arising from the reorganization process can be entered under future payment, and when these expenses take place a decrease in the reorganized debt could be recorded.

c. Recording the recapitalization accounting:

Case 1: The recapitalization based on development strategy of the company:

- The company issues shares to pay bonds and debt, an increase in the owner's equity mobilized according to fair value (issue price of shares or acceptable value of paid-in capital) could be made along with an entry of amount received from the mobilization of capital.

Liability Acc. 111 – Cash

Liability Acc. 112 – Cash in bank

Asset Acc. 411 (4111) Sources of capital (Owner's investment)

Asset/Liability Acc. 411 (4112) – Source of capital (Premium on capital stock)

When the company repays debt or bonds at their maturity, accountants record a decrease in debt along with the sum used for repaying arising

debts:

Liability Acc. 341, 342, 343...

Asset Acc. 111 – Cash

Asset Acc. 112 – Cash in bank

- The company issues shares or gets loans to buy treasury stocks, enter issued bonds according to their fair value (issue price or accepted value of loan) and the sum received from the mobilization of capital.

Liability Acc. 111 – Cash

Liability Acc. 112 – Cash in bank

Liability Acc. 343 (3432) – Bond issued (Bond discount)

Asset Acc. 343 (3431) Bond issued (Face value of bond)

Asset Acc. 343 (3433) Bond issued (Bond premium)

When the company uses proceeds from bonds to purchase treasury stock, accountants record an increase in fair value of treasury stocks (buying price plus costs) and a decrease because of the sum spent on these stocks.

Liability Acc. 419 – Treasury stock

Asset Acc. 112 – Cash in bank

Asset Acc. 111 – Cash

Case 2: Recapitalization based on agreements with creditors under supervision of court:

- According to agreements with creditors, debts are turned into owner's equity, an increase in source of capital is recorded and difference between reorganized debt and owner's equity is recorded under premium on capital stock.

Liability Acc. 331, 311, 341, 342, 343...

Asset Acc. 411 (4111) – Source of capital (Owner's investment)

Asset Acc. 411 (4112) – Source of capital (Premium on capital stock)

- When repayment in cash is smaller than the principal according to the agreement, accountant record part of debt paid, and difference between the principal and paid reorganized debt is recorded under premium on capital stock.

Liability Acc. 331, 311, 341, 342, 343...

Asset Acc. TK 111,112

Asset Acc. 411 (4112) – Source of capital (Premium on capital stock).

- When the debt is settled as agreed using some

asset whose value is smaller than the principal, accountants record the repaid debt while the difference between the principal and the reorganized debt already paid is treated as premium on capital stock, difference between book value of the asset and the value settled as periodic income (the part of asset value used for repaying the debt is estimated as smaller or greater than the value of reorganized debt already paid):

Liability Acc. 331, 311, 341, 342, 343...

Liability Acc. 214 – Wear and tear

Asset Acc. 152, 153, 211, 217, 221...

Asset Acc. 411(4112) – Source of capital
(Premium on capital stock)

Asset Acc. 711 (Liability 811) – Other incomes (Other expenses)

- If both parties agree to reorganize the company by restructuring debt-related provisions, and the reorganized debt is greater than the future payment, accountants record the debt as future payable and the difference as premium on capital stock. When the recapitalization entails expenses payable in future, accountants record these expenses along with an increase under payable. When settling these expenses, a decrease in the reorganized debt should be recorded. If these expenses are exempted, an increase in the premium on capital stock is recorded. The decrease in reorganized debt should be equal to future payable.

Liability Acc. 331, 311, 341, 342, 343...

Asset Acc. 411 (4112) – Source of capital
(Premium on capital stock)

When the recapitalization produces expenses payable in future:

Liability Acc. 242 – Prepaid expenses

Liability Acc. 811 – Other expenses

Asset Acc. 341, 342...

When settling recapitalization expenses:

Liability Acc. 331, 311, 341, 342, 343...

Asset Acc. 112 – Cash in bank

When expenses are exempted, they are transferred to premium on capital stock:

Liability Acc. 341, 343...

Asset Acc. 411 (4112) – Source of capital
(Premium on capital stock)

Case 3: Recapitalization through financial intermediary:

Creditors sell unpaid debts to DATC. It be-

comes a new creditor and reaches agreements with ex-creditors about provisions of recapitalization and handling of unsolved problems to help the company resume its operation and turns part of debt into owner's equity. After succeeding in recapitalization, DATC sells its equity in the reorganized company to get back its investment.

- Transferring debts from various creditors to the debt management company, details of debts transferred from old creditors to the new one must be recorded.

- As for receivables that can't be acquired but can be sold to the new creditor, details of debts transferred to new debtors must be recorded. When the buyer of debt makes repayment, a decrease in debt receivable and an increase in cash due to retrieval of debt must be recorded.

- If the agreement allows a write-off, accountant record the written-off amount and an increase in income from agreement-based financial settlement:

Liability Acc. 311, 341, 342, 343...

Asset Acc. 711 – Other incomes

- If the agreement allows debts to be turned into owner's equity, the said amount of debt will be recorded under source of capital, and difference between reorganized debt and owner's equity under premium on capital stock:

Liability Acc. 331, 311, 341, 342, 343...

Asset Acc. 411 (4111) – Source of capital
(Owner's investment)

Asset Acc. 411 (4112) – Source of capital
(Premium on capital stock)

- When all parties agree to restructure debt-related provisions and the organized debt is greater than the future payable, accountants register a decrease in the debt turning it into future payable, and the difference is recorded under premium on capital stock.

+ Reducing the reorganized debt to the future payable:

Liability Acc. 331, 311, 341, 342, 343...

Asset Acc. 411 (4112) – Source of capital
(Premium on capital stock)

When the recapitalization produces expenses as future payables, such expenses should be recorded along with an increase in liabilities (payables). When these expenses are settled, ac-

countants record a decrease in the reorganized debt (debit balance). If the expenses are exempted, add an increase to premium on capital stock.

Liability Acc. 242 – Prepaid expenses

Liability Acc. 811 – Other expenses

Asset Acc. 341, 342...

When settling recapitalization expenses, make entries in:

Liability Acc. 331, 311, 341, 342, 343...

Asset Acc. 112 – Cash in bank

If expenses are exempted, they are added to premium on capital stock:

Liability Acc. 341, 343...

Asset Acc. 411 (4112) – Source of capital (Premium on capital stock)

After recapitalization and handling of financial problems, the company can be privatized. The privatization and handling of unsolved assets are carried out according to Decree 187/2004/NĐ-CP dated Nov. 16, 2004 and Circular 106/2008/TT-BTC dated Nov. 18, 2008 that provide guidelines for accountants on the privatization.

d. Presentation of financial statement

Information about reorganized capital is presented in the financial statement under liabilities and owner's equity based on data initially recorded in agreements between parties during the recapitalization. The premium on capital stock during the recapitalization is interpreted separately from the reorganized source of capital.

e. Disclosure of information

The company should disclose all information about reorganized capital according to the following contents:

- Recapitalization method

- Total premium on capital stock recorded during the recapitalization

- Increases in source of capital arising from the process of changing debt to capital

- Expenses arising from the recapitalization

The above-mentioned opinions may be useful for the joint effort to perfect the accounting system needed for the recapitalization and further development of companies in Vietnam■

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