

Value Relevance of Troubled Debt Restructurings and Its Policy Implications

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Abstract:

This paper investigates the market and accounting based valuation effects of troubled debt restructurings (TDR) in financially distressed debtor firms. I first rely on extant valuation theories to predict the impact of a TDR on shareholders' wealth. Next, some empirical evidence on the beneficial outcomes and informativeness of TDR is provided: significantly positive announcement and post-announcement excess returns and higher excess returns to subsequently consummated restructurings and subsequent survivors. The paper also provides a comprehensive critique of SFAS No. 15, the current generally accepted accounting principle (GAAP) on troubled debt restructurings. Since this long-criticized GAAP requires different reporting practices for full-settlement and modification type restructurings, the market's assessment of their impact on returns is also measured. Finally, a valuation model conditional on book values and earnings is used to test the value relevance of the reported financial statement bottom lines and TDR related disclosure. I find that the amount of debt restructured disclosed in the footnotes is more value relevant than the restructuring gain recognized in the income statement. The results suggest that modification of the terms of the outstanding debt is at least as beneficial and informative as its full settlement. Results also lend support to prior studies that have found that earnings are less value relevant than reported book-values in financially distressed loss firms. The policy implication is that the recognition of the reduction in the outstanding liability and the related gain in the financial statements of TDR firms that undertake modifications would be more congruent with the valuation effects assessed by market participants.

Keywords: Private workouts, financial distress, debt restructuring, valuation, capital markets, GAAP, SFAS No.15