**\*E14-21 (Term Modification without Gain—Debtor’s Entries)**

On December 31, 2010, the American Bank enters into a debt restructuring agreement with Barkley Company, which is now experiencing financial trouble. The bank agrees to restructure a 12%, issued at par, $3,000,000 note receivable by the following modifications:

**1.** Reducing the principal obligation from $3,000,000 to $2,400,000.

**2.** Extending the maturity date from December 31, 2010, to January 1, 2014.

**3.** Reducing the interest rate from 12% to 10%.

Barkley pays interest at the end of each year. On January 1, 2014, Barkley Company pays $2,400,000 in cash to Firstar Bank.

**Instructions**

**(a)** Will the gain recorded by Barkley be equal to the loss recorded by American Bank under the debt restructuring?

**(b)** Can Barkley Company record a gain under the term modification mentioned above? Explain.

**(c)** Assuming that the interest rate Barkley should use to compute interest expense in future periods is 1.4276%, prepare the interest payment schedule of the note for Barkley Company after the debt restructuring.

**(d)** Prepare the interest payment entry for Barkley Company on December 31, 2012.

**(e)** What entry should Barkley make on January 1, 2014?

**E21-7 (Lessee-Lessor Entries, Sales-Type Lease)**

On January 1, 2011, Palmer Company leased equipment to Woods Corporation. The following information pertains to this lease.

**1.** The term of the noncancelable lease is 6 years, with no renewal option. The equipment reverts to the lessor at the termination of the lease.

**2.** Equal rental payments are due on January 1 of each year, beginning in 2011.

**3.** The fair value of the equipment on January 1, 2011, is $200,000, and its cost is $150,000.

**4.** The equipment has an economic life of 8 years, with an unguaranteed residual value of $10,000. Woods depreciates all of its equipment on a straight-line basis.

**5.** Palmer sets the annual rental to ensure an 11% rate of return. Woods’s incremental borrowing rate is 12%, and the implicit rate of the lessor is unknown.

**6.** Collectability of lease payments is reasonably predictable, and no important uncertainties surround the amount of costs yet to be incurred by the lessor.

**Instructions:**

(Both the lessor and the lessee’s accounting period ends on December 31.)

**(a)** Discuss the nature of this lease to Palmer and Woods.

**(b)** Calculate the amount of the annual rental payment.

**(c)** Prepare all the necessary journal entries for Woods for 2011.

**(d)** Prepare all the necessary journal entries for Palmer for 2011.