New Debt Extinguishment Guidance

In May 2017, the Governmental Accounting Standards Board (GASB) released Statement No. 86, *Certain Debt Extinguishment Issues.* Governments currently account for certain debt extinguishments differently than bond refundings, depending on the resources used. Under the new rules, the treatment will be similar whether a government borrows to extinguish a debt or uses existing resources. In addition, Statement 86 adds a few new requirements for any debt extinguishment or in-substance defeasance.

Background

Current GASB standards provide guidance on debt extinguishment and refunding. Statement 62 provides guidance for each of these circumstances:

- Debt is extinguished using exclusively a government's existing resources (not resources from debt proceeds)
- Debtor is legally released from being the primary obligor under the debt

Statement 7 and Statement 23 provide guidance for debt refundings, in which new debt is issued and the proceeds repay old debt. Debt refundings fall into two broad categories:

- Current refundings – proceeds of new debt immediately repay old debt
- Advance refundings – proceeds of new debt are placed into an irrevocable trust with an escrow agent and invested until they are used to pay the government's old debt at a future time; the amount of new debt proceeds invested in escrow must be sufficient to meet the interest and principal payments on old debt

Governments currently account for what is essentially the same transaction in two different ways, depending on the resources used to retire a debt obligation.

In-Substance Defeasance

Defeasance is a provision that voids a bond or loan when the borrower sets aside cash or bonds sufficient to service the borrower's debt. Advance refundings generally result in the in-substance defeasance of debt, in which debt is considered defeased for accounting and financial reporting purposes even though a legal defeasance has not occurred. Defeased debt—both legal and in-substance—and the related assets placed in trust to repay the debt are no longer reported on the face of the financial statements. Governments are required to disclose information in the financial statement notes about debt defeased in substance. Statement 86 establishes the same requirements if a government places only existing resources in a trust to extinguish the debt.

"Whether you borrow the money to extinguish the debt or use cash you already have, the treatment ought to be the same because the economic substance of the transaction is the same," said GASB Chair David A. Vaudt. "From a government's perspective, the source of the money that is being used to refund debt should not matter as long as the requirements for in-substance defeasance are met."

Recognition & Presentation

When only existing resources are placed in escrow for debt repayment, the difference between the reacquisition price (amount required to be placed in the trust) and the net carrying amount of the old debt would be immediately recognized in the period the transaction occurs. The flows statements would present the difference as a separate gain or loss. Payments to the escrow agent made from existing resources should be reported as debt service expenditures in financial statements.

Governments that defease debt using only existing resources would provide a general description of the transaction in the notes to the financial statements in the period of the defeasance, *i.e.*, the amount of the debt, cash or other assets placed in escrow, the reasons for the defeasance and the cash flows required to service the debt. In subsequent periods, only the amount of remaining debt outstanding at period-end would be disclosed. For subsequent periods, governments would be able to combine the debt amounts defeased in substance using refunding bond proceeds with debt defeased in substance with existing resources.

Prepaid Insurance

Governments often obtain insurance on debt to gain a lower interest rate. GASB Statement No. 65, *Items Previously Reported as Assets and Liabilities*, removed the specific authoritative guidance on how to treat prepaid insurance on extinguished debt. Under the new rules, a government extinguishing debt (either a legal extinguishment or an in-substance defeasance) would include any remaining prepaid insurance related to the extinguished debt in the net carrying amount of that debt to calculate the difference between the reacquisition price and the net carrying amount of the extinguished debt.

Disclosure

New disclosure would be required if a government is not prohibited from substituting escrowed trust investments with non-risk-free assets. The aggregate amount of related defeased debt covered by the substitutable investments would be disclosed as long as the defeased debt remains outstanding. The amount would be disclosed separately from the total amount of debt defeased in substance that remains outstanding.

Effective Date & Transition

The standard is effective for periods beginning after June 15, 2017, with earlier adoption encouraged. Transition would be on a retroactive basis, if practicable.

For more information, contact your BKD advisor.

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