GASB Exposure Draft

August 22, 2016

Comments Due: October 28, 2016

Proposed Statement

of the Governmental Accounting Standards Board

Certain Debt Extinguishment Issues

This Exposure Draft of a proposed Statement of Governmental Accounting Standards is issued by the Board for public comment. Written comments should be addressed to:

Director of Research and Technical Activities
Project No. 19-25E

Governmental Accounting Standards Board

CERTAIN DEBT EXTINGUISHMENT ISSUES

WRITTEN COMMENTS

Deadline for submitting written comments: October 28, 2016

Requirements for written comments. Comments should be addressed to the Director of Research and Technical Activities, Project No. 19-25E, and emailed to director@gasb.org or mailed to the address below.

OTHER INFORMATION

Public hearing. The Board has not scheduled a public hearing on the issues addressed in this Exposure Draft.

Public files. Written comments will become part of the Board's public file and are posted on the GASB's website.

Orders. This Exposure Draft may be downloaded from the GASB's website at www.gasb.org. For information on prices for printed copies, please contact the Order Department at the following address:

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Notice to Recipients of This Exposure Draft

The Governmental Accounting Standards Board (GASB) is responsible for (1) establishing and improving standards of state and local governmental accounting and financial reporting to provide useful information to users of financial reports and (2) educating stakeholders—including issuers, auditors, and users of those financial reports—on how to most effectively understand and implement those standards.

The due process procedures that we follow before issuing our standards and other communications are designed to encourage broad public participation in the standards-setting process. As part of that due process, we are issuing this Exposure Draft setting forth a proposed Statement that would establish standards on certain issues related to accounting and reporting for debt extinguishment transactions.

We invite your comments on all matters in this proposed Statement. Because this proposed Statement may be modified before it is issued as a final Statement, it is important that you comment on any aspects with which you agree as well as any with which you disagree. To facilitate our analysis of comment letters, it would be helpful if you explain the reasons for your views, including alternatives that you believe the GASB should consider.

All responses are distributed to the Board and to staff members assigned to this project, and all comments are considered during the Board's deliberations leading to a final Statement. In deciding on changes in accounting and financial reporting standards, the GASB also takes into consideration the costs of preparing and reporting the information and its benefits to users of financial statements. When the Board is satisfied that all alternatives have adequately been considered, and modifications have been made as considered appropriate, a vote is taken on the Statement. A majority vote is required for adoption.

Summary

The objective of this proposed Statement is to improve consistency in accounting and financial reporting for transactions in which only existing resources—resources other than the proceeds of refunding debt—are placed in a trust for the sole purpose of extinguishing debt. This proposed Statement also would improve accounting and financial reporting for prepaid insurance on debt that is extinguished and notes to the financial statements for debt that is defeased in substance.

Accounting and Financial Reporting for In-Substance Defeasance of Debt Using Only Existing Resources

Statement No. 7, *Advance Refundings Resulting in Defeasance of Debt*, requires that debt be considered defeased in substance if the debtor irrevocably places refunding debt proceeds with an escrow agent in a trust to be used solely for satisfying scheduled payments of both principal and interest of the defeased debt. The trust also is required to meet certain conditions for the transaction to qualify as an in-substance defeasance. This proposed Statement would establish essentially the same requirements if a government places only existing resources in a trust to extinguish the debt. Any difference between the reacquisition price (the amount required to be placed in the trust) and the net carrying amount of the debt defeased in substance using only existing resources would be recognized as a separately identified gain or loss in the period of the defeasance in financial statements using the economic resources measurement focus.

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. In all periods following an in-substance defeasance of debt using only existing resources, the amount of that debt that remains outstanding at period-end would be disclosed.

Prepaid Insurance Related to Extinguished Debt

For governments that extinguish debt, whether through a legal extinguishment or through an in-substance defeasance, this proposed Statement would require that any remaining prepaid insurance related to the extinguished debt be included in the net carrying amount of that debt for the purpose of calculating the difference between the reacquisition price and the net carrying amount of the debt.

Notes to Financial Statements for In-Substance Defeasance Transactions

One of the criteria for determining an in-substance defeasance is that the trust be limited to holding only monetary assets that are classified as being essentially risk-free. If the substitution of essentially risk-free monetary assets with monetary assets that are not essentially risk-free is not prohibited, governments would disclose that fact in the period in which the debt is defeased in substance. In subsequent periods, governments would disclose the amount of debt defeased in substance that remains outstanding for which that risk of substitution exists.

Effective Date and Transition

The requirements of this proposed Statement would be effective for reporting periods beginning after June 15, 2017. Earlier application would be encouraged.

How the Changes in This Proposed Statement Would Improve Accounting and Financial Reporting

The requirements of this proposed Statement would increase consistency in accounting and financial reporting for debt extinguishments by establishing uniform guidance for derecognizing debt that is defeased in substance, regardless of whether existing resources or refunding debt proceeds are placed in a trust for the purpose of extinguishing that debt. The requirements of this proposed Statement also would enhance consistency in financial reporting of prepaid insurance related to debt that has been extinguished. In addition, this proposed Statement would enhance the decision-usefulness of information in notes to financial statements regarding debt that has been defeased in substance.

Unless otherwise specified, pronouncements of the GASB apply to financial reports of all state and local governmental entities, including general purpose governments; public benefit corporations and authorities; public employee retirement systems; and public utilities, hospitals and other healthcare providers, and colleges and universities. Paragraph 2 discusses the applicability of this Statement.

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INTRODUCTION

1. The objective of this Statement is to improve consistency in accounting and financial reporting for certain debt extinguishments.

STANDARDS OF GOVERNMENTAL ACCOUNTING AND FINANCIAL REPORTING

Scope and Applicability of This Statement

2. This Statement establishes standards of accounting and financial reporting for transactions in which only existing resources—that is, resources other than the proceeds of refunding debt—are placed in a trust for the purpose of extinguishing debt. This Statement also amends accounting and financial reporting requirements for prepaid insurance associated with debt that is extinguished. Finally, this Statement establishes an additional disclosure requirement related to debt that is defeased in substance. The requirements of this Statement apply to financial statements of all state and local governments.

3. This Statement amends Statement No. 7, *Advance Refundings Resulting in Defeasance of Debt,* paragraph 4; Statement No. 23, *Accounting and Financial Reporting for Refundings of Debt Reported by Proprietary Activities,* footnote 4; Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments,* paragraphs 22 and 24; Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements,* paragraphs 124 and 127; and Statement No. 65, *Items Previously Reported as Assets and Liabilities,* footnote 3.

Accounting and Financial Reporting for In-Substance Defeasance of Debt Using Only Existing Resources

4. Debt is considered defeased in substance for accounting and financial reporting purposes if the government irrevocably places only existing resources—that is, resources other than the proceeds of refunding debt—with an escrow agent in a trust to be used solely for satisfying scheduled payments of both interest and principal of the defeased debt, and the possibility that the government will be required to make future payments on the debt is remote. The trust is restricted to owning only monetary assets that are essentially risk-free as to the amount, timing, and collection of interest and principal. The monetary assets should be denominated in the currency in which the debt is payable. For debt denominated in U.S. dollars, essentially risk-free monetary assets are limited to:

a. Direct obligations of the U.S. government
b. Obligations guaranteed by the U.S. government
c. Securities backed by U.S. government obligations as collateral and for which interest and principal payments on the collateral generally flow immediately through to the security holder.

In addition, the monetary assets held by the trust are required to provide cash flows (from interest and maturity of those assets) that approximately coincide, as to timing and amount, with the scheduled interest and principal payments on the defeased debt. However, some securities described above can be paid before their scheduled maturities and so are not essentially risk-free as to the timing of the collection of interest and principal.[1] As a result, they do not qualify for defeasance purposes.

Recognition in Financial Statements Using the Economic Resources Measurement Focus

5. When a government places only existing resources with an escrow agent in a trust that meets the criteria for an in-substance defeasance in paragraph 4, the debt should no longer be reported as a liability in the financial statements using the economic resources measurement focus. Any difference between the reacquisition price[2] and the net carrying amount[3] of the debt should be recognized as a separately identified gain or loss in the period of the in-substance defeasance.

Recognition in Financial Statements Using the Current Financial Resources Measurement Focus

6. Payments to the escrow agent made from existing resources should be reported as debt service expenditures in financial statements using the current financial resources measurement focus.

Notes to Financial Statements

7. Governments that defease debt using only existing resources should provide a general description of the transaction in the notes to the financial statements in the period of the defeasance. A general description of the transaction may include the amount of the debt, the amount of existing resources placed with the escrow agent, the reasons for the defeasance, and the cash flows required to service the defeased debt.

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[1]For example, if the escrowed securities are callable, there is no assurance that the reinvested funds would provide the yields necessary to meet the required debt service payments.

[2]Reacquisition price is the amount required to repay previously issued debt. In an in-substance defeasance, it is the amount placed in escrow that, together with interest earnings, is necessary to pay interest and principal on the debt and any call premium.

[3]Net carrying amount is the amount due at maturity, adjusted for any unamortized premium or discount and prepaid insurance related to the debt, as well as any deferred outflows of resources or deferred inflows of resources associated with a derivative instrument that is an effective hedge of the debt.

8. In all periods following an in-substance defeasance of debt using only existing resources, governments should disclose the amount of that debt defeased in substance that remains outstanding, if any, at the period-end. This amount may be combined with the amount of debt defeased in substance through refunding transactions that remains outstanding, if any, required by paragraph 14 of Statement 7.

Prepaid Insurance Related to Extinguished Debt

9. Governments that extinguish debt, whether through a legal extinguishment or through an in-substance defeasance, should include the amount of any remaining prepaid insurance related to the extinguished debt in the net carrying amount of that debt for the purpose of calculating the difference between the reacquisition price and the net carrying amount of the extinguished debt.

Notes to Financial Statements for In-Substance Defeasance Transactions

10. In the period in which debt is defeased in substance, whether through a refunding transaction or through the use of only existing resources, governments should disclose the following risk, if applicable: substitution of essentially risk-free monetary assets[4] with monetary assets that are not essentially risk-free is not prohibited.

11. In all periods following an in-substance defeasance, governments should disclose the total amount of debt defeased in substance that remains outstanding for which the risk of substitution discussed in paragraph 10 exists, if any. This amount should be disclosed separately from the amount of debt defeased in substance that remains outstanding, which is required to be disclosed by paragraph 14 of Statement 7 and paragraph 8 of this Statement.

EFFECTIVE DATE AND TRANSITION

12. The requirements of this Statement are effective for reporting periods beginning after June 15, 2017. Earlier application is encouraged.

13. Changes adopted to conform to the provisions of this Statement should be applied retroactively by restating financial statements, if practicable, for all prior periods presented. If restatement for prior periods is not practicable, the cumulative effect, if any, of applying this Statement should be reported as a restatement of beginning net position (or fund balance or fund net position, as applicable) for the earliest period restated. In the first period that this Statement is applied, the notes to the financial statements should disclose the nature of the restatement and its effect. Also, the reason for not restating prior periods presented should be disclosed.

[4]See paragraph 4 of Statement 7 or paragraph 4 of this Statement, as applicable.

The provisions of this Statement need not be applied to immaterial items.

Appendix A

BACKGROUND

A1. Statement No. 7, *Advance Refundings Resulting in Defeasance of Debt,* and Statement No. 23, *Accounting and Financial Reporting for Refundings of Debt Reported by Proprietary Activities,* establish accounting and financial reporting requirements for current and advance refundings. Those standards include definitions of legal defeasance and in-substance defeasance, the criteria for determining an in-substance defeasance, and disclosure requirements. Debt extinguishment transactions occur frequently in the governmental environment. Since 2008, the volume of debt refunding activity has increased significantly. In recent years, the topic of debt refundings has been rated as a priority by members of the Governmental Accounting Standards Advisory Council (GASAC).

A2. The Board initiated pre-agenda research in 2014 to examine the effectiveness of the accounting and financial reporting requirements of Statements 7 and 23 and relevant sections of Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*. The results of the research were discussed by the Board in April 2015 and by the GASAC in July 2015. The pre-agenda research indicated that the standards on debt extinguishments are conceptually sound, generally operational, and meeting user needs. However, certain inconsistencies were identified regarding the application of in-substance defeasance accounting when a government places only existing resources or a combination of existing resources and refunding debt proceeds in a trust for the purpose of extinguishing debt.

A3. In September 2015, the Board added a project on certain debt extinguishment issues to the practice-issue portion of the GASB's current technical agenda. Deliberations began in January 2016. The scope of the project subsequently was expanded to include other issues, such as consideration of the treatment of prepaid insurance related to extinguished debt. Feedback on project issues was provided by GASAC members at their March 2016 and August 2016 meetings.

Appendix B

BASIS FOR CONCLUSIONS

Introduction

B1. This appendix discusses factors considered significant by Board members in reaching the conclusions in this Statement. It includes discussion of the alternatives considered and the Board's reasons for accepting some and rejecting others. Individual Board members may have given greater weight to some factors than to others.

Scope and Applicability of This Statement

B2. In establishing the scope of this Statement, the Board considered certain issues identified through the pre-agenda research discussed in Appendix A. The main issue identified was that when only existing resources were placed in a trust for the sole purpose of extinguishing debt, some governments would derecognize the debt and assets while other governments would continue to report the debt and assets. That research finding led the Board to conclude that accounting and financial reporting requirements should be considered for that type of debt extinguishment. Consideration of certain disclosure requirements related to defeased debt also was included in the scope to ensure that adequate information is being provided regarding the use of existing resources. One of the disclosure topics considered by the Board is the risk of investment substitution that can exist after debt is defeased in substance.

B3. Additionally, the Board determined that there is a need for authoritative guidance for prepaid insurance when the related debt is defeased. Statement No. 65, *Items Previously Reported as Assets and Liabilities,* requires prepaid insurance to be reported as an asset and recognized as an expense in a systematic and rational manner over the duration of the related debt. Statement 65 also removed the reference to issuance costs from the calculation of the net carrying amount of the old debt, which effectively removed the authoritative guidance on how to treat prepaid insurance related to refunded debt. That resulted in several technical inquiries from stakeholders. For consistency of financial reporting, the scope was expanded to also address prepaid insurance when the related debt is extinguished.

B4. In addition to considering the placement of only existing resources in a trust for the purpose of extinguishing debt, the Board also considered whether additional guidance is needed for the placement of both existing resources and refunding debt proceeds in a trust, which commonly occurs. Part of the consideration included how to account for the difference between the reacquisition price and the net carrying amount of the debt in this circumstance. The scope of the project did not include reconsideration of the amortization period of the deferral in a refunding transaction because research indicated that the current guidance is operational. The Board also considered the disclosure requirements for refunding transactions to ensure that essential information is provided regarding the use of existing resources.

Accounting and Financial Reporting for In-Substance Defeasance of Debt Using Only Existing Resources

Circumstances for In-Substance Defeasance

B5. When debt is defeased, it is no longer reported as a liability in the financial statements based on governmental accounting and financial reporting requirements. Statement 7 established certain requirements that should be met for a refunding transaction to be recognized as an in-substance defeasance. Paragraph 4 of Statement 7 states that the "trust is restricted to owning only monetary assets that are essentially risk-free as to the amount, timing, and collection of interest and principal." Essentially risk-free monetary assets are explicitly limited to the specific types of assets identified in that paragraph. The GASB's research did not identify any significant issues in practice with the requirements needed to qualify for in-substance defeasance accounting and financial reporting. Based on these findings, the Board did not substantially amend those requirements.

B6. The Board reviewed the requirements in paragraph 4 of Statement 7 pertaining to in-substance defeasance accounting and determined that governments also could meet those requirements when no refunding debt is issued, such as when only existing resources are used. Economically, if a government irrevocably places only existing resources in a trust for the sole purpose of extinguishing debt, and the requirements of paragraph 4 of Statement 7 are met, the government has sufficiently met its obligations related to the outstanding debt to merit derecognition of the debt. The Board concluded that the fact that existing resources, rather than proceeds from borrowing, are placed in the trust should not be a barrier to in-substance defeasance accounting and should not result in different financial statement recognition.

B7. Regarding the use of only existing resources, paragraph 4 of this Statement applies essentially the same requirements pertaining to in-substance defeasance as those needed when using refunding bond proceeds per paragraph 4 of Statement 7. However, paragraph 4 of Statement 7, which lists the assets that qualify as essentially risk-free monetary assets, includes as an example of direct obligations of the U.S. government, the state and local government series (SLGS) that the U.S. Treasury issues. Because purchasing SLGS is currently limited to specific refunding transactions, the Board determined it would be inappropriate to include those specific securities as an example of direct obligations of the U.S. government for extinguishments using only existing resources.

Recognition in Financial Statements Using the Economic Resources Measurement Focus

B8. For transactions in which only existing resources are used to defease debt, the Board considered whether the difference between the net carrying amount of debt and its reacquisition price should be deferred and recognized over future periods or be immediately recognized. As discussed in paragraph B6, this Statement results in consistent accounting and financial reporting for the defeased debt for all in-substance defeasances under the economic resources measurement focus, regardless of the source of the resources that are placed in escrow. However, there will be differences in how those in-substance defeasance transactions are reported in the resource flows statements. When debt is refunded, the difference between the reacquisition price and the net carrying amount of the old debt is recognized as a component of the interest expense related to the new debt over the shorter of the remaining life of the old debt or the life of the new debt. In a refunding, new debt is substituted for old debt, and the recognition of the difference reflects the effects on future costs. This is not the case when debt is defeased in-substance using only existing resources. Immediate recognition of the difference between the reacquisition price and the net carrying amount of the debt as a gain or loss is consistent with the requirement in paragraph 126 of Statement 62. That Statement requires immediate recognition when cash is used to call debt in an early extinguishment. The Board believes immediate recognition of the difference as a gain or loss in a flows statement is a better representation of the economic substance of that transaction versus deferring the difference for recognition in future periods.

B9. Paragraph 126 of Statement 62 also requires the reporting of any gain or loss on an early extinguishment of debt as a separate item in the resource flows statements prepared using the economic resources measurement focus. The Board considered whether this Statement should provide specific display guidance and concluded that requiring the presentation of a separately identified gain or loss will increase consistency among governments for reporting similar transactions and appropriately emphasize the transaction on the face of the financial statements.

Recognition in Financial Statements Using the Current Financial Resources Measurement Focus

B10. For transactions in which only existing resources are used to defease debt, the Board considered the appropriateness of applying the guidance from paragraph 8 of Statement 7, which requires that payments to the escrow agent made from resources other than refunding debt proceeds be reported as debt service expenditures. The Board determined that the classification for payments of existing resources to an escrow agent outside of a refunding transaction as debt service expenditures is consistent with accounting for such payments in a refunding transaction. The Board concluded that including that guidance in this Statement provides for consistent classification in resource flows statements prepared using the current financial resources measurement focus.

Notes to Financial Statements

B11. Paragraphs 11–14 of Statement 7 provide the disclosure requirements for advance and current refunding transactions. The Board considered whether those disclosure requirements also should be required when only existing resources are used to defease debt. The Board concluded that a general description of the transaction is essential to a user's understanding of the transaction. The Board noted that some examples of what may be included in the general description of a refunding transaction are listed in paragraph 22 of the Basis for Conclusions of Statement 7. Those examples include the amount of the defeased debt, the amount of existing resources placed with the escrow agent, and the reasons for the defeasance. Additionally, the Board concluded that the amount of cash flows required to service the defeased debt is another relevant example of what may be included. The Board believes that by providing examples of information to include in the general description, the level of detail to be disclosed in the notes to the financial statements can be determined through professional judgment.

B12. The Board also determined that providing the amount of debt defeased in substance in the period of the transaction and in all subsequent periods for which debt defeased in substance remains outstanding will provide users with essential information about the amount of debt in the government's name from which the government is not legally released. The Board does not believe it is necessary for subsequent period disclosures to distinguish the outstanding amounts of debt defeased in substance using only existing resources from debt defeased in substance through a refunding transaction. Therefore, the Board concluded that in subsequent reporting periods, disclosure of the amount of debt defeased in substance using only existing resources that remains outstanding can be combined with the disclosure of debt that is defeased in substance as specified in previous standards.

B13. The Board also considered (a) whether governments should be required to disclose the difference between the cash flows required to service the debt and the cash flows for the placement of existing resources with an escrow agent and (b) whether the economic gain or loss resulting from the transaction is essential information if only existing resources are used to defease debt in substance. The Board believes the difference between the two cash flows does not provide users with the same essential information as it does under a refunding transaction that is addressed within the scope of Statement 7. The Board also notes that, even though the gain or loss on an in-substance defeasance using only existing resources is recognized in the period of the transaction, the use of existing resources to defease debt also may have an economic impact on a government that will affect future operating decisions. However, the Board does not believe there is a way to appropriately calculate and report the opportunity cost of using existing resources to defease debt rather than for other governmental purposes. Therefore, the Board concluded that those two disclosures are not essential for a user's understanding of an in-substance defeasance transaction when only existing resources are used.

Accounting for In-Substance Defeasance of Debt Using Existing Resources in Conjunction with Refunding Debt Proceeds

B14. The Board reaffirmed the existing requirement to defer the difference between the reacquisition price and the net carrying amount of the old debt (hereinafter, the difference) when existing resources are used in conjunction with refunding debt proceeds. The Board considered alternatives to deferral accounting for the difference, including deferral of only a portion of the difference based on the proportion of resources placed in escrow from refunding debt proceeds. However, the Board believes that when existing resources are used in a refunding transaction in conjunction with refunding debt proceeds, the primary result is still a substitution of new debt for old debt and the purpose of using existing resources is to meet the debt service requirements. Therefore, the Board concluded that deferral of the difference is appropriate. The Board also concluded that the disclosure requirements in paragraphs 11–14 of Statement 7 are sufficient to incorporate the impact of using existing resources in a refunding transaction. Additional disclosure requirements considered by the Board are discussed in paragraphs B22–B24.

Prepaid Insurance Related to Extinguished Debt

B15. Prior to being amended by Statement 65, Statement 23 required debt issuance costs, including prepaid insurance, that had not been recognized as an expense to be included in the net carrying amount of the refunded debt. Thus, remaining prepaid insurance was reported as a component of the difference between the net carrying amount of the old debt and the reacquisition price, which was recognized as a component of interest expense on the new (refunding) debt. Statement 65 also amended Statement 62's glossary definition of net carrying amount to remove the reference to issuance costs in that calculation. By removing the reference to issuance costs from the calculation of net carrying amount, Statement 65 effectively removed the specific authoritative guidance for how to treat prepaid insurance related to extinguished debt.

B16. Obtaining insurance on debt often results in a more beneficial interest rate for the issuing government. When insured debt is refunded, the prepaid insurance will continue to influence the interest rate on that debt until it is extinguished. Consequently, when debt is defeased in substance, any prepaid insurance that remains in effect will continue to provide additional security for the debt until it is paid in full by the escrow agent. That affected the Board's decisions as discussed below.

Prepaid Insurance Related to Debt Defeased in Substance through a Refunding Transaction

B17. The Board considered whether prepaid insurance related to refunded debt should be included in the net carrying amount of that debt for the purpose of calculating the difference between its reacquisition price and its net carrying amount under Statement 23, as amended. The Board believes that prepaid insurance on the old (refunded) debt should be included in the old debt's net carrying amount because this best reflects the economic substance of the transaction. Including prepaid insurance in the carrying amount of the old insured debt recognizes the economic effect that insuring the old (refunded) debt has on the amount recognized as interest expense on the new (refunding) debt over the shorter of either the life of the old debt or the life of the new debt.

B18. The Board considered three other alternatives: (a) fully recognizing the prepaid insurance as an expense in the period when the refunding occurs; (b) recognizing the prepaid insurance as a component of interest expense over the original life of the old debt even if it has been defeased in substance; and (c) recognizing the prepaid insurance as a component of interest expense over the original life of the old debt until it is called, even if the debt has been defeased in substance, and recognizing an expense for any remaining amount when the debt is called. The Board believes those three alternatives do not appropriately reflect the direct connection between the prepaid insurance and the interest rates achieved through the refunding transaction and, therefore, do not properly reflect the economic substance of the transaction.

Prepaid Insurance Related to Debt Defeased in Substance Using Only Existing Resources

B19. The Board also considered whether prepaid insurance related to debt that is defeased in substance using only existing resources should be included in the calculation of the net carrying amount of that insured debt when it is defeased, which would result in immediate recognition of an outflow of resources (as a component of the gain or loss on the extinguishment). The Board believes that prepaid insurance related to the defeased debt is best recognized in full as a loss in the period when the debt extinguishment occurs because there is no future debt repayment period over which the loss could be recognized. Immediate recognition of a loss is consistent with the Board's decision to immediately recognize a gain or loss when only existing resources are used to defease debt. The Board concluded that this treatment is best accomplished by including the prepaid insurance in the calculation of the net carrying amount of the insured debt.

B20. In arriving at this conclusion, the Board considered three other alternatives: (a) separately recognizing an expense or loss on the prepaid insurance in the period the defeasance occurs, independent of the gain or loss recognized for the extinguishment of the debt; (b) recognizing the prepaid insurance as a component of interest over the original life of the insured debt even though it has been defeased in substance and, thus, is no longer recognized as a liability in the statement of net position; and (c) recognizing the prepaid insurance as a component of interest over the original life of the insured debt until it is called even if the debt has been defeased in substance, and recognizing an expense for any remaining amount when the debt is called. The Board believes that continuing to recognize a periodic charge of prepaid insurance as a component of interest expense related to debt that has been derecognized would be inappropriate because there would be no recognized liability associated with the prepaid amount.

Prepaid Insurance Related to Other Debt Extinguishments

B21. The Board concluded that the decision to include prepaid insurance in the net carrying amount calculation should apply to all extinguishments of debt. Under Statement 65, all issuance costs, including prepaid insurance, are excluded from the net carrying amount for purposes of calculating the difference between the reacquisition price and the net carrying amount of debt in an extinguishment. The Board believes that amending the definition of net carrying amount for debt extinguishments to include prepaid insurance will provide specific authoritative guidance on how to account for remaining prepaid insurance when debt is extinguished.

Notes to Financial Statements for In-Substance Defeasance Transactions

B22. In addition to the disclosure requirements in paragraphs 7 and 8, discussed in paragraphs B11–B13, the Board considered whether there was a need for additional disclosures for in-substance defeasance transactions in general. The Board considered a disclosure related to the risk that investments held in the trust could be substituted with investments that do not meet the criteria for being essentially risk-free, as provided in paragraph 4 of this Statement and in paragraph 4 of Statement 7. The Board believes that many state or local laws, trust or escrow agreements, and bond indentures prohibit substituting essentially risk-free monetary assets with monetary assets that do not meet the criteria for being classified as essentially risk-free. However, in some instances, such substitution may not be expressly prohibited. In those instances, the Board acknowledges that the government still may qualify for in-substance defeasance accounting. That is, the absence of a prohibition for substituting investments at a future date does not prevent governments from initially meeting the in-substance defeasance requirements in the period of the transaction.

B23. Substitution with investments that have a higher risk could affect the sufficiency of the escrowed assets to meet the principal and interest requirements on the defeased debt as those payments come due and, consequently, could affect the market price of the defeased debt. In instances when a government is not prohibited from subsequently substituting the essentially risk-free monetary assets with monetary assets that do not meet the criteria for being classified as essentially risk-free, the Board concluded that information regarding the risk of substitution is essential to a user's understanding of the risk that the future debt service requirements will not be properly covered. In addition to requiring disclosure of such circumstances in the period of the defeasance, the Board believes that continuing disclosure of the total amount of debt defeased in substance outstanding at the end of the reporting period that is subject to this risk is essential to users' understanding.

B24. The Board also considered potential disclosures related to verification of the investments held in the trust, call dates of old debt, bond covenants that remain in effect after the debt is defeased in substance, the identity of the escrow agent, and the types of investments held by the escrow agent in the trust. The Board concluded that disclosure should not be required because that information is not essential for users of the financial statements to sufficiently understand the transaction.

Considerations Related to Benefits and Costs

B25. The overall objective of financial reporting by state and local governments is to provide information that assists users (the citizenry, legislative and oversight bodies, and investors and creditors) in assessing the accountability of governments and in making economic, social, and political decisions. One of the principles guiding the Board's setting of standards for accounting and financial reporting is the assessment of expected benefits and perceived costs. The Board strives to determine that its standards (including disclosure requirements) address a significant user need and that the costs incurred through the application of its standards, compared with possible alternatives, are justified when compared to the expected overall public benefit.

B26. Present and potential users are the primary beneficiaries of improvements in financial reporting. Persons within governments who are responsible for keeping accounting records and preparing financial statements, as well as managers of public services, also benefit from the information that is collected and reported in conformity with GASB standards. The costs to implement the standards are borne primarily by governments and, by extension, their citizens and taxpayers. Users also incur costs associated with the time and effort required to obtain and analyze information to meaningfully inform their assessments and decisions.

B27. The Board's assessment of the expected benefits and perceived costs of issuing new standards is unavoidably more qualitative than quantitative because no reliable and objective method has been identified for quantifying the value of improved information in financial statements. Furthermore, it is difficult to accurately measure the costs of implementing new standards until implementation has actually taken place. Nonetheless, the Board undertakes this assessment based on the available evidence regarding expected benefits and perceived costs with the objective of achieving an appropriate balance between maximizing benefits and minimizing costs.

B28. The primary source of information on the expected benefits of this project is the pre-agenda research, which showed diversity in practice in the financial reporting of debt when only existing resources are placed in a trust for the sole purpose of extinguishing that debt. Additionally, the Board identified diversity in the reporting of prepaid insurance related to debt that is extinguished. This Statement will reduce that diversity in practice by providing uniform guidance. Financial statement users will benefit through increased comparability of the financial statements.

B29. Although the Board recognizes that it is difficult to accurately measure the costs of implementing new standards, the Board believes that implementation costs for the additional debt extinguishment guidance established in this Statement will be minimal because the Statement expands existing in-substance defeasance guidance that governments have been using in refunding transactions for many years. Although this Statement also increases the note disclosure requirements related to debt that is defeased in substance, the Board believes the information needed for the disclosures is readily accessible to governments.

B30. Considering the benefits of the increased comparability of financial statements and the anticipated minimal incremental implementation costs, the Board believes that the intended benefits of this Statement justify the costs.

Effective Date and Transition

B31. The provisions of this Statement are effective for reporting periods beginning after June 15, 2017. The Board concluded that this effective date is appropriate because governments implementing the guidance in this Statement will have ready access to information about the amounts of assets placed in trust and the amounts of related debt. Additionally, the Board concluded that, due to the recent effective date of Statement 65, governments will have access to the information about prepaid insurance needed to implement the guidance in this Statement. The Board believes the effective date of this Statement will provide sufficient lead time to allow governments to prepare for implementation. Some governments may wish to implement the guidance earlier than the effective date, which this Statement encourages.

B32. With respect to transition, the Board concluded that it is appropriate to require retroactive application of the provisions of this Statement, if practicable. The phrase *if practicable* has been used in other GASB standards in a similar context as used in this Statement with respect to transition provisions that require restating the financial statements for all prior periods presented. The Board believes that reasonable efforts should be deployed before a government determines that restatement of all prior periods presented is not practicable. In other words, *inconvenient* should not be considered equivalent to *not practicable.*

Appendix C

CODIFICATION INSTRUCTIONS

C1. The instructions that follow update the June 30, 2016 *Codification of Governmental Accounting and Financial Reporting Standards* (Codification) for the effects of the provisions of this Statement. Only the paragraph number of the Statement is listed if the paragraph will be cited in full in the Codification.

* * *

[Update cross-references throughout.]

* * *

REPORTING LIABILITIES SECTION 1500

.127 [Revise the first sentence as follows:] Accounting and financial reporting for debt extinguishments, including current refundings, advance refundings that result in legal or in-substance defeasance of debt, in-substance defeasance of debt completed using only existing resources, and troubled debt restructuring is discussed in Section D20.

* * *

DEBT EXTINGUISHMENTS AND TROUBLED DEBT RESTRUCTURING SECTION D20

Sources: [Add GASB Statement XX.]

[Revise heading that precedes paragraph .101 as follows:] Scope and Applicability of This Section

.101 [In the first sentence, replace *current or advanced refunding* with *current or advance refunding or the placement of only existing resources in a trust*; insert the following after the third sentence:] Paragraphs .121–.128 provide guidance on accounting and financial reporting for transactions in which only existing resources—that is, resources other than the proceeds of refunding debt—are placed in a trust for the sole purpose of extinguishing debt. [GASBS 7, ¶1 and ¶7, as amended by GASBS 34, ¶82; GASBS 23, ¶3; GASBS 34, ¶16; GASBS 35, ¶5; GASBS 62, ¶124, as amended by GASBS 70, ¶12 and GASBS XX, ¶4–¶11; GASBS 62, ¶128; GASBS XX, ¶2]

[Insert new paragraph .102 as follows; renumber current paragraphs .102 and .103:]

.102 This section applies to all state and local governmental entities, including public benefit corporations and authorities and public utilities, hospitals and other healthcare providers, and colleges and universities. [GASBS 7, ¶7, as amended by GASBS 34, ¶82; GASBS 23, ¶3; GASBS 62, ¶3; GASBS XX, ¶2]

[Remove current paragraph .104 and the heading that precedes it.]

.106 [Replace *must* with *are required to*.] [GASBS 7, ¶4, as amended by GASBS XX, ¶4]

[Revise footnote 10 as follows:] *Net carrying amount* is the amount due at maturity, adjusted for any unamortized premium or discount and prepaid insurance related to the old debt, as well as any deferred outflows of resources or deferred inflows of resources associated with a derivative instrument that is an effective hedge of the old debt. [GASBS 23, fn4, as amended by GASBS 53, ¶24, GASBS 65, fn3, and GASBS XX, ¶9; GASBS 65, fn3, as amended by GASBS XX, ¶9]

[Insert new paragraphs .118 and .119, including footnote, as follows; renumber subsequent paragraphs and footnotes:]

.118 In the period in which debt is defeased in substance, governments should disclose the following risk, if applicable: substitution of essentially risk-free monetary assets[15] with monetary assets that are not essentially risk-free is not prohibited. [GASBS XX, ¶10]

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[15]See paragraph .106. [GASBS XX, fn4]

.119 [GASBS XX, ¶11]

[Insert new paragraphs .121–.128, including headings and footnotes as follows; renumber subsequent paragraphs and footnotes:]

In-Substance Defeasance of Debt Using Only Existing Resources

.121 Debt is considered defeased in substance for accounting and financial reporting purposes if the government irrevocably places only existing resources—that is, resources other than the proceeds of refunding debt—with an escrow agent in a trust to be used solely for satisfying scheduled payments of both interest and principal of the defeased debt, and the possibility that the government will be required to make future payments on the debt is remote. The trust is restricted to owning only monetary assets that meet the risk-free requirements and cash flow requirements in paragraph .106. [GASBS XX, ¶4 and fn1]

.122–.123 [GASBS XX, ¶5 and ¶6, including headings and footnotes]

Notes to Financial Statements

.124 The disclosures required by paragraphs .125–.127 should distinguish between the primary government and its discretely presented component units. The reporting government's financial statements should make those discretely presented component unit disclosures that are essential to fair presentation of the basic financial statements. Determining which component unit disclosures are essential to fair presentation is a matter of professional judgment and should be done on a component unit–by–component unit basis. A specific type of disclosure might be essential for one component unit but not for another depending on the individual component unit's relationship with the primary government. For example, if a primary government is obligated in some manner for the debt of a particular component unit, it is likely that debt-related disclosures should be made for that component unit. [GASBS 14, ¶11; GASBS 14, ¶63, as amended by GASBS 61, ¶11]

.125–.126 [GASBS XX, ¶7 and ¶8]

.127 In the period in which debt is defeased in substance, governments should disclose the following risk, if applicable: substitution of essentially risk-free monetary assets[18] with monetary assets that are not essentially risk-free is not prohibited. [GASBS XX, ¶10]

[18]See paragraph .121. [GASBS XX, fn4]

.128 [GASBS XX, ¶11]

.503 [Revise the definition in current paragraph .503 as follows:] The amount due at maturity, adjusted for unamortized premium or discount and prepaid insurance, if any. [GASBS 62, ¶127, as amended by GASBS 65, ¶15 and GASBS XX, ¶9]

[Revise heading .701 as follows:]

.701 Scope and Applicability of This Section

[Delete heading .706; renumber subsequent headings.]

[Insert new headings .715–.718 corresponding to the headings that precede paragraphs .121–.124 and renumber subsequent headings. Under each new heading, include the following:]

No questions assigned.

* * *

DERIVATIVE INSTRUMENTS **SECTION D40**

.118 [In subparagraph (e), revise as follows:] The hedged debt is defeased as a result of a current refunding, an advance refunding, or the use of only existing resources resulting in an in-substance defeasance. [GASBS 53, ¶22, as amended by GASBS XX, ¶4]

.120 [Revise the first sentence as follows:] If the termination event is the defeasance of the hedged debt (paragraph .118e), whether through a current refunding, an advance refunding, or the placement of only existing resources in a trust, the deferred outflow of resources or deferred inflow of resources should be included in the net carrying amount of the old debt for purposes of calculating the difference between that amount and the reacquisition price of the old debt in accordance with paragraphs .111, .112, and .122 of Section D20, "Debt Extinguishments and Troubled Debt Restructuring." [GASBS 53, ¶24, as amended by GASBS 63, ¶8 and GASBS XX, ¶4; GASBS XX, ¶5 and fn3]