1977

Proposed statement of position on accounting for advance refundings of debt;Accounting for advance refundings of debt

American Institute of Certified Public Accountants. Accounting Standards Division

EXPOSURE DRAFT

PROPOSED STATEMENT OF POSITION ON ACCOUNTING FOR ADVANCE REFUNDINGS OF DEBT

DECEMBER 27, 1977

Issued by the Accounting Standards Executive Committee of the
American Institute of Certified Public Accountants
For Comment From Persons Interested in Accounting and Reporting

Comments should be received by February 27, 1978, and addressed to
Gabriel V. Carifi, Manager, Accounting Standards Division, File Ref. No. 4225
AICPA, 1211 Avenue of the Americas, New York, N.Y. 10036

AICPA

American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

December 27, 1977

To Practice Offices of CPA Firms; Members
of Council; Technical Committee Chairmen;
State Society and Chapter Presidents,
Directors, and Committee Chairmen;
Organizations Concerned With Regulatory,
Supervisory, or Other Public Disclosure
of Financial Activities; Persons Who Have
Requested Copies:

An exposure draft of a proposed statement of position entitled Accounting for Advance Refundings of Debt accompanies this letter.

Comments and suggestions on any aspect of the enclosed draft are sought and will be appreciated. They should be addressed to Gabriel V. Carifi, Manager, Accounting Standards Division, File Ref. No. 4225, at the AICPA, by February 27, 1978. The Accounting Standards Executive Committee will be particularly interested in the reasoning underlying comments and suggestions.

Sincerely yours,

Arthur R. Wyatt

Arthur R. Wyatt, Chairman
Accounting Standards
Executive Committee

Gabriel V. Carifi

Gabriel V. Carifi, Manager
Accounting Standards Division

PROPOSED STATEMENT OF POSITION ON ACCOUNTING FOR ADVANCE REFUNDINGS OF DEBT

INTRODUCTION

1. A refunding of debt is the replacement of old debt with new debt and takes place to obtain a perceived economic advantage. Although this perceived advantage may take various forms, it is frequently lower interest rates, a revised payment schedule, an extension of maturity dates, or the removal of restrictions. An advance refunding is a refunding in which new debt is issued before the maturity or intended call date of the old debt, primarily for the purpose of replacing the old debt at a specified future date.

2. This statement of position addresses accounting for advance refundings.[1] It is not intended to modify APB Opinion 26, *Early Extinguishment of Debt*, or FASB Statement 4, *Reporting Gains and Losses From Extinguishment of Debt*. The Addendum to APB Opinion 2, "Accounting Principles for Regulated Industries," states that "differences may arise in the application of generally accepted accounting principles as between regulated and nonregulated businesses, because of the effect in regulated businesses of the rate-making process," and discusses the application of generally accepted accounting principles to regulated industries. This statement of position should be applied to regulated companies that are subject to the rate-making process in accordance with the provisions of the Addendum.

3. Paragraphs 9 to 15 of this statement of position apply to accounting for advance refundings, including advance refundings entered into by nonprofit organizations other than state and local governmental units, that are reported in financial statements prepared in conformity with generally accepted accounting principles. Paragraphs 16 to 18 apply to state and local governmental units. Paragraph 19 sets forth appropriate disclosures, and paragraph 20 discusses the effective date and transition.

4. To illustrate an advance refunding, assume that three years ago a corporation's capital improvements were financed by 9 percent tax-exempt industrial revenue bonds of a governmental unit. The industrial revenue bonds were issued by the governmental unit and the proceeds were used to construct capital improvements for the corporation. The corporation's payments to the governmental unit were structured to meet the debt service requirements of the bonds, both in amount and timing. During the past three years, interest rates in the tax-exempt bond market dropped from 9 percent to 6 percent, making it advantageous for the corporation, through the governmental unit, to replace the 9 percent debt. If the 9 percent debt is not callable, or if management does not intend to have the debt called until a future date, and the 6 percent debt is issued to replace the 9 percent issue, an advance refunding has occurred.

5. Advance refundings involving tax-exempt debt are subject to arbitrage rules under the Internal Revenue Code (section 103(c)) and related regulations that, in general, prohibit the yield realized from the investment of the proceeds of a new debt from exceeding the yield on the debt itself. Compliance with those rules is necessary for the interest on the debt to be exempt from federal income tax and possibly state and local tax; compliance can be achieved by investing in U.S. Treasury obligations that yield a rate of interest not exceeding the yield on the new debt. The arbitrage rules do not prohibit investment in other securities as long as the yield is low enough to comply with those rules.

6. As defined below, three methods are used to achieve advance refunding of debt: net advance refunding, full cash advance refunding, and crossover advance refunding. The Appendix to this statement of position illustrates each of the methods and the appropriate accounting.

7. The accounting standards division believes guidance is needed

[1] Some advance refundings of debt involve corresponding changes in the provisions of existing leases. In this regard, see the December 19, 1977, FASB exposure draft, *Accounting for Leases: Changes in the Provisions of Lease Agreements Resulting from Refundings of Tax-Exempt Debt: An Amendment of FASB Statement No. 13.*

concerning (a) the timing of income statement recognition of a gain or loss from an advance refunding, (b) when the refunded debt, the refunding debt, or both should be included in the balance sheet, and (c) the method of income statement recognition for interest related to the debts.

DEFINITIONS

8. The following definitions apply to the terms used in this proposed statement of position:

Refunding debt (sometimes referred to as *new debt*)—Debt issued to provide funds to replace the refunded debt at a specified future date(s).

Refunded debt (sometimes referred to as *old debt*)—Debt for which payment at a specified future date(s) has been provided by the issuance of refunding debt.

Advance refunding—A transaction in which refunding debt is issued to replace the refunded debt at a specified future date(s) with the proceeds placed in trust or otherwise restricted to replacing the refunded debt.

Defeasance provision—A provision in the refunded debt instrument that provides the terms by which the debt may be legally satisfied and the related lien released without the debt's necessarily being retired.

Defeasance—Legal satisfaction of debt under the terms of a defeasance provision.

Net advance refunding—An advance refunding in which the proceeds from the new debt plus the income earned on the investment of the proceeds is sufficient to pay the interest and principal on the old debt and any call premium. The old debt is often defeased in a net advance refunding.

Full cash advance refunding—An advance refunding in which both revenue and special obligation bonds are sold and the net proceeds are sufficient to pay the interest and principal on the old debt and any call premium. The old debt is usually defeased in this type of advance refunding. Proposed Internal Revenue regulations would eliminate the advantage of a full cash advance refunding by having the arbitrage rules apply separately to each new issue.

Special obligation bonds—Debt that is issued concurrently with revenue bonds in a full cash advance refunding, normally at a lower interest rate and with a shorter maturity date than the revenue bonds. The proceeds from the revenue and special obligation bonds are placed in trust, and the income realized from investment of the trust assets serves as collateral for, and will be used to service and retire, the special obligation bonds.

Crossover advance refunding—An advance refunding in which the new debt is the liability of the governmental unit until the date it is assumed by the entity obligated to service the old debt (date of crossover). The proceeds from the new debt plus the income earned on the investment of those proceeds is sufficient to pay the principal and any call premium of the old debt and the interest on the new debt until the date of crossover. Until the date of crossover, collateral for the new debt is represented by the proceeds from its issuance. The old debt is serviced by the entity until the date of crossover, at which time the proceeds from the new debt are used to retire the old debt and the entity becomes obligated to service the new debt. In a crossover advance refunding, the old debt is never defeased at the time of advance refunding.

THE DIVISION'S CONCLUSIONS

Entities Other Than State and Local Governmental Units

Defeasance Transactions

9. The accounting standards division believes that an advance refunding in which the refunded debt is defeased results in an early extinguishment of debt because the refunded debt is legally satisfied. The gain or loss from the advance refunding should be determined in accordance with the provisions of APB Opinion 26 and should be classified in accordance with FASB Statement 4. Since the old debt is legally satisfied, it is not a liability of the entity and should not be included in the balance sheet; only the new debt should be included. When special obligation bonds are issued as part of the advance refunding, they should not be presented in the balance sheet because they will be serviced from the earnings of the proceeds of the advance refunding and, therefore, represent an obligation of the trustee and not an obligation of the entity.

Nondefeasance Transactions

10. The division believes that advance refundings meeting all of the following criteria are completed transactions that should be accounted for the same as defeased transactions because the obligation for the refunded debt is satisfied in substance, even though in form the refunded debt is not defeased.

- The issuer is irrevocably committed to refund the old debt.
- The proceeds of the new debt are placed in an irrevocable trust with a reputable trustee for the primary purpose of satisfying the old debt at a specified future date(s).
- The proceeds of the new debt are invested in direct U.S. Treasury obligations with maturities that approximate the debt service requirements of the trust.
- The invested proceeds (trust assets) are not subject to lien for any purpose other than in connection with the advance refunding transaction.

11. In advance refunding transactions in which the refunded debt is not defeased and the transaction does not meet the criteria in paragraph 10, the division believes that the obligation for the refunded debt is not satisfied in substance and there is no early extinguishment of debt. Consequently, no immediate gain or loss should be recognized

on the transaction. However, if the retirement date(s) of the old debt has been established, any (1) call premium, (2) unamortized premium or discount, and (3) initial issue costs should be systematically recognized in the income statement over the remaining term of the old debt as an adjustment of the cost of borrowing related to the old debt. In addition, the income earned on the proceeds from the new debt and the interest expense on both the old and new debts should be recognized in the income statement. The proceeds from the new debt should be reported as an asset, and both the old and new debts should be reported as liabilities.

Crossovers

12. The division believes that a crossover advance refunding should be accounted for in the same manner as other nondefeasance advance refunding transactions. Therefore, if the criteria in paragraph 10 are met, the accounting in paragraph 9 should be followed. If the criteria are not met, the crossover should be accounted for in the manner described in paragraph 11.

Cash Obtained From Other Sources

13. Often a portion of the cash needed to accomplish an advance refunding is obtained from sources other than the issuance of new debt, for example, an existing sinking fund related to the old debt or cash accumulated by the entity. If the old debt is defeased, the accounting in paragraph 9 should be followed, regardless of the portion of cash obtained from other sources. If the old debt is not defeased and the primary source of cash needed to accomplish the advance refunding is obtained from the issuance of new debt,[2] the accounting in paragraph 9 should be followed if all the cash, regardless of source, is invested in the manner specified in paragraph 10. Otherwise, in nondefeasance transactions the cash from other sources should be accounted for as a sinking fund, and the cash from the new debt should be accounted for in accordance with paragraphs 10 or 11. The old debt related to the sinking fund should be based on the relationship of the cash obtained from other sources and the income to be earned from the investment of that cash to the total cash necessary to accomplish the entire refunding of the old debt.

Third-Party Reimbursement to Hospitals

14. If a third party is obligated to reimburse a hospital for the loss from an advance refunding, the hospital should report the loss net of the reimbursement. A portion of the reimbursement attributable to costs that cannot be claimed in the current year should be accounted for as a deferred charge and should be reduced in each subsequent year by the amount of reimbursement allowed. To the extent reimbursement is not reasonably assured, the loss should be recognized in the year incurred, and a subsequent reimbursement should be recorded when received.

Income Tax Accounting

15. In most cases, the gain or loss from an advance refunding will not be entirely applied for income tax purposes in the period of the advance refunding. Therefore, income tax allocation in accordance with APB Opinion 11, *Accounting for Income Taxes,* should be applied to a gain or loss charged to income in different periods for financial reporting and tax purposes.

State and Local Governmental Units

Enterprise Funds

16. In accounting for an advance refunding of debt that is an obligation of an enterprise fund, the accounting recommended for entities other than state and local governmental units should be followed.

General Obligation Bonds[3]

17. In advance refundings of general obligation bonds in which there is defeasance, there is an early extinguishment of debt. Therefore, the old debt should be removed from the long-term debt group of accounts and be replaced by the new debt. The debt service fund should account for the gross proceeds of the new debt as revenue, and the issue costs and the amount transferred to the trustee to retire the old debt, as expenditures. The amount transferred to the trustee should be shown in two parts: (1) retirement of principal and (2) gain or loss on advance refunding of debt.

18. If the advance refunding of general obligation bonds does not result in defeasance, the governmental unit is responsible for the new debt and remains responsible for the old debt until it is retired. Therefore, both debts should be presented in the long-term debt group of accounts. The debt service fund should account for the gross proceeds of the new debt as revenue and the issue costs as an expenditure, increasing the restricted fund balance. The net proceeds of the new debt should be recorded as an asset. Income earned on the proceeds from the new debt should be recorded as revenue in the debt service fund along with the interest expense on both the old and new debts.

---

[2] For purposes of this statement of position, the primary source of cash is new debt when at least 75 percent of the total cash necessary to accomplish the entire refunding of the old debt is obtained from the proceeds of the new debt and the income to be earned from the investment of those proceeds.

[3] Presently, this section of the exposure draft does not recommend that any advance refundings that do not result in defeasance be accounted for as if defeased. If the division would apply the criteria of paragraph 10 to advance refundings not resulting in defeasance, those refundings meeting the criteria would be accounted for the same as defeased transactions. The division solicits views of respondents on whether the criteria of paragraph 10 should be applied to advance refundings of general obligation bonds that do not result in defeasance.

Disclosure

19. Financial statements for the period in which an advance refunding occurs should include a general description of the advance refunding along with disclosures required by FASB Statement 4. When the refunded debt is eliminated from the balance sheet, the advance refunding transaction should be disclosed in the financial statements for each subsequent period until the old debt and any special obligation bonds are retired, because the refunded debt and possibly special obligation bonds are outstanding and the entity's name will continue to be associated with those obligations.

Effective Date and Transition

20. This proposed statement of position is effective for advance refundings of debt consummated on or after January 1, 1978. Earlier application of this proposed statement of position is encouraged for advance refundings of debt consummated before January 1, 1978, but it should not be applied to advance refundings of debt consummated during fiscal years for which annual financial statements have previously been issued.

APPENDIX

ILLUSTRATION NO. 1

CALCULATION OF GAIN OR LOSS IN A NET ADVANCE REFUNDING WITH DEFEASANCE

In a net advance refunding, the proceeds from the new debt plus the income earned from the investment of those proceeds are sufficient to pay the interest, principal, and call premium on the old debt. After the advance refunding, the old debt is serviced by the investments in trust, and the new debt is serviced by the entity services.

Assumptions

Old debt	
Principal outstanding	$50,000,000
Interest rate	9.5%
Earliest call date	5 years
Call premium	3%
Unamortized issue costs	$ 1,300,000
Unamortized discount	$ 700,000
New debt	
Principal	$60,000,000
Average coupon interest rate	5,372%
True interest cost—yield	6%
Issue costs	$ 1,507,479
Issue price	100
Period outstanding	30 years
Yield on direct U.S. Treasury obligations	6%

Calculation of New Debt

New debt and proceeds from new debt required to provide for payment of old debt

	Present value of future cash requirements at 5.372%	Earnings on direct U.S. Treasury obligations	Total future cash requirements
Call premium—old debt	$ 1,154,689	$ 345,311	$ 1,500,000
Principal—old debt	38,489,643	11,510,357	50,000,000
Interest—old debt	20,355,668	3,394,332	23,750,000
Gross proceeds of new debt	60,000,000	15,250,000	75,250,000
Debt issue costs	(1,507,479)	1,507,479	
Net proceeds to be invested	$58,492,521	$16,757,479	$75,250,000

After payment of the new debt issue costs, the proceeds from the new debt total $58,492,521. As permitted by the IRS arbitrage regulations, the direct U.S. Treasury obligations acquired with the proceeds of the new debt will yield 6 percent (to earn $16,757,479).

Proceeds from the new debt will be sufficient to service the old debt as follows:

Present value of call premium (discounted at 6%)	$ 1,120,887
Present value of interest requirements (discounted at 6%)	20,008,728
Present value of principal (discounted at 6%)	37,362,906
Proceeds from the new debt invested in direct U.S. Treasury obligations	58,492,521
Issue costs	1,507,479
New debt	$60,000,000

Loss on Advance Refunding

New debt		$60,000,000
Issuance costs to be deferred and amortized over the life of new debt		(1,507,479)
		58,492,521
Carrying amount of old debt		
Principal	$50,000,000	
Unamortized discount	(700,000)	
Unamortized issue costs	(1,300,000)	48,000,000
Loss on advance refunding		$10,492,521

Entries[1]

Advance refunding date		
Loss on advance refunding	$10,492,521	
Deferred issue costs	1,507,479	
Old debt	50,000,000	
Unamortized discount–old debt		700,000
Unamortized issue costs–old debt		1,300,000
New debt		60,000,000

To record advance refunding of debt.

First year		
Interest expense	3,223,200	
Debt issue costs	50,250	
Deferred issue costs		50,250
Cash		3,223,200

To record amortization of debt issue costs and interest expense on new debt.

[1] These illustrative entries, as well as others that follow in this Appendix, exclude any related income tax effect.

ILLUSTRATION NO. 2

CALCULATION OF GAIN OR LOSS IN FULL CASH ADVANCE REFUNDING WITH DEFEASANCE

In a full cash advance refunding, the principal amount of the revenue bonds is calculated in the same manner as in net advance refunding. Special obligation bonds are issued to provide additional funds, which, together with the proceeds from the revenue bonds, will be sufficient to pay the interest, principal, and call premium on the older debt. After the advance refunding occurs, the old debt is serviced by the investments in trust and the revenue bonds are serviced by the entity. The special obligation bonds are serviced by the income earned on the investments in trust.

Assumptions

Old debt	
Principal outstanding	$50,000,000
Interest rate	9.5%
Earliest call date	5 years
Call premium	3%
Unamortized issue costs	$ 1,300,000
Unamortized discount	$ 700,000
Revenue bonds	
Principal	$60,000,000
Average coupon interest rate	5.372%
True interest cost—yield	6%
Issue costs	$ 1,507,479
Issue price	100
Period outstanding	30 years
Yield on direct U.S. Treasury obligations[2]	6%
Special obligation bonds	
Principal	$17,150,479
Average coupon interest rate	3%
True interest cost—yield	3.5394%
Issue costs	$ 393,000
Issue price	100
Period outstanding	5 years
Yield on direct U.S. Treasury obligations[2]	3.5394%

Calculation of New Debt

Total future cash requirements of old debt	
Principal—old debt	$50,000,000
Call premium—old debt	1,500,000
Interest—old debt	23,750,000
Total future cash requirements of old debt	$75,250,000

Proceeds from sale of new debt

	Revenue bonds	Special obligation bonds	Total
Gross proceeds from sale of debt	$60,000,000	$17,150,479	$77,150,479
Debt issue costs	(1,507,479)	(393,000)	(1,900,479)
Net proceeds to be invested	$58,492,521	$16,757,479	$75,250,000

[2] IRS arbitrage regulations require that a separate yield must be calculated on the investments acquired with the proceeds of each issue.

After payment of debt issue costs, the proceeds from both issues total $75,250,000, which is sufficient to service the old debt until it is called. As permitted by the IRS arbitrage regulations, the direct U.S. Treasury obligations acquired with the proceeds of the revenue bonds and the special obligation bonds will yield 6 percent and 3.53994 percent respectively. The earnings on these investments will be sufficient to service the special obligation bonds as follows:

Earning on direct U.S. Treasury obligations used to service special obligation bonds	
Earnings on proceeds of revenue bonds at 6%	$16,757,479
Earnings on proceeds of special obligation bonds at 3.5394%	2,965,570
	$19,723,049
Debt service requirements of special obligation bonds	
Principal	$17,150,479
Interest at 3%	2,572,570
	$19,723,049

Loss on Advance Refunding[3]

Revenue bonds		$60,000,000
Issuance costs to be deferred and amortized over the life of the revenue bonds		(1,507,479)
		$58,492,521
Carrying amount of old debt		
Principal	$50,000,000	
Unamortized discount	(700,000)	
Unamortized issue costs	(1,300,000)	48,000,000
Loss on advance refunding		$10,492,521

Entries

Advance refunding date		
Loss on advance refunding	$10,492,521	
Deferred issue costs	1,507,479	
Old debt	50,000,000	
Unamortized discount—old debt		700,000
Unamortized issue costs—old debt		1,300,000
New debt		60,000,000
To record advance refunding of debt.		
First year		
Interest expense	3,223,200	
Debt issue costs	50,250	
Deferred issue costs		50,250
Cash		3,223,200
To record amortization of debt issue costs and interest expense on new debt.		

[3] The special obligation bonds are not included in the calculation of the loss on advance refunding or in the balance sheet, because they will be serviced from the earnings on the proceeds from the advance refunding and do not constitute an obligation of the entity.

ILLUSTRATION NO. 3

CALCULATION OF GAIN OR LOSS IN A CROSSOVER ADVANCE REFUNDING MEETING THE CRITERIA DESCRIBED IN PARAGRAPH 10

In a crossover advance refunding, the proceeds from the new debt plus the income earned from the investment of those proceeds are sufficient to pay the principal and call premium on the old debt and the interest on the new debt until the date of crossover. The entity continues to service the old debt until the date of crossover when the old debt is retired and the entity becomes obligated to service the new debt.

Assumptions

Old debt	
Principal outstanding	$50,000,000
Interest rate	9.5%
Earliest call date	5 years
Call premium—3%	$ 1,500,000
Unamortized issue costs	$ 1,300,000
Unamortized discount	$ 700,000
New debt	
Principal [4]	$51,500,000
Average coupon interest rate	5.372%
True interest cost—yield	5.9677%
Issue costs	$ 1,294,149
Issue price	100
Period outstanding	30 years
Yield on direct obligations of U.S.	5.9677%

Calculation of New Debt

New debt and proceeds from new debt required to provide for payment of old debt

	Present value of future cash requirements at 5.372%	Earnings on direct U.S. Treasury obligations	Total future cash requirements
Call premium—old debt	$ 1,154,689	$ 345,311	$ 1,500,000
Principal—old debt	38,489,643	11,510,357	50,000,000
Interest—new debt	11,855,668	1,977,232	13,832,900
New debt	51,500,000	13,832,900	65,332,900
Debt issue costs—new debt	(1,294,149)	1,294,149	
Proceeds to be invested	$50,205,851	$15,127,049	$65,332,900

After payment of the new debt issue costs, the proceeds from the new debt total $50,205,851. As permitted by the IRS arbitrage regulations, the direct U.S. Treasury obligations acquired with the proceeds from the new debt will yield 5.9677% (to earn $15,127,049).

Proceeds from the new debt will be sufficient to service the new debt for five years and then call the old debt, as follows:

Present value of call premium (discounted at 5.9677%)	$ 1,122,597
Present value of interest requirements (discounted at 5.9677%)	11,664,089
Present value of principal (discounted at 5.9677%)	37,419,165
Proceeds from the new debt invested in direct U.S. Treasury obligations	50,205,851
Issue costs	1,294,149
New debt	$51,500,000

[4] Note that the new debt is equal to the principal and call premium of the old debt.

Loss on Advance Refunding

New debt		$51,500,000
Issuance costs to be deferred and amortized over the life of new debt		(1,294,149)
		50,205,851
Carrying amount of old debt		
Principal	$50,000,000	
Unamortized discount	(700,000)	
Unamortized issue costs	(1,300,000)	48,000,000
		2,205,851
Present value of interest differential between old and new debts for five years		8,500,000
Loss on advance refunding		$10,705,851[5]

Entries

Advance refunding date		
Loss on advance refunding	$10,705,851	
Deferred debt issue costs	1,294,149	
Old debt	50,000,000	
Unamortized discount—old debt		700,000
Unamortized issue costs—old debt		1,300,000
New debt		51,500,000
Allowance for loss on advance refunding		8,500,000

To record advance refunding of debt.

First year		
Interest expense	456,620	
Allowance for loss on advance refunding		456,620

To accrue interest on the allowance for loss (considered to be similar to new debt) at 5.372%.

Amortization of deferred debt issue cost	43,138	
Interest expense	2,766,580	
Allowance for loss on advance refunding	1,983,420	
Cash		4,750,000
Deferred issue costs		43,138

To adjust allowance for loss on advance refunding to account for interest paid on 9.5 percent debt and to properly reflect interest expense at 5.372 percent debt.

[5] The difference of $213,330 between the losses resulting in the crossover advance refunding and the net advance refunding ($10,492,521) is equal to the difference in issue costs ($1,507,479 versus $1,294,149).