



October 24, 2016

Mr. David R. Bean  
Director of Research and Technical Activities  
Project No. 19-25E  
Governmental Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

Dear Mr. Bean:

The American Institute of Certified Public Accountants (AICPA) has reviewed the Governmental Accounting Standards Board (GASB) Exposure Draft (ED), *Certain Debt Extinguishment Issues*, and is pleased to offer its comments. Overall, we support the GASB's efforts to improve consistency in accounting and financial reporting for debt defeasance transactions.

Our most significant comments are included in the next section of this letter. The "Editorial Comments" section below includes editorial comments and other matters that could improve the clarity of standard.

### **SIGNIFICANT COMMENTS**

**Ability to Substitute Monetary Assets That Are Not Essentially Risk-Free Should Not Qualify as a Defeasance.** We believe that a transaction that allows the substitution of monetary assets that are not essentially risk-free **does not and should not** qualify for in-substance defeasance accounting and thus, recommend the Board eliminate the note disclosures discussed in paragraphs 10-11. This would be consistent with the criteria in paragraph 4 of the ED 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."

As drafted, there appears to be inconsistency in the ED between paragraph 4 and paragraphs 10-11 related to the qualification for defeasance when the trust *allows* for substitution of monetary assets that are not essentially risk-free. For further insight, we read a related GASB staff paper for the May 2016 Board meeting (Issue 1, Paper 1). The paper discussed whether the substitution clause would impact the irrevocability criteria in paragraph 7, but did not appear to directly address whether the ability to substitute for a non-risk-free investment would preclude the entity from in-substance defeasance accounting, even if the trust is initially funded with essentially risk-free investments.

Although we strongly believe the inclusion of such a substitution clause should preclude the entity from defeasance accounting (which would negate the necessity for note disclosure as discussed in paragraphs 10-11 of the ED), we offer the following observations if the Board maintains the positions expressed in the ED.

- First, we suggest the circumstances to which the disclosure requirement applies be addressed in more depth. None of the members that assisted with our response had experience with such a substitution clause and thus, we are unclear whether such a clause would exist in the trust document itself or as an outside legal provision (for example, state statute) that could be utilized to violate the trust document. We also suggest that the discussion of substitution in the last sentence of paragraph B22 of the Basis for Conclusions be revised to reference the other criteria that need to be met in order to qualify for in-substance defeasance under paragraph 4 if a substitution clause exists.
- Second, the accounting should be clarified for situations in which monetary assets that are not risk-free are substituted (that is, the debt would no longer meet the criteria for defeasance, in-substance defeasance, or refunding; thus the debt and restricted cash would need to be reported and any deferred outflows or inflows of resources related to defeased debt would be eliminated). The accounting should be articulated in the final Statement so that there is consistency in application when such substitutions occur.
- Finally, we anticipate a significant increase in audit effort to determine whether such substitution has occurred. Today, the audit effort in years subsequent to the in-substance defeasance primarily focuses on verifying the outstanding balance of defeased debt as of the end of the current year, and not verifying or confirming the monetary assets that are in the irrevocable trust. The inclusion of paragraphs 10-11 will introduce additional audit procedures to evaluate whether the substitution clause exists for all previously defeased debt. For those defeasances in which the substitution provision exists, the escrow would have to be evaluated at each reporting period to determine if monetary assets that are not essentially risk-free were substituted. Defeased debt often remains a disclosure for an extensive period of time. While we believe auditors can obtain the evidence, we question the necessity of this given our belief that it should not qualify for defeasance and that a substitution clause that allows for substitution of non-risk-free investments is not commonly incorporated into the terms of the transaction.

**Guidance Needed to Address Defeasance Accounting when Both New and Existing Resources are Used.** We recommend the Board specifically address the accounting for the defeasance of debt when both new and existing resources are used to properly present the transaction in financial statements using the economic resources measurement focus. We recognize the Board's consideration of this issue in paragraph B14, but disagree with the tentative conclusions. We believe the appropriate accounting should be to apportion the transaction and apply Statement No. 23 *Accounting and Financial Reporting for Refundings of Debt Reported by Proprietary Activities* to debt defeased using new resources and the new Statement to debt defeased using existing resources.

It is a common occurrence for governments to use a mixture of resources. Without additional guidance, a government could construct a defeasance using minimal new resources to defer recognition of the resulting gain or loss. As proposed, if a defeasance involves new resources, the guidance in GASB Statement No. 7, *Advance Refundings Resulting in Defeasance of Debt* or GASB Statement No. 23 applies. The accounting under GASB Statement No. 23 differs from that proposed in this ED in that the refunding activity gets the benefit of carrying a deferred outflow or inflow of resources resulting from the difference between the reacquisition price and the net carrying amount of the debt. Contrast that treatment with paragraph 5 of the ED which requires the recognition of any difference between the reacquisition price and the net carrying amount of the debt as a gain or loss in the period of the in-substance defeasance. Given the variation in the recognition of the difference (deferred and recognized over time versus gain or loss wholly recognized in the period of the defeasance), we believe the transaction should be apportioned based on new and existing resources. In the event the Board disagrees with our recommendation, we recommend that a paragraph be included within the authoritative section of the standard specifically addressing the accounting (for the gain or loss) when both new and existing resources are used to defease debt.

**Address Accrued Interest and Deferred Outflows or Inflows of Resources Related to the Defeased Debt with Regard to Computation of the Gain or Loss.** We recommend the Board explicitly address deferred outflows or inflows of resources and accrued interest related to the debt being defeased related to the computation of the gain or loss.

- Accrued interest is often included in the reacquisition price (amount required to repay previously issued debt) but is excluded from the definition of net carrying amount (see footnote 3 of the ED). There is a possibility of preparers miscalculating the gain or loss on defeasance if accrued interest is included as a component of reacquisition price but excluded from the net carrying amount. Item Z.23.1 of the *GASB Implementation Guide 2015-1* addresses this specific issue with regard to GASB Statement No. 23. We suggest the Board include the guidance in this ED for existing resources and incorporate the guidance into Statement No. 23 through an amendment and eliminate Item Z.23.1. Another

option would be to include an item in the next edition of the *Implementation Guide* to address the issue for this ED.

- Additionally, we recommend the final Statement address the recognition of deferrals related to the defeased debt, similar to paragraph 5 of GASB Statement No. 23. The debt being defeased may have a deferred outflow or inflow related to a previous defeasance which is not addressed in this ED.

## **EDITORIAL COMMENTS**

**Scope Clarification.** We recommend the Board clarify the scope of the ED in paragraph 2 to make clear that certain components of the ED address defeasance with existing and/or refunding with new resources as it may not be clear given the structure of the paragraph. The first sentence is very clear regarding the establishment of standards for defeasance using only existing resources. The second and third sentences may not be clear that they are applicable to defeasance from new and/or existing resources. The following provides suggested edits for clarification:

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 addresses transactions in which either existing resources or refundings are placed in a trust for the purpose of extinguishing debt as further described. ~~also~~ This Statement amends accounting and financial reporting requirements for prepaid insurance associated with debt that is extinguished. ~~Finally, this~~ 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.

**Codification Instructions - Clarify Changes.** The Codification instructions could be improved by marking the changes of existing text. For example, underline additions as follows:

### **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.

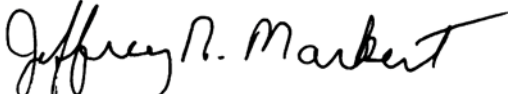
**Suggested Revisions for Clarity.** We recommend the Board strengthen the second sentence of paragraph 7 of the ED to use “should” and to be more explicit that it relates to the debt defeased. The first sentence indicates the government “should provide a general description of the transaction...” However, the second sentence uses a “may” to describe what elements be considered as part of the description.


Par 7. ....A general description of the transaction ~~may~~ **should** include the amount of the **defeased** 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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The AICPA appreciates the opportunity to comment on the ED. This comment letter was prepared by members of the AICPA’s State and Local Government Expert Panel and was reviewed by representatives of the Financial Reporting Executive Committee who did not object to its issuance. Representatives of the AICPA would be pleased to discuss these comments with you at your convenience.

Sincerely,

  
Jeffrey N. Markert  
Chair  
AICPA State and Local Government  
Expert Panel

  
Mary M. Foelster  
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cc: State and Local Government Expert Panel  
James Dolinar  
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