



North Carolina Office of the State Controller

Financial Reporting Update

GASB 86 Effective for FY 2018

February 16, 2018

In May 2017, the Governmental Accounting Standards Board (GASB) issued GASB Statement No. 86, *Certain Debt Extinguishment Issues* (GASB 86). GASB 86 establishes standards of accounting and financial reporting for in-substance defeasance of debt in which cash and other monetary assets acquired with only existing resources – resources other than the proceeds of refunding debt – are placed in an irrevocable trust for the purpose of extinguishing debt. GASB 86 also clarifies accounting and financial reporting for prepaid insurance on debt that is extinguished and establishes additional note disclosure requirements for debt that is defeased in-substance.

In-Substance Defeasance of Debt Using Only Existing Resources

GASB Statement No. 7, *Advance Refundings Resulting in Defeasance of Debt*, (GASB 7) requires that debt be considered defeased in-substance when the debtor irrevocably places cash or other monetary assets acquired with refunding debt proceeds in a trust to be used solely for satisfying scheduled payments of both principal and interest of the defeased debt. The trust is required to meet certain conditions for the transaction to qualify as an in-substance defeasance. GASB 86 establishes essentially the same requirements for when a government places cash and other monetary assets acquired with only existing resources in an irrevocable trust to extinguish the debt. Placing only existing resources in a trust to extinguish debt is now considered a type of in-substance defeasance if all other criteria are met.

Recognition in Financial Statements Using the Economic Resources Measurement Focus [Government Wide Statements and Proprietary Funds (Enterprise Funds and Component Units, such as Universities)]:

When a government places cash and other monetary assets acquired with only existing resources with an escrow agent in a trust that meets the criteria established in GASB 7 for an in-substance defeasance, the debt should no longer be reported as a liability in the financial statements. Any difference between the reacquisition price and the net carrying amount of the debt defeased in-substance using only existing resources, together with any deferred outflows of resources or deferred inflows of resources from prior refundings, should be recognized as a separately identified gain or loss in the period of the in-substance defeasance. This financial reporting is different from when debt is defeased through a refunding. When only existing resources are used to defease debt the calculated difference is immediately recognized as a gain or loss instead of deferring the difference for recognition in future periods. New accounts have been created to report this gain or loss. The gain should be reported in account 437520 Gain on in-substance defeasance of debt and the loss should be reported in account 535341



Loss on in-substance defeasance of debt. These accounts will be classified as a nonoperating revenue (expense) using account caption Gain (Loss) on in-substance defeasance of debt.

Recognition in Financial Statements Using the Current Financial Resources Measurement Focus (Governmental Funds):

Payments to the escrow agent made from existing resources should be reported as debt service expenditures. This financial reporting is different from how payments to the escrow agent are reported in advance and current refundings. In advance and current refundings, payments to the escrow agent from resources provided by the new debt is reported as an other financing use – payment to refunded bond escrow agent.

GASB 86 should be applied retroactively. If entities have extinguished debt in prior years by placing cash and other monetary assets acquired with only existing resources in an irrevocable trust, determine if the transactions were properly reported in the financial statements in accordance with GASB 86. If not, determine if restatements are required. Materiality should be considered.

Note Disclosures:

When debt is extinguished using only existing resources, governments 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, for example, the amount of the defeased debt, the amount of cash and other monetary assets acquired with existing resources placed with the escrow agent, the reasons for the defeasance, and the amount of cash flows required to service the defeased debt.

In periods following an in-substance defeasance of debt using only existing resources, the amount of that debt that remains outstanding at period-end should be disclosed. Disclosure of the remaining amount of outstanding debt defeased in-substance using only existing resources can be combined with the disclosure of debt that is defeased in-substance through refunding transactions as specified in previous GASB standards.

Prepaid Insurance Related to Extinguished Debt

GASB 86 clarifies guidance on how to treat prepaid insurance of extinguished debt. For governments that extinguish debt, whether through a legal extinguishment or through an in-substance defeasance, GASB 86 requires any of the 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. GASB Statement No. 65, *Items Previously Reported as Assets and Liabilities*, removed guidance on how to treat prepaid insurance related to refunded debt causing inconsistent application. GASB 86 clarifies that prepaid insurance on the old (refunded) debt should be included in the old debt's net carrying amount. GASB 86 revised the definition of the net carrying amount as follows: 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.



Retroactive application is required. Entities should determine if previously refunded debt was insured, and if so, was the prepaid insurance of the defeased debt treated properly for financial reporting purposes in prior year refundings in accordance with GASB 86. If GASB guidance was not properly applied, determine if restatements are required. Materiality should be considered.

Additional Note Disclosure for All In-Substance Defeasance Transactions

GASB 86 establishes an additional note disclosure for all in-substance defeasance transactions. One of the qualifying criteria for an in-substance defeasance is that the trust hold only monetary assets that are 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 should disclose that fact in the period in which the debt is defeased in-substance. This must be disclosed if the substitution is not prohibited.

In subsequent periods, governments should disclose the amount of debt defeased in-substance that remains outstanding, if any, for which that risk of substitution exists. That amount should be disclosed separately from the total amount of debt defeased in-substance that remains outstanding.

Some state or local laws, trust or escrow agreements, and bond indentures prohibit substituting essentially risk-free monetary assets that do not meet the criteria for being classified as essentially risk-free. In other instances, such substitution is not expressly prohibited. In those instances, the government 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. If 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, information regarding the risk of substitution should be disclosed. Continuing disclosure of the amount of debt defeased in-substance outstanding at the end of the reporting period that is subject to this risk of substitution should also be disclosed. If the government substitutes essentially risk-free assets with non-risk-free assets, an evaluation should be made to determine whether each of the criteria for in-substance defeasance reporting continues to be met.

Implementation:

OSC is not aware of any state laws that prohibit the substitution of risk-free monetary assets for in-substance defeasance transactions. Entities should review trust or escrow agreements, bond indentures, etc. to determine if the substitution of risk-free monetary assets for in-substance defeasance transactions is prohibited. If it is not prohibited, these new disclosures are required for defeasances in the current year. Additionally, the amount of debt that remains outstanding at fiscal year-end that was defeased in-substance in prior years should also be disclosed.

To gain additional understanding of GASB 86, please refer to the following resource:

- The GASB webpage from which you can access a PDF file of GASB 86 as well as other GASB pronouncements – [GASB Pronouncements](#)



Thank you for your time and attention to this important change. OSC will continue to provide updates as the standard is implemented. Questions regarding this specific update should be directed to Joy Darden at (919) 707-0520 or joy.darden@osc.nc.gov.