Institute of Chartered Accountants of New Zealand

FINANCIAL REPORTING STANDARD NO. 26
1995

ACCOUNTING FOR DEFEASANCE OF DEBT

Issued by the Financial Reporting Standards Board
Institute of Chartered Accountants of New Zealand

Approved May 1995 by the Accounting Standards Review Board
under the Financial Reporting Act 1993

CONTENTS

This Standard replaces SSAP-26: Accounting for Defeasance of Debt (1990); although that Statement will continue to apply until the completion of accounting periods which begin prior to 1 September 1995.

This Standard should be read in the context of the Explanatory Foreword to General Purpose Financial Reporting published by the Council, Institute of Chartered Accountants of New Zealand.

The Accounting Standards Review Board (the Board) has approved FRS-26: Accounting for Defeasance of Debt, for the purposes of the Financial Reporting

Act 1993, to apply to reporting entities, the Crown and all departments, Offices of Parliament and Crown entities (each of which is defined in the Act).

The Board has also approved this Standard to apply to local authorities (as defined in the Act) from 1 July 1998.

1 INTRODUCTION

COMMENTARY

1.1 This Standard deals with the circumstances in which the liability of a debtor for a debt may be considered extinguished by defeasance, the accounting methods to be employed, and the required disclosure in respect of debt defeasance.

1.2 The *Statement of Concepts for General Purpose Financial Reporting* defines a liability as a future sacrifice of service potential or of future economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events. In this Standard the word liability is used interchangeably with the word debt.

1.3 The liability of a debtor may be extinguished:

(a) by repayment or replacement with another liability;

(b) through legal defeasance, including forgiveness, assumption of the obligation by a third party or legal judgement; or

(c) through an in-substance defeasance.

1.4 The Financial Reporting Standards Board recognises that in a number of cases there may be differences between the *Statement of Concepts for General Purpose Financial Reporting* and the specific requirements of particular financial reporting standards. This Standard requires a virtually certain condition regarding non-reassumption of debt servicing obligations to be satisfied before a liability can be considered defeased. This degree of certainty is a higher level of probability than that required for recognition under the *Statement of Concepts for General Purpose Financial Reporting* and is considered justified to enhance reliable external financial reporting.

1.5 This Standard does not cover the circumstances in which it is appropriate for amounts of assets and liabilities to be set off in the statement of financial position. These are dealt with in FRS-27: *Right of Set-off*. The set-off of assets and liabilities should not be confused with the extinguishment of a debt. Set-off is a disclosure issue, that is, how certain recognised assets and recognised liabilities should be presented in a statement of financial position. In contrast, extinguishment is a recognition issue, that is, whether an asset or a liability exists and whether continued recognition is warranted in the statement of financial position.

1.6 Financial reporting standards are paragraphs in bold type-face in this Standard. Where appropriate, interpretive commentary paragraphs in plain type-face follow the financial reporting standards.

2 APPLICATION

STANDARD

2.1 This Standard applies to the general purpose financial reports of all entities.

2.2 The financial reporting standards set out in this Standard shall apply to all financial reports where such application is of material consequence. A statement, fact, or item is material if it is of such a nature or amount that its disclosure, or the method of treating it, given full consideration of the circumstances applying at the time the financial report is completed, is likely to influence the users of the financial report in making decisions or assessments.

2.3 This Standard applies to financial reports covering periods beginning on or after 1 September 1995.

3 STATEMENT OF PURPOSE

COMMENTARY

3.1 The purpose of this Standard is to specify:

(a) the circumstances when a debt is to be considered extinguished by "defeasance";

(b) the accounting methods to be employed when a debt is defeased; and

(c) the disclosures required about the defeasance of debt in the financial report.

4 DEFINITIONS

STANDARD

The following terms are used in this Standard with these meanings:

4.1 "Cash balances" means balances which are held:

(a) with a creditworthy bank which is unrelated to the debtor; and

(b) by a trust (that qualifies in terms of paragraph 5.4) for meeting debt servicing requirements or the costs of administering the trust

for the minimum period practicable, usually not exceeding seven days, for the purpose of matching the maturities of the securities acquired with the debt servicing requirements and the costs of administering the trust.

4.2 "Creditworthy bank" means a deposit-taking institution rated by an internationally recognised credit rating agency as an investment grade risk.

COMMENTARY

4.3 Moody's and Standard and Poor's are considered internationally recognised credit rating agencies for the purposes of this Standard.

STANDARD

4.4 "Creditworthy government" means a government with a credit rating from an internationally recognised credit rating agency, no less than the rating afforded to the long-term foreign currency denominated debt securities of the New Zealand Government.

COMMENTARY

4.5 If the credit rating of the government issuing or guaranteeing the risk-free securities falls below the New Zealand Government rating, because either their own or the New Zealand Government rating has changed, that government will no longer be a creditworthy government for the purposes of this Standard.

STANDARD

4.6 "Debt servicing requirements" means obligations for principal, interest, other related liabilities under the debt, and includes any related foreign exchange exposure.

COMMENTARY

4.7 Entities that incur liabilities assume the obligation for the repayment of principal, interest, and certain fees and associated expenses. Whenever such amounts are denominated in a foreign currency, debt servicing obligations for the purposes of this Standard include all the costs of providing the currency equivalent of the amount ultimately paid or to be paid in principal, interest, and when applicable, fees and other associated expenses in the foreign currency.

STANDARD

4.8 "Defeasance" means the release of a debtor from the primary obligation for a debt other than by repayment.

COMMENTARY

4.9 The debtor may be released in a defeasance arrangement from debt servicing requirements of the total principal and interest obligations or of the whole or part of either principal or interest. Partial defeasance is when part of the total principal and interest obligation is defeased; this is considered in paragraphs 5.7 to 5.12.

STANDARD

4.10 "In-substance defeasance" means a defeasance other than a "legal defeasance" in which the debtor effectively and irrevocably achieves release from the primary obligation for a debt, by either:

(a) having a risk-free entity assume the debt; or

(b) by employment of a trust

in accordance with paragraphs 5.3 and 5.4 respectively.

COMMENTARY

4.11 Under this Standard, in-substance defeasance is subject to strict conditions before the liability is to be considered extinguished for accounting purposes and removed from the statement of financial position. A debt is not to be treated as extinguished, nor is it to be removed from the statement of financial position as a consequence of an in-substance defeasance unless it is virtually certain that the debtor will not be required either to assume again the primary obligation for the debt servicing requirements, or to satisfy any guarantees, indemnities, borrowing covenants or the like for the debt servicing requirements.

STANDARD

4.12 "Legal defeasance" means a defeasance in which the release of the debtor from the primary obligation for a debt is either:

(a) acknowledged formally by:

- **(i) the creditor; or**
- **(ii) a duly appointed trustee or agent of the creditor; or**

(b) established by legal judgment.

COMMENTARY

4.13 A legal defeasance may occur where the debt ceases to exist, or when the creditor formally acknowledges that the original debtor no longer has the primary obligation for the debt. In this latter circumstance a legal defeasance need not constitute the full legal settlement of debt.

4.14 A debt is not to be treated as extinguished nor is it to be removed from the statement of financial position as a consequence of a legal defeasance unless it is virtually certain that the debtor will be neither required to:

(a) assume again the primary obligation for the debt servicing requirements; nor required to

(b) satisfy any guarantees, indemnities, borrowing covenants, or the like for the debt servicing requirements.

STANDARD

4.15 "Primary obligation" for a liability comprises the debt servicing requirements and associated fees contracted for between debtor and creditor parties or agencies thereof.

4.16 "Risk-free assets" means monetary assets held in risk-free securities and cash balances.

4.17 "Risk-free entity" means a creditworthy government or a body guaranteed by a creditworthy government.

4.18 "Risk-free securities" means the securities of a creditworthy government or securities guaranteed by a creditworthy government.

COMMENTARY

4.19 Risk-free securities are restricted to securities of a creditworthy government and securities guaranteed by a creditworthy government, as only governments have the coercive power to tax.

STANDARD

4.20 "Secondary obligations" for a liability comprise undertakings that support the performance of a debtor under specific primary obligations.

COMMENTARY

4.21 Secondary obligations would normally include indemnities and guarantees, and may include various forms of borrowing covenants or pledges.

5 FINANCIAL REPORTING

Extinguishment of Debt

STANDARD

5.1 A debt shall be accounted for as having been extinguished when, and only when, the debt is:

(a) settled through repayment or replacement by another liability; or

(b) subject to a legal defeasance which meets the conditions set out in paragraph 5.2; or

(c) subject to an in-substance defeasance in which a risk-free entity assumes responsibility for the debt servicing requirements in a manner which satisfies paragraph 5.3; or

(d) subject to an in-substance defeasance employing a trust which meets the conditions set out in paragraph 5.4.

Legal Defeasance

STANDARD

5.2 The condition to be met before a debt shall be accounted for as having been extinguished by legal defeasance is that it shall be virtually certain that the debtor will be neither required to:

(a) assume again the primary obligation for the debt servicing requirements; nor required to

(b) satisfy any secondary obligations for the debt servicing requirements.

In-substance Defeasance by Assumption of Debt

STANDARD

5.3 The conditions to be met before a debt shall be accounted for as having been extinguished through an in-substance defeasance involving assumption of that debt by another entity are:

(a) the assuming entity is a risk-free entity or, when the assuming entity is not a risk-free entity the assumption is unconditionally guaranteed by a creditworthy government; and

(b) it is virtually certain that the debtor will not be required to assume again the primary obligation for the debt servicing requirements or to satisfy any secondary obligations for the debt servicing requirements.

In-substance Defeasance Employing a Trust

STANDARD

5.4 A debt shall be accounted for as extinguished through an in-substance defeasance employing a trust only when all the following conditions are met:

(a) risk-free assets are irrevocably transferred to a trust when:

(i) the trustees are independent of and remain independent of the entity, and

(ii) the trust is used solely to administer those risk-free assets to meet the debt servicing requirements of the debt;

(b) the risk-free assets transferred to the trust shall provide cash flows from interest and principal sufficient to match approximately in timing and amount the debt servicing requirements of the debt being defeased;

(c) the risk-free assets transferred to the trust shall be denominated in the same currency as the debt being defeased; if this denomination is achieved with a financial instrument, the counter-party shall be a risk-free entity;

(d) the risk-free assets transferred to the trust shall be fixed or variable interest rate securities that match the interest profile of the debt; if this matching is achieved with a financial instrument, the counter-party shall be a risk-free entity; and

(e) it is virtually certain that the debtor will not be required either to assume again the primary obligation for the debt servicing requirements or to satisfy any secondary obligations for the debt servicing requirements.

Reinstatement of Debt

STANDARD

5.5 When a debt has been considered as extinguished for financial reporting purposes, but subsequently the conditions in paragraphs 5.2, 5.3 or 5.4, which allowed the defeasance, cease to be met, both the debt and the assets shall be reinstated in the statement of financial position.

COMMENTARY

5.6 An example of when reinstatement of an extinguished debt is required is when assets in a trust cease to be risk-free assets in terms of paragraph 4.16.

Partial Extinguishment of Debt

STANDARD

5.7 When the amount to be defeased, in accordance with paragraphs 5.2, 5.3 or 5.4, is equal to some or all of the principal of a debt or is equal to some or all of the interest on a debt, the defeasance shall be accounted for as a partial extinguishment of debt (partial defeasance).

5.8 When there is partial extinguishment of a debt, the outstanding liability shall be determined by discounting the remaining debt servicing requirements at the original interest rate or original interest rates implicit in the original debt arrangement.

COMMENTARY

5.9 Whatever the legal form of a partial extinguishment, the economic substance is defeasance of a part of the principal and the interest on that part.

5.10 When only the principal of a debt has been defeased, the debtor has still to pay the interest and so has a liability for the interest. This liability is calculated by discounting the amounts still to be paid at the interest rate implicit in the original debt servicing requirements. Thus, although the legal form of the arrangement is that no principal remains payable, the economic substance is that the defeasance has extinguished only part of the principal together with the interest on that part. An amount of debt can be treated as defeased only if the debtor has no further debt servicing requirements for that amount of debt.

5.11 When only the interest of a debt has been defeased, an interest component remains in the amount of legal principal to be paid in the future. As in paragraph 5.10 the amount of the remaining liability is calculated by discounting the future payments at the interest rate implicit in the original debt servicing arrangement. Thus, although the legal form of the arrangement is that no interest remains payable, the economic substance is that the defeasance has extinguished part of the principal together with the interest on that part.

5.12 The undefeased principal and interest in a partial defeasance are to be accounted for on the basis of the reduction in the present value of the outstanding balance at each balance date.

Instantaneous Defeasance

STANDARD

5.13 An instantaneous defeasance, whether legal or in-substance, shall be recognised and shall be accounted for when the instantaneous defeasance meets the conditions in any of paragraphs 5.2, 5.3 or 5.4.

COMMENTARY

5.14 On occasions a defeasance may occur either simultaneously with, or shortly after, the original debt is incurred. These transactions are referred to as instantaneous defeasance transactions. Certain jurisdictions view the principal purpose of such transactions is often to borrow and invest to achieve benefits rather than to extinguish existing debt.

5.15 This Standard takes the view that debt is to be removed from the statement of financial position of the debtor only when the primary obligation of the debtor has been discharged or the debtor has been placed in virtually the same position as if the debt has been discharged. Thus, although it is quite possible to distinguish the circumstances of a normal defeasance from those of an instantaneous defeasance, it may not be possible to distinguish the position of the debtor in terms of subsequent lack of primary obligation. Accordingly, this Standard does not preclude accounting for an instantaneous defeasance as an extinguishment, providing the conditions set out in any of paragraphs 5.2, 5.3 or 5.4 for defeasance are met.

Cost of Defeasance

STANDARD

5.16 Any costs incurred in arranging a defeasance of debt shall be recognised as an expense at the time of entering into the defeasance arrangement.

5.17 When there are on-going costs to be incurred in administering a trust employed for an in-substance defeasance, either:

(a) those costs shall be met by transferring sufficient risk-free assets to the trust to meet those costs in addition to the debt servicing obligations; or

(b) the debtor shall recognise a liability and expense for those costs at the time of entering the defeasance arrangement.

Gains and Losses on Defeasance of Debt

STANDARD

5.18 When the carrying amount of an asset given up in defeasance of a debt differs from the carrying amount of the debt, the difference shall be recognised as a gain or loss on defeasance in the statement of financial performance, as at the time of entering into the defeasance arrangement. Any expense recognised in accordance with paragraph 5.16 or 5.17 shall be included in the determination of that gain or loss. When the application of this financial reporting standard results in the reinstatement of a liability and asset, the difference between the amount of the liability and the asset reinstated shall be recognised at the time of reinstatement as a gain or loss on reinstatement.

COMMENTARY

5.19 The amounts of assets and liabilities to be accounted for in terms of paragraph 5.18 are to be calculated by discounting their future cash flows at the rates of interest implicit in the arrangements giving rise to those assets and liabilities. When a defeasance of debt leads to the adjustment of the carrying amount of assets and liabilities, these adjustments are to be included in the gain or loss on defeasance.

5.20 In some in-substance defeasances, the assets given up by the debtor will achieve a higher rate of return than the rate of interest on the debt being defeased and therefore a gain arises from the difference between the carrying amount of the assets and the carrying amount of the debt being defeased. When this happens, the extinguishment of the debt and the giving up of the assets together result in a realised gain. This gain is to be recognised immediately in the statement of financial performance.

5.21 In some defeasance arrangements, including legal defeasance, the debtor may forgo the stipulated interest receivable on a long-term receivable as part of the arrangement. Before determining the gain or loss on defeasance, it is necessary in these cases to bring to account a discount in relation to the receivable, which is determined by discounting the sum receivable in the future (at the rate implicit in the arrangement giving rise to the receivable) to its principal equivalent at the time of the defeasance. The amount of the decrease in the carrying amount of the receivable, together with the amount of any other asset given up, are then compared with the carrying amount of the debt to determine the gain or loss on the defeasance.

Disclosures

STANDARD

5.22 The financial report shall disclose:

(a) in the period in which the defeasance takes place:

- **(i) the aggregate carrying amount of assets given up for the purpose of defeasance;**
- **(ii) the aggregate carrying amount of debt extinguished by defeasance;**
- **(iii) the net gain or loss on defeasance recognised in the statement of financial performance;**

(b) in the period in which amounts previously derecognised are reinstated:

- **(i) the aggregate amount of the assets reinstated;**
- **(ii) the aggregate amount of the liability reinstated;**
- **(iii) the net gain or loss on reinstatement recognised in the statement of financial performance;**
- **(iv) the reason for the entity having to reinstate the liability;**

(c) for any debt defeased by an in-substance defeasance, details of:

- **(i) any amounts defeased but as yet unsettled and their maturity dates;**

(ii) **any outstanding secondary obligations with the maximum exposure of these secondary obligations; and**

(d) for any debt defeased by a legal defeasance, details of any outstanding secondary obligations with the maximum exposure of these secondary obligations.

COMMENTARY

5.23 Paragraph 5.2 requires that legal defeasances are to be recognised only when it is virtually certain that the debtor will not be required either to assume again the primary obligation for the debt servicing requirements, or to satisfy any guarantees or indemnities for the debt servicing requirements. However, legal defeasances often include some form of indemnity or guarantee when, under some circumstances, the original debtor is to assume again some or all of the original obligations. When it is virtually certain that the debtor will not be required to assume again any of the obligations, these arrangements may be accounted for as legal defeasances; disclosure is made of such circumstances. This Standard therefore requires a statement of the maximum exposure under these forms of indemnity or guarantee.

APPENDIX

Comparison of FRS-26 with International and Australian Accounting Standards

This comparison appendix, which was prepared as at 1 May 1995 and deals only with significant differences in the standards, is produced for information only and does not form part of the standards in FRS-26.

The Australian Accounting Standard comparable with FRS-26 is:

- AASB 1014: *Set-off and Extinguishment of Debt*.

The International Accounting Standards Committee has not issued an accounting standard comparable with FRS-26.

The following summarises the significant differences between FRS-26 and AASB 1014.

Scope

AASB 1014 deals with both set-off and extinguishment of debt. FRS-26 deals only with extinguishment of debt; set-off is dealt with separately in FRS-27: *Right of Set-off*.

Definitions

FRS-26 includes in its definition of "cash balances" the requirement that cash balances be held by a creditworthy bank which is unrelated to the debtor. No such requirement is contained in AASB 1014.

FRS-26 defines the term "creditworthy government" with reference to the New Zealand Government and internationally recognised credit rating agencies. AASB 1014 has no corresponding definition.

The definition of "debt servicing requirements" in FRS-26 includes foreign exchange exposures and contractual fees within obligations. AASB 1014 does not included these items.

The term "risk-free assets" is defined in both FRS-26 and AASB 1014. A difference arises between the two definitions through the use of the term "securities of a risk-free entity" in AASB 1014. This term requires a body to be guaranteed under statute by a creditworthy government. FRS-26 does not have any corresponding requirement.

Extinguishment of Debt

FRS-26 requires a "virtually certain" condition regarding the non-reassumption of debt servicing obligations to be satisfied before a liability can be accounted for as having been defeased.

The corresponding condition in AASB 1014 is that the reassumption of debt servicing requirements is “highly improbable”, which is a lesser degree of probability than that required under FRS-26.

In-substance Defeasance through use of a Trust

While the standards are substantially in agreement about the conditions to be fulfilled for the recognition of a defeasance through the use of a trust, the following are the additional features in FRS-26

(a) The Standard requires specifically that the cash flows from the risk-free assets transferred to the trust should match approximately in timing and amount the servicing requirements of the debt.

(b) The Standard requires specifically that the risk-free assets transferred to the trust should be fixed or variable rate securities that match the interest profile of the debt. If this is achieved with a financial instrument, the counter-party is to be a risk-free entity.

Gain/Loss Recognition on Reinstatement

FRS-26 (paragraph 5.18) specifies the accounting treatment of gains or losses that may arise in the event that the application of FRS-26 gives rise to the reinstatement of an asset or liability.

AASB 1014 is silent on the accounting treatment of gains or losses arising from reinstatement of an asset or liability.

Disclosure

FRS-26 requires disclosure of the following information which is not required to be disclosed under AASB 1014:

- In respect of debt defeased by in-substance defeasance:
  - the maturity dates of any amounts defeased but as yet unsettled.
- In the period in which amounts previously derecognised are reinstated:
  - the aggregate amount of assets reinstated;
  - the aggregate amount of the liability reinstated;
  - the net gain or loss on reinstatement recognised in the statement of financial performance; and
  - the reason for the entity having to reinstate the liability.

AASB 1014 requires disclosure of the following information which is not required in FRS-26:

- In respect of debt defeased by legal defeasance;
  - disclosure of the amounts defeased which are outstanding.

FRS-26

HISTORY

Previously issued accounting standards superseded by this Financial Reporting Standard:

SSAP-26: Accounting for Defeasance of Debt (issued October 1990 and effective for periods commencing on or after 1 April 1991).

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