

Statement of Financial Accounting Standards No. 76

Note: This Statement has been completely superseded

[FAS76 Status Page](#)
[FAS76 Summary](#)

Extinguishment of Debt

an amendment of APB Opinion No. 26

November 1983



Financial Accounting Standards Board

of the Financial Accounting Foundation

401 MERRITT 7, P.O. BOX 5116, NORWALK, CONNECTICUT 06856-5116

Copyright © 1983 by Financial Accounting Standards Board. All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without the prior written permission of the Financial Accounting Standards Board.

Statement of Financial Accounting Standards No. 76

Extinguishment of Debt

an amendment of APB Opinion No. 26

November 1983

CONTENTS

	Paragraph Numbers
Introduction and Scope.....	1– 2
Standards of Financial Accounting and Reporting:	
Circumstances for an Extinguishment of Debt	3– 5
Disclosures	6
Amendments to Other Pronouncements.....	7–11
Effective Date and Transition.....	12
Appendix A: Background Information.....	13–16
Appendix B: Basis for Conclusions	17–44

FAS 76: Extinguishment of Debt

an amendment of APB Opinion No. 26

FAS 76 Summary

This Statement provides guidance to debtors as to when debt should be considered to be extinguished for financial reporting purposes. This project was undertaken in response to requests to clarify the circumstances that constitute extinguishment and because the Board learned of growing diversity in practice.

This Statement specifies that debt is to be considered extinguished if the debtor is relieved of primary liability for the debt by the creditor and it is probable that the debtor will not be required to make future payments as guarantor of the debt. This Statement also specifies that, even though the creditor does not relieve the debtor of its primary obligation, debt is to be considered extinguished if (a) the debtor irrevocably places cash or other essentially risk-free monetary assets in a trust solely for satisfying that debt and (b) the possibility that the debtor will be required to make further payments is remote. This Statement amends APB Opinion No. 26, *Early Extinguishment of Debt*, to make it apply to all extinguishments of debt, whether early or not, other than those currently exempted from its scope, such as debt conversions and troubled debt restructurings.

This Statement is applicable to transactions occurring after December 31, 1983, with earlier application encouraged in annual financial statements that have not been previously issued. This Statement also permits the restatement of previously issued financial statements to apply this Statement retroactively.

INTRODUCTION AND SCOPE

1. This Statement addresses what shall be considered to be an extinguishment of debt, which in turn affects when the debtor recognizes a gain or loss on extinguishment. This Statement does not address the accounting for redeemable preferred stock. The circumstances for an extinguishment of debt described in paragraphs 3(b) and 3(c) do not apply to debt that is convertible into the debtor's equity securities. Furthermore, the circumstances for an

extinguishment of debt described in paragraph 3(c) apply only to debt with specified maturities and fixed payment schedules; consequently, those circumstances do not apply to debt with variable terms that do not permit advance determination of debt service requirements, such as debt with a floating interest rate.

2. Because extinguishment of debt currently is addressed by APB Opinion No. 26, *Early Extinguishment of Debt*, that Opinion is amended to refer to the standards in this Statement for guidance about what shall be considered to be an extinguishment of debt. This Statement also amends that Opinion to make it apply to all extinguishments of debt, whether early or not, other than those currently exempted from its scope, such as debt conversions as described in that Opinion and troubled debt restructurings as described in FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Circumstances for an Extinguishment of Debt

3. A debtor shall consider debt to be extinguished for financial reporting purposes in the following circumstances:

- a. The debtor pays the creditor and is relieved of all its obligations with respect to the debt. This includes the debtor's reacquisition of its outstanding debt securities in the public securities markets, regardless of whether the securities are cancelled or held as so-called treasury bonds.
- b. The debtor is legally released ¹ from being the primary obligor under the debt either judicially or by the creditor and it is probable ² that the debtor will not be required to make future payments with respect to that debt under any guarantees.
- c. The debtor irrevocably places cash or other assets in a trust to be used solely for satisfying scheduled payments of both interest and principal of a specific obligation and the possibility that the debtor will be required to make future payments with respect to that debt is remote. In this circumstance, debt is extinguished even though the debtor is not legally released from being the primary obligor under the debt obligation.

Restrictions on the Nature of Assets in Trust

4. The following requirements regarding the nature of the assets held by the trust shall be met to effect an extinguishment of debt under paragraph 3(c):

- a. The trust shall be restricted to owning only monetary assets ³ that are *essentially risk free* as to the amount, timing, and collection of interest and principal. The monetary assets shall be denominated in the currency in which the debt is payable. For debt denominated in U.S.

dollars, essentially risk-free monetary assets shall be limited to:

- (1) Direct obligations of the U.S. government
- (2) Obligations guaranteed by the U.S. government
- (3) Securities that are backed by U.S. government obligations as collateral under an arrangement by which the interest and principal payments on the collateral generally flow immediately through to the holder of the security.

However, some securities described in the previous sentence can be paid prior to scheduled maturity and so are not essentially risk free as to the *timing* of the collection of interest and principal; thus, they do not qualify for ownership by the trust.

- b. The monetary assets held by the trust shall 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 debt that is being extinguished.

Costs Related to Placing Assets in Trust

5. If, in conjunction with placing assets in trust to effect an extinguishment of debt, it is expected that trust assets will be used to pay related costs, such as trustee fees, as well as to satisfy scheduled interest and principal payments of a specific debt, those costs shall be considered in determining the amount of funds required by the trust. On the other hand, if the debtor incurs an obligation to pay any related costs, the debtor shall accrue a liability for those probable future payments in the period that the debt is recognized as extinguished.

Disclosures

6. If debt is considered to be extinguished under the provisions of paragraph 3(c), a general description of the transaction and the amount of debt that is considered extinguished at the end of the period shall be disclosed so long as that debt remains outstanding.

Amendments to Other Pronouncements

7. Paragraph 2 of Opinion 26, which addresses the applicability of that Opinion, is superseded and replaced by the following:

Applicability. This Opinion applies to all extinguishments of debt, whether early or not, except debt that is extinguished through a troubled debt restructuring and debt that is converted to equity securities of the debtor pursuant to conversion privileges provided in terms of the debt at issuance. It supersedes Chapter 15 of ARB No. 43 and paragraph 19 of APB Opinion No. 6. However, it does not alter the accounting for convertible debt securities described in APB Opinion No. 14.

8. Paragraph 3(a) of Opinion 26, which defines *early extinguishment*, is superseded and replaced by the following:

- a. *Extinguishment of debt.* FASB Statement No. 76, *Extinguishment of Debt*, defines transactions that the debtor shall recognize as an extinguishment of debt.
9. The following terms and phrases are deleted from Opinion 26 as indicated:
 - a. In paragraph 3(c), the term *early*
 - b. In paragraph 19, the phrase *before scheduled maturities*
 - c. In paragraph 21, the phrase *before maturity*.
10. The last sentence of footnote 1 of FASB Statement No. 22, *Changes in the Provisions of Lease Agreements Resulting from Refundings of Tax-Exempt Debt*, which refers to AICPA Statement of Position (SOP) 78-5, *Accounting for Advance Refundings of Tax-Exempt Debt*, is superseded and replaced by the following:

FASB Statement No. 76, *Extinguishment of Debt*, provides criteria for determining whether the advance refunding should be recognized as an extinguishment of the existing debt at the date of the advance refunding.
11. The reference to SOP 78-5, *Accounting for Advance Refundings of Tax-Exempt Debt*, is deleted from Appendix A of FASB Statement No. 32, *Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters*.

Effective Date and Transition

12. This Statement shall be effective for transactions entered into after December 31, 1983. Earlier application of this Statement is encouraged for transactions in fiscal years for which annual financial statements have not previously been issued. Furthermore, retroactive application of this Statement to transactions occurring during fiscal years for which annual financial statements have previously been issued is permitted, in which case the effects on restated per share amounts of prior years shall be disclosed.

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

This Statement was adopted by the affirmative votes of four members of the Financial Accounting Standards Board. Messrs. Kirk, March, and Mosso dissented.

Messrs. Kirk, March, and Mosso dissent from this Statement because they do not believe that extinguishment of debt accounting and resultant gain or loss recognition should be extended to situations wherein the "debtor is not legally released from being the primary obligor under the debt obligation." (Refer to paragraph 3(c).) They believe such accounting should be limited to situations described in paragraphs 3(a) and 3(b), which are more consistent with both present

practice and the concept in paragraph 143 of FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises*, that "a liability once incurred by an enterprise remains a liability until it is satisfied in another transaction or other event or circumstance affecting the enterprise." In their opinion, the setting aside of assets in trust does not, in and of itself, constitute either the disposition of assets with potential gain or loss recognition or the satisfaction of a liability with potential gain or loss recognition. Though dedicated to a single purpose, assets in the trust continue to be assets (that is, probable future economic benefits) of the debtor until applied to payment of the debt. Likewise, the liability continues to be a liability of the original debtor until satisfied by payment or by agreement of the creditor that the debtor is no longer the primary obligor. Dedicating the assets might ensure that the debt is serviced in timely fashion, but that event alone just matches up cash flows; it does not satisfy, eliminate, or extinguish the obligation. For a debt to be satisfied, the creditor must be satisfied.

Members of the Financial Accounting Standards Board:

Donald J. Kirk, *Chairman*
Frank E. Block
Victor H. Brown
John W. March
David Mosso
Robert T. Sprouse

Appendix A: BACKGROUND INFORMATION

Introduction

13. This project was undertaken because the FASB was asked to clarify the circumstances that should cause debt to be considered to be extinguished. Specific inquiries focused on a type of transaction discussed in SOP 78-5. That SOP is one of the AICPA documents from which the FASB is extracting specialized accounting and reporting principles and practices ⁴ and is issuing them in FASB Statements after appropriate due process, as discussed in Statement 32.

14. SOP 78-5 stipulates that, in an advance refunding, ⁵ a debtor has extinguished its tax-exempt debt if a legal defeasance ⁶ of that debt has occurred. The SOP also establishes criteria for determining when a debtor would account for a transaction as an extinguishment of its tax-exempt debt even though legal defeasance of the debt has not occurred. Those transactions, which are described in SOP 78-5 and are referred to as "in-substance defeasance," involve placing assets in trust and irrevocably restricting their use solely to satisfy specific debt. The FASB was specifically asked whether the criteria for "in-substance defeasance" of tax-exempt debt could be used in determining if debt other than tax-exempt debt has been

extinguished.

Issuance of Exposure Drafts

15. An Exposure Draft of a proposed Statement, *Extinguishment of Debt and the Offsetting of Restricted Assets against Related Debt*, was issued on October 13, 1982 with a 60-day comment period. The Exposure Draft proposed a new exception to the general principle in paragraph 7 of APB Opinion No. 10, *Omnibus Opinion—1966*, that assets and liabilities should not be offset unless right of setoff exists. The Exposure Draft also proposed that debt be considered to be extinguished only when the debtor's obligation to the creditor has been satisfied, thereby not permitting "in-substance defeasance" transactions to be accounted for as extinguishments. In addition, the Exposure Draft proposed that debt not be considered to be extinguished if there is any continuing or contingent recourse to the debtor with respect to the debt. The Board received 62 letters of comment in response to the Exposure Draft. Respondents indicated concerns about portions of that Exposure Draft.

16. After considering the comments received, the Board concluded that the Exposure Draft should be revised and reissued for public comment. On July 14, 1983, the Board issued a revised Exposure Draft, *Extinguishment of Debt*, with the following principal changes from the October 1982 Exposure Draft:

- a. Debt would be considered extinguished if the debtor is relieved by the creditor from being primarily liable for the debt and is virtually assured that it will not be required to make future payments as guarantor of the debt. Furthermore, even though the creditor does not relieve the debtor of its primary obligation, debt would be considered extinguished if the debtor irrevocably places cash or other assets in a trust to be used solely for satisfying specific debt service requirements of that debt obligation and the debtor is virtually assured that it will not be required to make further payments with respect to the debt that is being recognized as extinguished.
- b. No change was proposed to the general principle in Opinion 10 that assets and liabilities should not be offset unless right of setoff exists.

The Board received 75 comment letters on the revised Exposure Draft.

Appendix B: BASIS FOR CONCLUSIONS

17. This appendix discusses the significant comments received on the revised Exposure Draft and the factors deemed significant by members of the Board in reaching the conclusions in this Statement, including alternatives considered and reasons for accepting some and rejecting others. The Board concluded that it could reach an informed decision on the basis of existing information without a public hearing. Individual Board members gave greater weight to some

factors than to others.

Assumption of Debt by Third Party

18. The Board believes there is a substantive difference between being primarily liable for an obligation and being only secondarily liable for that obligation. Thus, the Board believes that the assumption by a third party of a debtor's obligation to pay a debt and the concurrent agreement by the creditor to look primarily to that third party and only secondarily to the original debtor is an event that affects the original debtor's accounting for that debt. FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises*, states in paragraph 143 that "a liability once incurred by an enterprise remains a liability until it is satisfied in another transaction or other event or circumstance affecting the enterprise." The Board believes that being legally released from being the primary obligor for a debt is "another transaction or other event or circumstance affecting the enterprise" that satisfies a debtor's obligation if it is probable that the debtor will not be required to make future payments with respect to the debt. Concepts Statement 3 also recognizes the substantive difference between being primarily and secondarily liable in paragraphs 136 and 137, which state:

. . . Most liabilities bind a single enterprise or other entity, and those that bind two or more enterprises or other entities are commonly ranked rather than shared. For example, a primary debtor and guarantor may both be obligated for a debt, but they do not have the same obligation—the guarantor must pay only if the primary debtor defaults and thus has a contingent or secondary obligation, which ranks lower than that of the primary debtor.

. . . The probability that a secondary or lower ranked obligation will actually have to be paid must be assessed to apply the definition [of a liability].

Accordingly, the Board stated in paragraph 3(b) of the revised Exposure Draft that a debtor shall consider debt to be extinguished for financial reporting purposes, even though the creditor has not been paid in full, if the debtor is legally released from being the primary obligor under the debt either judicially or by the creditor and is virtually assured that it will not be required to make future payments with respect to that debt under any guarantees. Although the respondents supported the Board's distinction between being primarily liable for an obligation and being only secondarily liable for that obligation, many felt that paragraph 3(b) posed implementation problems in two respects: (a) use of the term *virtually assured* and (b) requirement for a legal release from the creditor.

Use of the Term Virtually Assured

19. Many respondents stated that the revised Exposure Draft's requirement that the debtor be *virtually assured* that it will not be required to make future payments with respect to the debt imposes too high a level of confidence when applied to debt assumptions, particularly real estate transactions. Because the debtor legally has only a contingent liability, the accounting for which

is addressed by FASB Statement No. 5, *Accounting for Contingencies*, respondents generally suggested that the term *virtually assured* be replaced by the term *probable* as used in Statement 5. The Board concurs with those respondents and has changed paragraph 3(b) accordingly.

Requirement for a Legal Release from the Creditor

20. Some respondents thought the requirement in paragraph 3(b) for a legal release from the creditor was too strict and would change current practice for some real estate transactions. They suggested that debt be considered extinguished whenever a "debt assumption" gives the debtor assurance that it will not be required to make future payments, even though the debtor is not legally released from being the primary obligor under the debt obligation. The Board decided to retain the requirement for a legal release in paragraph 3(b) because that subparagraph focuses on the important distinction between being primarily liable for an obligation and being only secondarily liable for that obligation. The Board specifies in paragraphs 3(c) and 4 the conditions for an extinguishment when the debtor continues to be legally liable as the primary obligor. The Board believes third party debt "assumptions" without a legal release from the primary obligation effectively create for the debtor a receivable from the third party for the payments expected to be made by that party on the debtor's behalf.

21. Some respondents asked whether a legal release by the creditor is necessary for the extinguishment of nonrecourse debt that is assumed in conjunction with the sale of assets that serve as sole collateral for that debt. The Board believes that such a sale and related assumption effectively accomplish a "legal release" for the seller/debtor and has added a footnote to paragraph 3(b) to clarify that point.

In-Substance Defeasance and Extinguishment of Debt

22. The Board believes that, in general, recognizing the effect of in-substance defeasance transactions as extinguishing debt is reasonable because settlement in cash is not always feasible and the effect of an in-substance defeasance is essentially the same. Accordingly, the Board believes that, in certain circumstances, debt should be considered extinguished for financial reporting purposes even though the debtor is not legally released from being the primary obligor under the debt obligation. In the July 1983 revised Exposure Draft, the Board proposed in paragraph 3(c) that debt be considered extinguished if the debtor irrevocably places cash or other assets in a trust to be used solely for satisfying specific debt service requirements of a debt obligation and the debtor is virtually assured that it would not be required to make future payments with respect to that debt, even though the debtor was not legally released from being the primary obligor under the debt obligation. The revised Exposure Draft also would have imposed certain restrictions in paragraph 4 regarding the nature of the assets held by the trust to reinforce the high threshold imposed by the Board for recognizing an extinguishment of debt when the debtor remains the primary obligor.

23. Most respondents supported the concept that an in-substance defeasance is an

extinguishment of debt for financial reporting purposes, although some respondents suggested changes to the revised Exposure Draft. Many respondents commented about (a) the requirement in paragraph 3(c) that the debtor be *virtually assured* and (b) the requirement in paragraph 4 that the trust assets be *essentially risk free*.

Use of the Term Virtually Assured

24. The respondents' most frequent concern was about the use of the term *virtually assured*. Some perceived the term as requiring a level of confidence so near absolute certainty as to be unworkable—a level that goes beyond the intent of the conceptual framework. Others objected to use of the term because it was undefined and no substantive guidance was provided to apply it. Still other respondents were concerned because they saw no need for a new term. Many respondents recommended that the Board use terms that are used in other accounting standards, such as *probable* and *remote* as defined in Statement 5.

25. The Board agreed that use of a new term is unnecessary and changed paragraph 3(c) to use the term *remote*. In doing so, the Board does not intend to lower the high threshold of this Statement for in-substance defeasance transactions; the term *remote* establishes a high test and the trust assets are still required by paragraph 4 to be essentially risk free.

26. As discussed above, paragraph 3(c) of this Statement now requires that the possibility be remote that the debtor will be required to make future payments with respect to the debt. That requires an assessment of the circumstances at the date of the in-substance defeasance transaction regarding the likelihood of the debtor's being required to make such future payments. A requirement for such future payments by the debtor could arise due to an inadequacy of trust assets attributable not only to a failure to realize scheduled cash flows from trust assets but also to an acceleration of the debt's maturity due to a violation of a covenant of the debt issue being extinguished or, if cross-default provisions exist, of a covenant of another debt issue.

27. The Board believes that a debtor's placing assets irrevocably in a trust to be used solely to pay the debtor's obligation is "another transaction or other event or circumstance affecting the enterprise" (refer to paragraph 18 of this Statement) that effectively satisfies a debtor's obligation if the possibility is remote that the debtor will be required to make further payments with respect to the debt that is being recognized as extinguished. The Board believes that such an arrangement ensures that the debtor has no "probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events," the definition of a liability in paragraph 28 of Concepts Statement 3 (footnote references omitted). Thus, the Board believes that the debtor should remove the liability for the debt from its balance sheet.

Requirement That Assets Be Essentially Risk Free

28. The revised Exposure Draft stipulated two requirements that the assets placed in trust in an in-substance defeasance had to meet:

- a. They are monetary assets that are *essentially risk free* as to collection of interest and principal.
- b. Their maturities do not extend beyond the maturity of the debt that is being extinguished.

Those requirements were intended to eliminate nearly all risk that the trust would not have funds available to meet the scheduled interest and principal repayments on the defeased debt.

29. Most respondents requested further guidance about what assets should be considered essentially risk free. Some respondents considered investments in direct obligations of the U.S. government as the only monetary assets that could be considered essentially risk free because they alone were cited as an example. Some respondents disputed the Board's view that an investment in highly rated corporate securities should not be considered to be essentially risk free as to collection of interest and principal. A few respondents asked whether trust assets also had to be risk free with respect to the timing of the collection of principal and interest.

30. The Board believes the concept of in-substance defeasance requires trust assets to be risk free not only with respect to the collection of principal and interest but also with respect to the timing of those collections. Paragraph 4(a) clarifies that point.

31. Although it would prefer to provide only broad guidance as to what monetary assets are to be considered essentially risk free under paragraph 4, the Board decided that specific guidance is needed to preserve the high threshold it considers necessary for in-substance defeasance transactions. Accordingly, the Board stipulated that, for debt denominated in U.S. dollars, essentially risk-free assets shall be limited to direct obligations of the U.S. government, obligations guaranteed by the U.S. government, and securities collateralized by U.S. government obligations, provided such monetary assets are essentially risk free as to both the collection of interest and principal and the timing of such collections. The Board believes that securities that are backed by U.S. government obligations as collateral should be considered essentially risk free as to the timing of the collection of interest and principal only if an arrangement exists in which the interest and principal payments on the collateral generally flow immediately through to the holder of the security, for example, as in a closed trust.

32. Several respondents asked the Board to provide guidance regarding the in-substance defeasance of debt denominated in foreign currencies and whether the trust can use forward contracts to protect against exchange rate changes if only U.S. government obligations qualify for trust assets. The Board concluded that neither U.S. government obligations nor such forward contracts would be essentially risk-free monetary assets to defease debt denominated in foreign currencies. Consequently, paragraph 4(a) requires that the trust invest only in monetary assets that are denominated in the currency in which the debt is payable. The level of assurance with respect to the collection of interest and principal, and the timing of such collections, from monetary assets denominated in foreign currencies should be equivalent to that required for the in-substance defeasance of debt denominated in U.S. dollars.

33. Some respondents questioned the accounting for reacquiring in the marketplace debt that has previously been extinguished due to an in-substance defeasance, specifically whether further gain or loss could be recognized. The Board believes that, if a debtor purchases its own debt securities that have previously been recognized as extinguished in an in-substance defeasance, the debtor is making an investment in the future cash flows from the trust and should report its investment as an asset in its balance sheet. The debtor should not be considered to be reextinguishing its debt. Thus, no gain or loss should be recognized from such purchase of those debt securities.

The Need for Matching Maturities and the Effect of Reinvestment Earnings

34. Inherent in the concept of in-substance defeasance is the matching of the trust's cash inflows from its investments with its cash outflows for paying periodic interest payments and principal repayment. The Board believes that matching of assured inflows with scheduled outflows is important so that the trust is not exposed to any risk on reinvesting premature inflows. SOP 78-5 recognized the importance of matching cash flows and required that "the funds used to consummate the advance refunding [be] invested in qualifying securities with maturities that approximate the debt service requirements of the trust." As a surrogate for requiring the matching of trust inflows and outflows, the revised Exposure Draft (a) required that the monetary assets held by the trust have maturities not extending beyond the maturity of the debt being extinguished and (b) excluded from the defeasance computation any earnings from the reinvestment of the scheduled net inflows from maturity of the trust's initial investments. That exclusion was intended to preclude significant mismatching of cash flows. Some respondents incorrectly interpreted the exclusion of reinvestment earnings as a prohibition against compounding interest.

35. The Board has decided to address more directly the need for matching the trust's cash flows. Consequently, paragraph 4(b) requires that the monetary assets held by the trust provide cash flows (from interest and maturity) that approximately coincide, as to timing and amount, with the scheduled interest and principal payments on the debt that is being extinguished. That requirement will serve to minimize significant reinvestment earnings.

Partial Defeasances

36. Some respondents asked whether the in-substance defeasance of only a portion of the obligations under a debt issue was permitted by the revised Exposure Draft. Although in-substance defeasance transactions have typically, as the Board understands, comprehended an entire debt issue, the Board believes that conceptually there is no impediment to a partial in-substance defeasance. In a partial in-substance defeasance, the debt considered extinguished will be either (a) a pro rata portion of all remaining interest and principal repayment obligations of the debt issue or (b) the principal and interest payments for a specific debt instrument (such as a serial bond with a specific scheduled maturity). Thus, the debtor cannot recognize a partial defeasance of the obligation for only the interest payments or for only the principal repayment.

Applicability

37. Several respondents asked whether the revised Exposure Draft permits the in-substance defeasance of convertible debentures, debt with floating interest rates, and capitalized lease obligations. Respondents also asked whether the document was intended to apply to preferred stock with mandatory redemptions provisions. The Board has concluded that the provisions for an extinguishment in paragraphs 3(b) and 3(c) do not apply to convertible debentures due to the inseparability of the debt and the conversion option and to the fact that there will be no obligation to pay if the debentures are converted. The Board decided that the circumstances for an extinguishment of debt described in paragraph 3(c) apply only to debt with specified maturities and fixed payment schedules; consequently, the provisions for in-substance defeasance in paragraph 3(c) do not apply to debt with floating interest rates because of the uncertainty of the future debt service requirements. However, the provisions for in-substance defeasance generally apply to capitalized lease obligations if the lease obligation has a specified maturity and a fixed payment schedule. The Statement does not apply to preferred stock with mandatory redemption provisions because the Board has not addressed whether such preferred stock should be accounted for as debt.

38. Consistent with Opinion 26, this Statement does not address extinguishment through conversion of debt by exchange for equity securities of the debtor pursuant to conversion privileges provided in the terms of the debt at issuance. In addition, this Statement amends Opinion 26 to apply to an extinguishment of debt whether or not the extinguishment was early, consistent with FASB Statement No. 4, *Reporting Gains and Losses from Extinguishment of Debt*, which also applies to all debt extinguishments. The Board understands that extinguishments at scheduled maturity would seldom involve gain or loss under Opinion 26.

Disclosure Requirements

39. Some respondents opposed the requirement in the revised Exposure Draft to continue disclosing in the financial statements of subsequent periods information about debt that had been extinguished in a defeasance transaction until that specific debt issue no longer remained outstanding. Those respondents considered the continuing disclosures to be unnecessary, particularly since Statement 5 addresses disclosures for contingencies. Those respondents also considered the continuing disclosures to contradict the substance of the transaction and to raise doubt about the propriety of recognizing an extinguishment. The Board believes that, because an outstanding defeased debt issue is not reported in the balance sheet, continuing disclosures are needed in the notes to provide useful information to the creditors and investors about that debt issue. Accordingly, the requirement was retained.

Offsetting Assets against Liabilities

40. Several respondents to the revised Exposure Draft commented about offsetting assets

against liabilities, though it was apparent that some respondents had confused *offsetting with extinguishment*. In the Board's view, *offsetting* is a display issue—how recognized assets and recognized liabilities should be presented in a balance sheet (or how other recognized elements should be displayed in a basic financial statement). In contrast, *extinguishment* is a recognition issue—whether an asset or a liability exists and whether continued recognition is warranted in the basic financial statements. This Statement addresses when debt ceases to be a liability that warrants continued recognition in the balance sheet.

41. The Board has concluded that there is no need to create an additional exception to the general principle in Opinion 10 that the offsetting of assets and liabilities in the balance sheet is improper except if a right of setoff exists.

AICPA Statement of Position 78-5 and Extinguishment of Tax-Exempt Debt

42. The Board considered whether SOP 78-5 contains specialized accounting and reporting principles and practices that warrant extraction and issuance in an FASB Statement, as discussed in paragraph 13. "In-substance defeasance" transactions that have been accounted for as extinguishments under SOP 78-5 generally will continue to be accounted for as extinguishments under this Statement; thus, the related provisions of the SOP are no longer "specialized." Other provisions of the SOP relate to accounting by state and local governmental units and are not being extracted pending resolution of the FASB's involvement with standard setting for those entities. (Refer to paragraph 8 of Statement 32.) The Board believes the remainder of SOP 78-5 consists of descriptions and examples of refunding transactions that are not specialized accounting and reporting principles; thus, extraction is not warranted. Accordingly, this Statement deletes the reference to SOP 78-5 from Appendix A of Statement 32.

Amendment to Statement 22

43. Statement 22 addresses changes to lease agreements resulting from refundings of tax-exempt debt and specifies different accounting depending on whether the refunding is accounted for as an extinguishment. Footnote 1 of that Statement refers to SOP 78-5 for "descriptions of advance refundings that are and are not accounted for as early extinguishments of debt." This Statement amends Statement 22 to replace the footnote reference to SOP 78-5 with a reference to this Statement.

Effective Date and Transition

44. Several respondents suggested that the final Statement should permit, but not require, retroactive implementation and restatement of previously issued financial statements for transactions occurring in years previously reported so that similar transactions can be reported similarly. The Board concurs in that recommendation and has modified the Statement accordingly.

Footnotes

FAS76, Footnote 1--If nonrecourse debt (such as certain mortgages) is assumed by a third party in conjunction with the sale of an asset that serves as the sole collateral for that debt, the sale and related assumption effectively accomplish a legal release of the seller/debtor for purposes of applying this Statement.

FAS76, Footnote 2--*Probable* is used here, consistent with its use in FASB Statement No. 5, *Accounting for Contingencies*, to mean that it is likely that no payments will be required.

FAS76, Footnote 3--A monetary asset is money or a claim to receive a sum of money that is fixed or determinable without reference to future prices of specific goods or services.

FAS76, Appendix A, Footnote 4--The term *specialized* is used to refer to those accounting and reporting principles and practices in AICPA Guides and SOPs that are neither superseded by nor contained in Accounting Research Bulletins, APB Opinions, FASB Statements, or FASB Interpretations.

FAS76, Appendix A, Footnote 5--SOP 78-5 defines an *advance refunding* as a transaction in which refunding debt is issued to replace refunded debt at a specified future date, with the proceeds placed in trust or otherwise restricted to replacing the refunded debt.

FAS76, Appendix A, Footnote 6--*Defeasance* connotes the debtor's release from legal liability.