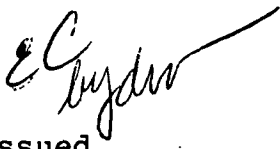


INFORMATION MEMORANDUM

October 22, 1984

TO: THE COMMISSION

FROM: OFFICE OF THE CHIEF ACCOUNTANT 

SUBJECT: FASB Technical Bulletin 84-4 issued
on Instantaneous In-Substance Defeasance

RESPONSIBLE STAFF: Ed Coulson (272-2130)
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SUMMARY

The FASB issued a technical bulletin ("TB") on October 17, 1984 that says that an instantaneous in-substance defeasance does not qualify as an extinguishment of debt under existing accounting principles.

The TB also discusses the circumstances under which it is appropriate to assess the remoteness of risk is determining that the cash inflows to the trust from its assets be "essentially risk free." It then provides guidance on accounting for the defeasance of callable debt.

In this instance, we believe that the FASB provided appropriate and timely guidance to questions about the implementation of its Statement No. 76.

DISCUSSION

Instantaneous In-Substance Defeasance

As the Commission is aware, the FASB issued Statement No. 76 which allowed in-substance defeasance of debt late in 1983. The Commission, after considerable discussion in an open meeting on December 21, 1983, rescinded its moratorium on in-substance defeasance. */

The issue of instantaneous defeasance came to our attention shortly thereafter in early 1984 when we were informed that Pepsico had been able to negotiate an arbitrage transaction involving a simultaneous purchase of German government backed securities and issuance of Pepsico debt to investors in European markets. Pepsico (as well as other companies) was able to borrow at one interest rate and simultaneously

*/ Financial Reporting Release (FRR) No. 15 (49 FR 53)
rescinding FRR 3 (47 FR 38868)

invest in essentially risk-free assets that yielded a higher interest rate. The company could then place those assets in an irrevocable trust to effect an instantaneous in-substance defeasance, which, because of the concurrent differences in interest rates, would allow the company to recognize a gain on the transaction immediately.

The FASB has indicated in the TB that SFAS No. 76 was issued as a mechanism for extinguishing debt when a cash settlement is not feasible. The Board expected that the effect of in-substance defeasance would be the same as a cash settlement of the debt. The TB states that instantaneous in-substance defeasance is significantly different from an in-substance defeasance of previously issued debt. The former is a borrow-and-invest activity, entered into specifically to effect a gain from the concurrent difference in interest rates, whereas any gain or loss on the latter transaction represents the effects of past changes in interest rates. Therefore, under the TB, an instantaneous in-substance defeasance does not qualify as an extinguishment of debt under SFAS No. 76.

The technical language that the TB uses to achieve its objective provides that debt may not be extinguished through an in-substance defeasance if the assets to be used were acquired at about the same time. See paragraph 3 of the TB attached.

Assessing Remoteness of Risk of Trust Assets

The TB goes on to provide guidance on when a debtor may use an assessment of the remoteness of risk in determining whether debt has been extinguished under SFAS No. 76. Generally the guidance says that where SFAS No. 76 has established specific criteria (principally on the nature of the assets to be placed in the trust) variations from those requirements on the basis that related risks are remote is not permitted. However, when considering possible external events, it is implicit in SFAS No. 76 that a judgment as to the remoteness of risk must be made. For example, in order to conclude that cash inflows to the trust from its assets are essentially risk free, a debtor is required to conclude that the likelihood of default of a sovereign government on its obligations held by the trust and the imposition of withholding taxes in future legislation are remote.

In-Substance Defeasance of Callable Debt

The TB allows the in-substance defeasance of callable debt because the mere existence of the option creates no risk that the debtor will be required to make further payments with respect to the debt because exercise of the option is at the debtor's discretion. It further notes that the existence of the call option does not change the debtor's previous surrender of control over the assets that were irrevocably placed in trust.

If exercise of the call option by the debtor prior to the debt's scheduled maturity is not remote, and the debtor takes the necessary action to effect a irrevocable future call (and thus, give the debt, in effect, a new earlier due date), extinguishment through an in-substance defeasance is possible provided the assets in the trust provide cash flows to service the debt to the new maturity date.

SFAS No. 76 allowed a debtor to purchase its own debt securities that has previously been recognized as extinguished and to report those investments as assets in its balance sheet. The TB says that whether the assets are acquired through a call option or on the open market, the accounting should be the same. However, because the assets in the trust must be used solely for satisfying scheduled payments of both principal and interest, the debtor may not use funds from the trust to purchase its debt securities. Other funds would have to be used. The call option may not enable the debtor to invade the trust and reacquire those assets prematurely.

Effective Date

The TB is effective for debt incurred on or after September 12, 1984. We do not know at this time how many, if any, registrants may have borrowed and purchased assets to be placed in trust at about the same time. We are aware of three companies who were contemplating these transactions, but we are not sure if they "incurred" the debt before September 12. We intend to interpret the effective date very strictly and believe we have the ability, based on the Commission's action in FRR No. 15, to forestall any attempted abuses.

Attachment - FASB Technical Bulletin No. 84-4

FASB Technical Bulletin

Title: In-Substance Defeasance of Debt

Reference: FASB Statement No. 76, *Extinguishment of Debt*

INSTANTANEOUS IN-SUBSTANCE DEFEASANCE

Question

1. May debt be extinguished through an in-substance defeasance (under paragraph 3(c) of Statement 76) if the debtor irrevocably places in trust assets that were acquired at about the time that the debt was incurred ?

Background

2. Some have indicated to the FASB that, due to differences in interest rates in different markets, the opportunity exists for a company to borrow at one interest rate and concurrently invest in "essentially risk-free" assets that yield a higher interest rate. They have suggested certain structured transactions (so-called instantaneous defeasance transactions) in which those assets would be irrevocably placed in trust to effect an in-substance defeasance of the newly issued debt under Statement 76, thereby immediately recognizing a gain related to the concurrent differences in interest rates.

Response

3. No. Debt may not be extinguished through an in-substance defeasance if the assets that the debtor irrevocably places in trust were acquired at about the time that the debt was incurred or were acquired as part of a series of investment activities (for example, purchasing assets or entering into a purchase agreement or futures contract) initiated at about the time that the debt was incurred. Similarly, debt may not be extinguished through an in-substance defeasance if the debt was incurred pursuant to a forward contract entered into at about the time the debtor acquired the assets being irrevocably placed in trust.

4. Although the conceptual basis for recognizing an in-substance defeasance as an extinguishment of debt does not impose special conditions, such as restrictions on



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how the borrowed funds are used or on when the debtor acquires the assets being placed in the trust, certain structured transactions warrant special consideration in determining whether debt is extinguished under Statement 76.

5. Enterprises that borrow funds and concurrently purchase higher-yielding securities to be used in an in-substance defeasance, thereby recognizing a gain on the extinguishment, are essentially engaging in borrow-and-invest activities. The proximity of the borrowing and the acquisition of securities suggest a structured transaction in which the enterprise borrowed with the intent of executing an in-substance defeasance. The effect of considering such structured borrow-and-invest transactions as extinguishments is substantively different from the effect of considering in-substance defeasances of previously outstanding debt as extinguishments. Such borrow-and-invest activities, in effect, hedge the debtor against the risk of changes in interest rates. Any gain or loss on extinguishing previously outstanding debt reflects in large measure the effect of past changes in interest rates for the debtor, whereas the gain or loss related to borrow-and-invest activities reflects principally the concurrent differences in interest rates when the debt was issued. Statement 76 states in paragraph 22 that "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.*" (Emphasis added.)

ASSESSING REMOTENESS OF RISK OF TRUST ASSETS

Question

6. In determining whether an in-substance defeasance transaction meets the requirement in paragraph 4(a) of Statement 76 that the cash inflows to the trust from its assets be essentially risk free, may a debtor use an assessment of the remoteness of the related risks?

Background

7. For an in-substance defeasance, paragraph 3(c) of Statement 76 requires that "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 [that] the possibility that the debtor will be required to make future payments with respect

to that debt is remote." Paragraph 4 addresses the nature of the assets that the debtor irrevocably places in trust and requires, among other things, that those assets be monetary assets "that are *essentially risk free* as to the amount, timing, and collection of interest and principal."

Response

8. No, in some circumstances; yes, in others. In requiring that the cash inflows to the trust in an in-substance defeasance be essentially risk free, Statement 76 establishes specific criteria with respect to certain aspects of the transaction but requires the use of judgment in assessing remoteness in other areas. The specified criteria of Statement 76 focus principally on the nature of the monetary assets placed in trust rather than on possible external events. For example, Statement 76 requires the following:

- a. The monetary assets placed in the trust must be denominated in the currency in which the debt is payable. (Refer to paragraphs 4(a) and 32 of Statement 76.)
- b. The monetary assets placed in the trust must be direct obligations of the sovereign government in whose currency the debt is payable or must be obligations collateralized by such government securities or guaranteed by that government. (Refer to paragraphs 4(a), 31, and 32 of Statement 76.)
- c. Monetary assets that are callable (that is, can be prepaid) are not essentially risk free as to the timing of the interest and principal payments to be received by the trust and thus do not qualify for ownership by the trust. (Refer to paragraph 4(a) of Statement 76.)

Statement 76 does not permit variations from those requirements on the basis that any related risks are remote. Thus, a debtor may not justify use of assets denominated in differing currencies in combination with a forward exchange contract on the basis that the likelihood of default on the forward contract is remote. Similarly, a debtor may not use securities issued by a sovereign government but denominated in a currency other than its own (for example, French government securities denominated in Swiss francs used to defease Swiss franc debt) on the basis that the likelihood of the French government's being unable to obtain sufficient Swiss francs to make timely payments is remote. Likewise, securities that are callable may not be used in the trust on the basis that the likelihood is remote that the call provision will introduce any risk that the trust could have insufficient funds.

9. However, for areas not specifically covered, Statement 76 requires the debtor to assess the remoteness of various contingencies in determining whether the cash inflows to the trust from its assets are essentially risk free. For example, since any default by a sovereign government on its obligations held by the trust would cause the trust assets to be insufficient to pay the defeased debt (thereby requiring the debtor to make up the deficiency), Statement 76 implicitly requires the debtor to conclude that the likelihood of a default by the sovereign government on its direct obligations is remote. Similarly, the likely resolution of other uncertainties that could affect the cash flows to the trust, such as the imposition of currency controls or withholding taxes through future legislation, needs to be assessed to determine whether it is remote that the debtor will be required to make further payments with respect to the debt.

IN-SUBSTANCE DEFEASANCE OF CALLABLE DEBT

Question

10. May a debt be extinguished through an in-substance defeasance if it is callable by the debtor?

Background

11. Paragraph 1 of Statement 76 states that the circumstances for an extinguishment of debt through an in-substance defeasance as described in paragraph 3(c) of the Statement "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."

Response

12. Yes. Debt that is callable by the debtor can be extinguished through an in-substance defeasance. The debtor's retention of an option to purchase the debt through a call provision is not, in itself, an impediment to an in-substance defeasance; the mere existence of the option creates no risk that the debtor will be required to make further payments with respect to the debt because exercise of the option is at the debtor's discretion. Furthermore, the existence of the call option does not miti-

gate the debtor's previous surrender of control over the assets that were irrevocably placed in trust.

13. If exercise of the call option by the debtor prior to the debt's scheduled maturity is not remote, the debtor ordinarily would not be able to extinguish the debt through an in-substance defeasance because the possibility of future payments with respect to the debt would also not be remote, as required by paragraph 3(c) of Statement 76. However, if the debtor plans to exercise the call option at a specific date and takes the necessary action currently to effect the call irrevocably for that future date (thereby giving the debt a new, earlier maturity date), extinguishment through an in-substance defeasance is possible provided the assets in the trust are structured to meet the cash flow requirements of the revised payment schedule and new maturity date.

14. Paragraph 33 of Statement 76 states 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." Whether such debt securities are purchased in the open market or acquired through exercise of a call option, it is appropriate to account for them as an investment in the future cash flows to be distributed by the trust as originally scheduled. However, because the assets in the trust must "be used *solely* for satisfying *scheduled* payments of both interest and principal" (Statement 76, paragraph 3(c); emphasis added), the debtor could not use funds from the trust to purchase its debt securities; rather, the debtor would need to use other funds to acquire the debt securities as an investment. Exercise of the call option would not negate compliance with the requirement in Statement 76 that the assets be irrevocably placed in trust because the call option should not enable the debtor to invade the trust and reacquire those assets prematurely.

EFFECTIVE DATE AND TRANSITION

15. The provisions of this Technical Bulletin are effective for debt incurred on or after September 12, 1984. Earlier application is encouraged for transactions in fiscal years for which annual financial statements have not previously been issued.

The Financial Accounting Standards Board has authorized its staff to prepare FASB Technical Bulletins to provide guidance on certain financial accounting and reporting problems on a timely basis, pursuant to the procedures described in FASB Technical Bulletin No. 79-1 (Revised), *Purpose and Scope of FASB Technical Bulletins and Procedures for Issuance*. The provisions of Technical Bulletins need not be applied to immaterial items. Copyright © 1984 by the Financial Accounting Standards Board.