

## Accounting for Gains/Losses on Bond Refundings

By Adam Fraley

Governments often elect to take advantage of favorable changes in interest rates by issuing new debt to refinance existing (old) debt. Likewise, a government may elect to refinance old debt to escape strict debt covenants. Such transactions are referred to as **refundings**. This is often a non-routine transaction that takes additional research and careful consideration to ensure the proper accounting treatment. Bond refundings also have different reporting requirements for governmental fund, proprietary fund and governmental activities reporting.

In the case of a current refunding, the proceeds of the refunding debt are applied immediately to redeem the old debt. In the case of an advance refunding, the proceeds of the refunding debt are placed into an irrevocable escrow account pending the call date or maturity of the old debt. Most advance refundings result in the defeasance of the old debt and, therefore, for accounting purposes, the debt is treated as though it had been redeemed and taken off the financial statements of the government by removing both the old debt and any related assets or liabilities in the form of issuance costs, premiums, discounts on the old debt.

In the case of both current refundings and advance refundings resulting in the defeasance of debt for governmental funds, GAAP direct that the proceeds of the refunding bonds, whether used for redemption or placed in escrow, and the payments into escrow or for redemption be reported as an “other financing source” and an “other financing use”, respectively, rather than as a revenue or expenditure. Otherwise these significant and irregular outflows and inflows could substantially distort a government’s regular debt service expenditure and revenue trends.

There often is a difference between the carrying amount of redeemed/defeased (old) debt, including all related assets and liabilities (i.e. unamortized premiums, discounts, and issuance costs) and its reacquisition price (the amount paid into the escrow account). In the private sector, this difference is classified as a gain or loss and reported on the operating statement in the period in which the transaction occurs. Proprietary funds, business-type activities, and governmental activities, on the other hand, defer and amortize this amount over the remaining life of the old debt (had it not been refunded) or the life of the new debt, whichever is shorter. Amortization should be calculated in a systematic and rational manner over this term and be expensed as a component of interest expense. In the meantime, the unamortized difference between the carrying amount of redeemed or defeased (old) debt and its reacquisition price should be reported as a deferred gain or loss and be reported as a direct reduction of (or addition to) the amount of refunding (new) debt reported on the statement of net assets, much like a bond premium or discount. Also like bond premiums or discounts, this unamortized balance should “follow the debt” for purposes of calculating the various components of net assets. Thus, any remaining unamortized balance associated with capital-related debt would be considered in the calculation of invested in capital assets net of related debt.

When governments enter into either a current refunding or an advance refunding transaction, GAAP requires that they present the following disclosures in the notes to the financial statements:

- A brief description of the refunding transaction
- The aggregate difference in debt service between the refunded debt and the refunding debt
- The economic gain or loss on the transaction

The economic gain or loss on a refunding transaction is calculated in the following manner:

- The present value of the debt service payments related to the refunding debt is calculated using the following formula:

$$\begin{array}{r} \text{Face amount of refunding bonds} \\ +/- \quad \text{Premium/Original Issue Discount} \\ + \quad \text{Accrued interest} \\ - \quad \text{Costs not recoverable through escrow earning} \\ \hline = \text{Present value of debt service repayments on} \\ \text{refunding debt} \end{array}$$

- A calculation is made to determine what effective interest rate applied to the debt service payments on the *refunding* bonds would result in the present value determined in the previous calculation.
- The effective interest rate calculated for the refunding bonds is then applied to the debt service on the *refunded* bonds to calculate the present value of debt service on the refunded bonds.
- The difference between the present value of the two debt service streams (refunding debt and refunded debt) constitutes the economic gain or loss on the transaction.

Any amounts of debt defeased *in substance*, but still outstanding as of the end of the fiscal year, should also be disclosed in the notes.

## Our Resources

As always, we are available as a resource to you as questions arise. We are in this together as both auditor and auditee will have to keep up with evolving and fluid guidance from the Federal and State governments.

Please contact any of our governmental partners and managers, at 1-800-277-0050 for assistance.

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