

Higher Education Technical Alert: Modifications and Extinguishments of Municipal Bonds

As discussed in Healthcare Technical Alert #2008-3, *Financial and Accounting Implications to Debt Obligors Who Utilize Bond Insurers*, the capital market continues to create challenges for clients that have issued¹ tax-exempt debt, particularly those with auction rate securities (ARS). In the current economic environment, many of those issuers are exercising their rights to call² the ARS in order to replace them with other types of bonds such as variable-rate demand obligations (VRDOs)³ or fixed rate bonds. Generally, this is achieved either by issuing new debt that is used to pay off the outstanding ARS (a refunding) or, if the ARS were structured as "multi-modal," by exercising an "interest mode conversion" option.

Bonds issued with a "multi-modal" option provide the issuer with a contractual right to change the interest feature of the bond from an auction-based interest rate to a stated rate, which may be either a different type of variable interest rate, or alternatively, to a fixed interest rate. An interest mode conversion to VRDOs typically involves the following steps:

- A "Notice of Interest Rate Conversion" is issued to inform the ARS bondholders of the interest rate conversion (i.e., exercise of the call option).
- Bondholders surrender the ARS to a tender agent.
- Simultaneously, "converted" bonds bearing the new interest rate mode are issued and are sold to investors. Purchasers may be new investors and/or the former ARS bondholders.
- The proceeds received from the new bonds are used to pay the former ARS bondholders a pre-determined amount specified in the bond indenture (e.g., par value). If the proceeds are insufficient, the issuer funds the shortfall.

Because in most cases a mode conversion involves a tender of the old ARS and marketing of new bonds (to new investors as well as existing bondholders), the interest rate mode conversion is similar to a traditional refunding. Thus, the same accounting considerations apply to mode conversions as to refundings.

The purpose of this Technical Alert is to address general accounting considerations related to these types of transactions for both private sector and governmental entities.

FASB Entities

¹ For purposes of this Alert, "issuers" refers to obligors in conduit bond financing structures as well as to governmental entities that issue debt directly.

² ARS typically contain a provision giving the issuer the right to repay the securities prior to their stated maturity. This "call option" generally is exercisable on any interest payment date. The issuer must pay the bondholder a pre-determined price specified in the bond contract, which may be par value or some premium above par value.

³ VRDOs are "puttable" (i.e., demand) bonds which bear interest at a variable rate determined based upon an interest rate index (e.g., LIBOR, SIFMA).

Modification or extinguishment?⁴

Under FASB rules, a refunding must be accounted for as either a) an issuance of new bonds with extinguishment of the old bonds, or b) a modification of the terms of the old bonds. The primary guidance for assessing whether an extinguishment or modification has occurred is EITF Issue No. 96-19, *Debtor's Accounting for a Modification of Exchange of Debt Instruments* (EITF 96-19). EITF 96-19 presumes that an "exchange" of debt instruments between a debtor and creditor has occurred.⁵ In the context of a tax-exempt debt issue, the notion of an "exchange" applies to any overlap between the holders of the old ARS and the holders of the new bonds (i.e., holders of the old ARS who reinvest in the new bonds). Applied literally, EITF 96-19 would require evaluation on a bondholder-by-bondholder basis to determine if an individual bondholder was a party to both the new debt instrument and the old debt instrument. When the debt consists of widely-held tax-exempt bonds, this may be impracticable. Clients may conclude that for transactions involving the issuance of new tax-exempt bonds to pay off old bonds that are widely-held, it is reasonable to regard the old bondholder group in the aggregate as a single creditor,⁶ unless the facts and circumstances indicate otherwise. When the old bondholder group can be regarded as a single creditor, the refunding transaction would be deemed to involve the issuance of a new debt obligation to one creditor and the concurrent satisfaction of an existing debt obligation to an unrelated creditor. Since there is no exchange of existing debt for new debt with the same creditor, the transaction would be accounted for as an extinguishment of the old debt and the issuance of new debt.

If facts and circumstances indicate that it is not appropriate to regard the old bondholders in the aggregate as a single creditor (for example, if a particular institutional investor has significant holdings of both the old and new bonds), it will be necessary to perform a cash flow analysis to determine whether the exchange of bonds involving that creditor is an extinguishment or a modification. In this example, the holdings of the institutional investor would need to be bifurcated from the widely-held portion of the bonds and analyzed under EITF 96-19. It is possible for such a transaction to be accounted for partly as a modification (for the "exchanged" portion) and partly as an extinguishment (for the "widely held" portion).

Performing an EITF 96-19 analysis involves determining whether the change in terms associated with an exchange with a creditor is "substantial." "Substantial" is defined as a change or changes in which the present value of the cash flows of the new debt instrument at the settlement date differs by at least 10 percent from the present value of the cash flows under the original terms. If the change in terms is "substantial," then the terms of the new debt instrument are considered to be "substantially different," and an extinguishment is deemed to have occurred. If the cash flow analysis indicates that the terms are not "substantially different," then the transaction is simply a modification of the terms of the original debt.

The distinction between extinguishment and modification is that a modification results in no gain or loss recognition and in different accounting for bond issuance/deferred financing costs. (These differences are discussed in subsequent sections.) In the current marketplace, since many issues are being refunded in a relatively short time after issuance date, the difference in treatment of old

⁴ This Alert does not contemplate the types of troubled debt restructurings addressed by FASB Statement No. 15 (FAS 15), *Accounting by Debtors and Creditors for Troubled Debt Restructurings*.

⁵ Refunding transactions typically involve a third-party intermediary (an investment bank) acting as agent on behalf of an issuer. In most cases, the actions of the intermediary should be viewed as those of the issuer in order to determine whether there has been an exchange of debt instruments/modification of terms between a debtor and creditor.

⁶ By analogizing to FAS 15

deferred financing costs can be significant, as minimal amortization of the deferred issuance costs may have occurred.

The IRS requires a similar type of "extinguishment versus modification" analysis to be performed for purposes of compliance with certain Treasury regulations related to tax-exempt bonds.⁷ The determination made for tax purposes should not be confused with the determination made for financial reporting purposes, as it is possible to reach different conclusions under the two analyses.

Accounting for modifications

If the analysis of cash flows under EITF 96-19 indicates that the change in terms associated with an exchange with a creditor is not "substantial," then a modification of the terms of the original debt has occurred. For accounting purposes, the old debt instrument is deemed to remain in force; thus no gain or loss from extinguishment is reported. Any unamortized deferred financing costs are not written off but rather, are amortized over the remaining term of the modified debt. New costs paid to third parties (e.g. underwriters, legal, etc.) should be expensed as incurred.

If a transaction is part-modification and part-extinguishment, then these determinations would need to be made on a pro-rata basis.

Accounting for extinguishments

Accounting for extinguishments is addressed in FAS 140, *Accounting for Transfers of Financial Assets and Extinguishment of Liabilities*, and APB 26, *Early Extinguishment of Debt*.

FAS 140 allows de-recognition (extinguishment) of the liability when the issuer pays the old bondholders and is relieved of its obligation to them. APB 26 states that a gain or loss should be recognized when an extinguishment occurs. The gain or loss⁸ is measured as the difference between the reacquisition price (i.e., amount paid to settle the old debt) and the net carrying amount of the extinguished debt. "Reacquisition price" includes amounts paid related to the extinguishment (i.e., call premiums, miscellaneous costs of reacquisition, etc.) and the fair value of any new securities issued. "Net carrying amount" includes unamortized debt issue costs and any unamortized debt discount or premium related to the extinguished debt.

Most ARS carry bond insurance. If bond insurance that was prepaid at the time of issuance continues in force on debt that is extinguished in a refunding or interest mode conversion (i.e., the organization retains the original bond insurance policy to cover the new bonds), it may be appropriate to bifurcate the unamortized prepaid bond insurance out of the deferred financing costs that will be written off in the extinguishment and continue to report them as deferred financing costs, with assessment made for impairment.

Governmental entities

When governmental business-type entities (GAS 20, paragraph 6 and 7 entities) refund debt, they apply the accounting guidance in GASB Statement No. 23, *Accounting and Financial Reporting for Refundings of Debt Reported by Proprietary Activities* (GAS 23), and the disclosure guidance in

⁷ See IRS Notices 2008-41 and 2008-27. For Treasury purposes, a transaction deemed to be a reissuance triggers an arbitrage rebate re-calculation and re-testing of whether the bonds meet the requirements for tax-exempt status; a modification will not.

⁸ FAS 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*, prohibits reporting gains or losses from debt extinguishments as extraordinary items unless they meet the APB 30 criteria for classification as extraordinary.

GASB Statement No. 7, *Advance Refundings Resulting in Defeasance of Debt* (GAS 7). This guidance differs from the FASB literature discussed above in that there is no requirement to evaluate whether the transaction is, in essence, a modification of the old debt rather than an extinguishment. GAS 23 requires that when a refunding occurs, the difference between the reacquisition price (i.e., principal, call premium, miscellaneous costs of reacquisition, etc.) and the net carrying amount of the old debt should be deferred and amortized as a component of interest expense in a systematic and rational manner over the remaining life of the old debt or the life of the new debt, whichever is shorter.

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This Alert is meant to highlight only certain of the general accounting implications for refundings and interest mode conversions. It is not intended to encompass all potential facts and circumstances, as debt instruments may contain a host of features not discussed in this Alert (e.g. auction date conversions, optional tenders, etc).

A critical aspect of ensuring that the appropriate accounting is reflected in the financial statements is appropriately identifying all of the facts and circumstances surrounding these transactions. The importance of obtaining an understanding of the underlying bond documents (i.e., bond indenture, loan and trust agreement, liquidity facility, etc.) cannot be overemphasized.

Questions

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