

Statement of Financial Accounting Standards No. 22

[FAS22 Status Page](#)
[FAS22 Summary](#)

Changes in the Provisions of Lease Agreements
Resulting from Refundings of Tax-Exempt Debt

an amendment of FASB Statement No. 13

June 1978



Financial Accounting Standards Board
of the Financial Accounting Foundation
401 MERRITT 7, P.O. BOX 5116, NORWALK, CONNECTICUT 06856-5116

Copyright © 1978 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. 22

Changes in the Provisions of Lease Agreements Resulting from Refundings of Tax-Exempt Debt

an amendment of FASB Statement No. 13

June 1978

CONTENTS

	Paragraph Numbers
Introduction and Background Information.....	1–11
Lessee Accounting	2– 5
Lessor Accounting.....	6– 7
Other Matters.....	8–11
Standards of Financial Accounting and Reporting:	
Amendments to FASB Statement No. 13	12–15
Effective Date and Transition.....	16
Appendix A: Illustration of Lessor and Lessee Accounting	
Required by Paragraph 12 of This Statement.....	17

FAS 22: Changes in the Provisions of Lease Agreements Resulting from Refundings of Tax-Exempt Debt

an amendment of FASB Statement No. 13

INTRODUCTION AND BACKGROUND INFORMATION

1. The FASB has been asked to reconcile an apparent inconsistency between *FASB Statement No. 13*, "Accounting for Leases," and *APB Opinion No. 26*, "Early Extinguishment of Debt," arising from refundings of tax-exempt debt, including advance refundings¹ that are accounted for as early extinguishments of debt. In some situations tax-exempt debt is issued to finance construction of a facility, such as a plant or hospital, that is transferred to a user of the facility by either lease or sale. A lease or, in the case of sale, a mortgage note generally serves as collateral for the guarantee of payments equivalent to those required to service the tax-exempt debt. Payments required by the terms of the lease or mortgage note are essentially the same, as to both amount and timing, as those required by the tax-exempt debt. In practice, a liability equivalent to the amount of the tax-exempt debt often has been included in the accounts of the lessee or the mortgagor. Some issuers of tax-exempt debt recently have entered into refundings and, concurrently, the terms of the related lease or mortgage note have been changed to conform with the terms of the refunding issue. If a refunding of tax-exempt debt results in a change in the provisions of a lease and the revised lease is classified as a capital lease by a lessee or a direct financing lease by a lessor, gain or loss is not recognized under Statement No. 13 (see paragraphs 14(a) and 17(f)(i) of the Statement). If a refunding of tax-exempt debt results in a change in the terms of a mortgage note, any gain or loss arising from the transaction because of the change in the carrying amount of the debt would be recognized currently in accordance with the provisions of Opinion No. 26.

Lessee Accounting

2. Paragraph 14(a) of *FASB Statement No. 13* sets forth the accounting by a lessee for a change in the provisions, a renewal, or an extension of an existing lease if the revised lease agreement is classified as a capital lease as follows:

If the provisions of the lease are changed in a way that changes the amount of

the remaining minimum lease payments and the change either (i) does not give rise to a new agreement... or (ii) does give rise to a new agreement but such agreement is also classified as a capital lease, the present balances of the asset and the obligation shall be adjusted by an amount equal to the difference between the present value of the future minimum lease payments under the revised or new agreement and the present balance of the obligation. The present value of the future minimum lease payments under the revised or new agreement shall be computed using the rate of interest used to record the lease initially.

3. In accounting for an early extinguishment of debt, paragraph 20 of *APB Opinion No. 26* requires that "a difference between the reacquisition price and the net carrying amount of the extinguished debt should be recognized currently in income of the period of extinguishment as losses or gains...." In this regard, paragraph 8 of *FASB Statement No. 4*, "Reporting Gains and Losses from Extinguishment of Debt," requires that "gains and losses from extinguishment of debt that are included in the determination of net income shall be aggregated and, if material,... classified as an extraordinary item, net of related income tax effect."

4. If a refunding of tax-exempt debt results in a change in the provisions of a capital lease that passes the perceived economic advantages of the refunding through to the lessee, paragraph 14(a) of *FASB Statement No. 13* requires the lessee to adjust both the asset and related obligation for any difference caused by a change in the provisions of a lease. If the perceived economic advantages of the same refunding had been passed through by a change in the terms of a mortgage note, the accounting specified by *APB Opinion No. 26* would result in the recognition of a gain or loss.

5. The Board considered the possibility of amending *APB Opinion No. 26* to defer recognition of gain or loss. That would not completely eliminate the inconsistency unless the gain or loss were included as an adjustment to the cost of the related property, because *FASB Statement No. 13* specifies that any difference resulting from a change in the provisions of a capital lease should be accounted for as an adjustment of the leased asset. In the interest of a timely resolution of the conflict, the Board decided that paragraph 14 of Statement No. 13 should be amended so that the accounting will be compatible with that specified by Opinion No. 26.

Lessor Accounting

6. Paragraph 17(f)(i) of *FASB Statement No. 13* specifies the accounting by a lessor for a change in the provisions, a renewal, or an extension of an existing lease if the revised lease agreement is classified as a direct financing lease as follows:

If the provisions of a lease are changed in a way that changes the amount of the remaining minimum lease payments and the change either (a) does not give rise to a new agreement... or (b) does give rise to a new agreement but such agreement is classified as a direct financing lease, the balance of the minimum lease payments

receivable and the estimated residual value, if affected, shall be adjusted to reflect the change... and the net adjustment shall be charged or credited to unearned income.

7. If a refunding of tax-exempt debt results in a change in the provisions of a lease that passes the perceived economic advantages of the refunding through to the lessee and the revised agreement is classified as a direct financing lease, paragraphs 18 (c) and 17(f)(i) of *FASB Statement No. 13* require the lessor to adjust the balance of the minimum lease payments receivable and unearned income. The lessor, on the other hand, would look to *APB Opinion No. 26* for guidance in accounting for a refunding. That Opinion requires recognition of a gain or loss concurrent with early extinguishments of debt. The Board has concluded that the accounting for changes in the provisions of a lease in connection with a refunding of tax-exempt debt should be compatible with the accounting for the refunding of the debt itself. The Board has, therefore, decided to amend paragraph 17 (f) of Statement No. 13 so that any gain or loss resulting from a change in the provisions of a lease agreement in connection with a refunding of tax-exempt debt is recognized when the tax-exempt debt is considered to have been extinguished.

Other Matters

8. An Exposure Draft of a proposed Statement on "Accounting for Leases: Changes in the Provisions of Lease Agreements Resulting from Refundings of Tax-Exempt Debt" was issued on December 19, 1977. The Board received 26 letters of comment in response to the Exposure Draft, most of which expressed general agreement.

9. Several respondents recommended that the final Statement should apply to all types of refundings and not be limited to refundings involving only tax-exempt debt. The Board noted that, typically, lessors in tax-exempt debt refundings are governmental or quasi-governmental agencies that are not affected by state or federal income tax regulations. For the most part, the governmental lessor's borrowing serves only to obtain necessary financing for the construction of the leased facilities. Refundings that do not involve tax-exempt debt may involve considerations beyond those normally present in the lessor/lessee relationship discussed above. The Board considered these recommendations and concluded that further consideration of the subject of refundings should not delay the issuance of this Statement.

10. The Board has concluded that on the basis of existing information it can reach an informed decision without a public hearing, and the effective date and transition specified in paragraph 16 are advisable in the circumstances.

11. The Addendum to *APB Opinion No. 2*, "Accounting for the 'Investment Credit'," states that "differences may arise in the application of generally accepted accounting principles as between regulated and nonregulated businesses, because of the effect in regulated businesses of the rate-making process" and discusses the application of generally accepted accounting

principles to regulated industries. Accordingly, the provisions of the Addendum shall govern the application of this Statement to those operations of a company that are regulated for rate-making purposes on an individual-company-cost-of-service basis.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

12. If prior to the expiration of the lease term a change in the provisions of a lease results from a refunding by the lessor of tax-exempt debt, including an advance refunding,² in which the perceived economic advantages of the refunding are passed through to the lessee and the revised agreement is classified as a capital lease by the lessee or a direct financing lease by the lessor, the change shall be accounted for as follows:

a. Lessee Accounting:

- i. If a change in the provisions of a lease results from a refunding by the lessor of tax-exempt debt, including an advance refunding that is accounted for as an early extinguishment of debt, the lessee shall adjust the lease obligation to the present value of the future minimum lease payments under the revised lease using the effective interest rate applicable to the revised agreement and shall recognize any resulting gain or loss currently as a gain or loss on early extinguishment of debt. Any gain or loss so determined shall be classified in accordance with FASB Statement No. 4.
- ii. If the provisions of a lease are changed in connection with an advance refunding by the lessor of tax-exempt debt that is not accounted for as an early extinguishment of debt at the date of the advance refunding and the lessee is obligated to reimburse the lessor for any costs related to the debt to be refunded that have been or will be incurred, such as unamortized discount or issue costs or a call premium, the lessee shall accrue those costs by the "interest" method³ over the period from the date of the advance refunding to the call date of the debt to be refunded.

b. Lessor accounting:⁴

- i. If a change in the provisions of a lease results from a refunding of tax-exempt debt, including an advance refunding that is accounted for as an early extinguishment of debt, the lessor shall adjust the balance of the minimum lease payments receivable and the estimated residual value, if affected (i.e., the gross investment in the lease) in accordance with the requirements of paragraphs 18(c) and 17(f)(i) of *FASB Statement No. 13*. The adjustment of unearned income shall be the amount required to adjust the net investment in the lease to the sum of the present values of the two components of the gross investment based on the interest rate applicable to the revised lease agreement. The combined adjustment resulting from applying the two preceding sentences shall be recognized as a gain or loss in the current period.
- ii. If a change in the provisions of a lease results from an advance refunding that is not accounted for as an early extinguishment of debt at the date of the advance refunding, the lessor shall systematically recognize, as revenue, any reimbursements to be received

from the lessee for costs related to the debt to be refunded, such as unamortized discount or issue costs or a call premium, over the period from the date of the advance refunding to the call date of the debt to be refunded.

13. The accounting prescribed in subparagraphs 12(a)(i) and 12(b)(i) for a refunding of tax-exempt debt is illustrated in Appendix A.

Amendments to FASB Statement No. 13

14. The introduction to paragraph 14 of *FASB Statement No. 13* is amended to read as follows:

Except for a change in the provisions of a lease that results from a refunding by the lessor of tax-exempt debt, including an advance refunding, in which the perceived economic advantages of the refunding are passed through to the lessee by a change in the provisions of the lease agreement and the revised agreement is classified as a capital lease (see *FASB Statement No. 22*), a change in the provisions of a lease, a renewal or extension¹⁴ of an existing lease, and a termination of a lease prior to the expiration of the lease term shall be accounted for as follows:

15. The introduction to paragraph 17(f) of *FASB Statement No. 13* is amended to read as follows:

Except for a change in the provisions of a lease that results from a refunding by the lessor of tax-exempt debt, including an advance refunding, in which the perceived economic advantages of the refunding are passed through to the lessee by a change in the provisions of the lease agreement and the revised agreement is classified as a direct financing lease (see *FASB Statement No. 22*), a change in the provisions of a lease, a renewal or extension¹⁹ of an existing lease, and a termination of a lease prior to the expiration of the lease term shall be accounted for as follows:

Effective Date and Transition

16. This Statement shall be effective for lease agreement revisions entered into on or after July 1, 1978. Earlier application is encouraged. In addition, the provisions of this Statement shall be applied retroactively at the same time and in the same manner as the provisions of *FASB Statement No. 13* are applied retroactively (see paragraphs 49 and 51 of Statement No. 13). Enterprises that have already applied the provisions of Statement No. 13 retroactively and have published annual financial statements based on the retroactively adjusted accounts before the effective date of this Statement may, but are not required to, apply the provisions of this Statement retroactively.

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

This Statement was adopted by the affirmative votes of five members of the Financial Accounting Standards Board. Messrs. March and Sprouse dissented.

Mr. March dissents because he believes the Statement will encourage differing treatment of similar transactions based merely on legal form rather than real substance. As stated in paragraph 1 of this Statement, tax-exempt debt refundings arise in situations where the user of a facility acquires that use by either a lease or sale. In either case, the governmental unit or authority often, if not usually, has no real liability to the holder of the debt who must look entirely to the resources of the lessee or mortgagor-purchaser. It is not logical to conclude that *FASB Statement No. 13* is even applicable under these circumstances. The logic of the provisions of paragraphs 7, 9, and 12(a) of this Statement rests on the substance of the lessee's obligations being the equivalent of debt.

The AICPA Statement of Position on "Accounting for Advance Refundings of Tax-Exempt Debt," referred to in footnote 1 of this Statement, requires users of such a facility that are mortgagors to record their obligations for both the refunding issue and the debt to be refunded in the future when the latter issue is not accounted for as an early extinguishment of debt. This Statement fails to state specific acceptance or rejection of the existing practice, referred to in paragraph 1, which recognizes the reality of the transaction by accounting for a lessee's obligations as debt in the same manner as a mortgagor. The Statement also fails to require presentation of the lessee's obligations under both the original and refunding debt issues still outstanding, in a manner parallel to the mortgagor; by such silence inviting the development of alternative practices.

Mr. Sprouse dissents because he believes that a loss related to an advance refunding is the result of past events (see paragraphs 8 and 9 of *APB Opinion No. 26*) and should be recognized at the time the refunding commitment is made and the loss becomes measurable (see paragraph 8 of *FASB Statement No. 5*). Despite identical changes in the cash flows required by a lease agreement, subparagraph 12(a)(i) of this Statement requires the lessee to immediately recognize a gain or loss while subparagraph 12(a)(ii) requires the lessee to spread the amount of that gain or loss over the period between the advance refunding and call date, depending on the way in which the lessor accounts for the related advance refunding of tax-exempt debt. Subparagraph 12(b)(i) and subparagraph 12(b)(ii) call for counterpart immediate recognition or systematic accrual by the lessor, respectively. Mr. Sprouse believes that a loss related to an advance refunding is not a function of future passage of time and therefore it should be recognized when it becomes known and measurable rather than spread over a future period of time.

Members of the Financial Accounting Standards Board:

Donald J. Kirk, *Chairman*

Oscar S. Gellein

John W. March

Robert A. Morgan

David Mosso

Robert T. Sprouse

Ralph E. Walters

Appendix A: ILLUSTRATION OF LESSOR AND LESSEE ACCOUNTING REQUIRED BY PARAGRAPH 12 OF THIS STATEMENT

17. The following example illustrates the application of the requirements of subparagraphs 12(a)(i) and 12(b)(i) of this Statement when a refunding of tax-exempt debt results in a change in the provisions of a lease agreement and the revised lease is classified as a direct financing lease by the lessor and as a capital lease by the lessee.

Computation Information

The following table summarizes the total debt service requirements of the serial obligation to be refunded and of the refunding obligation. It is presumed that the perceived economic advantages of the refunding results from the lower interest rate applicable to the refunding obligation. The resulting reduction in total debt service requirements will be passed through to the lessee by changing the terms of the related lease to conform with the debt service requirements of the refunding obligation. All costs that have been or that will be incurred by the lessor in connection with the refunding transaction will be passed through to the lessee.

Fifteen Year Serial Debt Service Requirements (\$000 omitted):

Obligation to Be Refunded			Refunding Obligation*			<u>Difference</u>
<u>Face Amount</u>	<u>Interest 7%</u>	<u>Total</u>	<u>Face Amount</u>	<u>Interest 5%</u>	<u>Total</u>	
\$50,000	\$32,300	\$82,300	\$52,000	\$23,150	\$75,150	\$7,150

LESSOR ACCOUNTING

Computation of Required Adjustments to Reflect Changes in the Terms of a Lease Resulting from a Refunding of Tax-Exempt Debt

Adjustment to Balance of Minimum Lease Payments Receivable:

Present balance of minimum lease payments receivable (equal to debt service requirements of obligation to be refunded)	\$82,300,000
Minimum lease payments receivable under revised agreement (equal to debt service requirements of refunding obligation)	<u>75,150,000</u>
Adjustment to reflect reduction in minimum lease payments receivable	<u>\$ 7,150,000</u>

Adjustment to Unearned Income:

Change in the sum of the present value of the two components of the gross investment using the interest rate applicable to each agreement	\$ 2,000,000
Change in the balance of minimum lease payments receivable	<u>7,150,000</u>
Adjustment to reflect reduction in balance of unearned income	<u>\$ 9,150,000</u>

Summary of Adjustments (\$000 omitted):

	Minimum Lease Payments Receivable	Unearned Income	Net Investment
Balance before Refunding	\$82,300	\$32,300	\$50,000
Adjustment	<u>(7,150)</u>	<u>(9,150)</u>	<u>2,000</u>
Balance after Refunding	<u>\$75,150</u>	<u>\$23,150</u>	<u>\$52,000</u>

Journal Entries to Record the Refunding and Changes in the Terms of the Lease Resulting from Refunding of Tax-Exempt Debt

Recoverable deferred issue costs	500,000	
Loss resulting from refunding of tax-exempt debt	1,500,000	
7% Outstanding obligation	50,000,000	
5% Refunding obligation		52,000,000

To record loss from refunding \$50,000,000—7% obligation with \$52,000,000—5% refunding obligation in accordance with the provisions of *APB Opinion No. 26*.

Unearned income	9,150,000	
Minimum lease payments receivable		7,150,000
Gain resulting from adjustment of lease terms		1,500,000

Recoverable deferred issue costs	500,000
----------------------------------	---------

To adjust unearned income by the amount required to adjust the net investment in the lease to the sum of the present values of the two components of the gross investment based on the interest rate applicable to the revised lease agreement in accordance with FASB Statement No. 22.

LESSEE ACCOUNTING

Computation of Required Adjustment to Lease Obligation to Reflect Changes in the Terms of the Lease Resulting from a Refunding of Tax-Exempt Debt

Adjustment to Balance of Lease Obligation:

Present balance of lease obligation under original agreement	\$ 50,000,000
Present value of future minimum lease payments under revised agreement	<u>51,500,000</u>
Adjustment to Lease Obligation	<u>\$ 1,500,000</u>

Journal Entry to Record Adjustment to Lease Obligation Resulting from Refunding of Tax-Exempt Debt

Loss resulting from revision to lease agreement	1,500,000	
Obligation under capital lease		1,500,000

To record the loss resulting from changes in the lease terms resulting from a refunding of tax-exempt debt. For purposes of calculating the present value of the future minimum lease payments, deferred issue costs were considered as additional interest in determining the effective interest rate applicable to the revised agreement. (The loss shall be classified in accordance with FASB Statement No. 4.)

Footnotes

FAS22, Footnote 1--An advance refunding involves the issuance of new debt to replace existing debt with the proceeds from the new debt placed in trust or otherwise restricted to retire the existing debt at a determinable future date or dates. Descriptions of advance refundings that are and are not accounted for as early extinguishments of debt are presented in the AICPA Statement of Position on "Accounting for Advance Refundings of Tax-Exempt Debt."

FAS22, Footnote 2--See footnote 1.

FAS22, Footnote 3--See paragraph 12 of *FASB Statement No. 13* and footnote 11 thereto.

FAS22, Footnote 4--This paragraph prescribes the accounting for a direct financing lease by governmental units that classify and account for leases of that kind.

FAS22, Appendix A, Footnote *--The face amount of the refunding obligation (\$52,000,000) is equal to the face amount of the obligation to be refunded (\$50,000,000) plus the redemption premium applicable to the obligation to be refunded (\$1,500,000) and the costs of issuance (\$500,000).