

Tax-Exempt Bonds—Accounting and Auditing Considerations in the Current Environment

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Table of Contents

Introduction and Background	3
Discussion of Accounting and Auditing Issues.....	5
Bond Restructuring	5
Applicable Guidance.....	5
Nongovernmental Issuers of Tax-Exempt Debt	5
Governmental Issuers of Tax-Exempt Debt	7
Derivatives	7
Applicable Guidance.....	7
Nongovernmental and Certain Governmental Proprietary Issuers of Tax-Exempt Debt.....	7
Governmental Issuers of Tax-Exempt Debt	8
Debt Covenants	9
Applicable Guidance.....	9
Nongovernmental and Certain Governmental Proprietary Issuers of Tax-Exempt Debt.....	9
Governmental Issuers of Tax-Exempt Debt	9
Events Occurring Subsequent to the Balance Sheet Date	10
Applicable Guidance.....	10
Nongovernmental and Governmental Issuers of Tax-Exempt Debt	10
Balance Sheet Classification (Issues Not Discussed Elsewhere)	11
Applicable Guidance.....	11
Nongovernmental Issuers of Tax-Exempt Debt	11
Governmental Issuers of Tax-Exempt Debt	12
Going Concern Considerations.....	13
Applicable Guidance.....	14
Nongovernmental and Governmental Issuers of Tax-Exempt Debt	14
Summary	14
Appendix A—Governmental Accounting Standards Board's Proposed Guidance for Derivatives	15

Introduction and Background

The current credit environment has affected the market for debt securities. While all debt securities may be affected, this article focuses on tax-exempt debt issued¹ by not-for-profit organizations and municipalities; states; cities; and other governments, such as redevelopment agencies, school districts, public universities, airports, and seaports. This article has a particular focus on debt that is referred to as (1) auction rate securities (ARSs) and (2) variable rate demand obligations (VRDOs). While the current environment presents accounting and auditing issues for investors in that tax-exempt debt, this article focuses on issues facing the issuers of that debt.

Traditional ARSs are long-term debt securities with legal maturities typically of at least 20 years, with interest rates that are reset periodically (typically every week or month, but, in some cases, every 35, 49, 60, or 90 days) in blind auctions held by investment banks. Because the interest rates are reset on a relatively short time frame, traditional ARSs were designed to be traded as liquid, short-term debt securities.

Most ARSs are guaranteed by a third party, typically known as a bond insurer, and the bond insurer's rating typically affects the rating of the bond. Recently, some bond insurers have experienced credit downgrades, while others have struggled to maintain their credit rating due in part to their exposure to subprime mortgages. As some investors became concerned that the troubled bond insurers may no longer be able to meet their obligations in the event of default, those investors have avoided ARSs.

In addition, many investors, such as investment banks, have experienced significant losses associated with their investments related to subprime mortgage securities, reducing the available capital for ARSs. As a result, many investment banks serving as auction agents, who previously may have purchased securities at auction to prevent failed auctions,² began to allow auctions to fail. Every major investment bank has experienced failed auctions, and no entity that has issued ARSs is insulated from these market conditions.

¹ For purposes of this article, the discussion of tax-exempt debt and entities that issue such debt includes conduit debt and organizations that are obligors under conduit debt.

² A failed auction occurs in circumstances in which not enough orders exist to purchase all the securities being sold at the auction.

Interest rates on ARSs with failed auctions typically default to the maximum rate defined in the related agreements. Some organizations have experienced interest rate increases from the low single digits to as high as 20 percent as a result of auction failures. Also, it is not uncommon to have an auction fail one week and be successful the following week, although, perhaps, with significantly higher interest rates. This has resulted in significant interest rate volatility and, in some cases, higher overall interest costs for entities issuing that debt.

Due to the significant increase in interest costs associated with ARSs due to the preceding factors and founded or unfounded fears in the credit markets, many issuers of ARSs are restructuring their ARSs in various ways depending on their specific facts and circumstances. Some are issuing new bonds (including VRDOs, which are discussed in more detail in the following), others changing the interest rate mode as provided for under existing agreements, some buying back their own bonds, and some pursuing a variety of other options.

VRDOs are short-term obligations that are characterized by a "put" or demand feature that gives the bondholder the ability to "put" the bonds back to a remarketing agent (or in some circumstances, to the issuer of the VRDO). If the "put" bonds cannot be remarketed to another investor, a liquidity facility issued by a financial institution (for example, a standby bond purchase agreement [SBPA], letter of credit [LOC], or line of credit) typically provides the agent or issuer of the VRDO funding to cover the put.

In addition, organizations may have interest rate swaps associated with tax-exempt debt. Based on the terms of these swap agreements, credit downgrades to the parties to the swap may trigger an automatic termination of the swap or a requirement to post collateral. In addition, changes in bond interest rates may result in the swap no longer effectively hedging the interest-rate risk associated with the debt.

This nonauthoritative article provides issuers of tax-exempt debt and their auditors an overview of the accounting and auditing considerations that may be relevant in light of these recent market events and entity transactions. The purpose of this article is to raise awareness about potential accounting and auditing issues that may be relevant to issuers of tax-exempt debt and their auditors (in connection with that tax-exempt debt), and to point readers toward accounting and auditing guidance that may be relevant to those issues. Each situation is different and should be evaluated based on its specific facts and circumstances. Some of those

issues, as well as the accounting and auditing guidance that may be applicable, are highlighted in the following.

Discussion of Accounting and Auditing Issues

Bond Restructuring

Not-for-profit organizations and governments wishing to restructure their ARSs have several options available, including but not limited to reacquiring the ARSs, refinancing the ARSs, or changing the security's interest rate mode (for example, from an auction rate to a fixed or variable rate). Certain of these actions may result in the ARSs being considered extinguished for accounting purposes. (In addition, such actions may affect the balance sheet classification of the liabilities, which is discussed later in this article.)

Applicable Guidance

Nongovernmental Issuers of Tax-Exempt Debt

Paragraph 16 of Financial Accounting Standards Board (FASB) Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*, provides guidance for determining circumstances in which a liability is considered extinguished.

Paragraph 16(a) of FASB Statement No. 140 provides that a liability should be considered extinguished (and derecognized) if "the debtor pays the creditor and is relieved of its obligation for the liability." This explicitly includes situations where the debtor reacquires its outstanding debt securities, regardless of whether the reacquired securities are held by the debtor (as *treasury bonds*) or cancelled.

Paragraph 16(b) of FASB Statement No. 140 provides that a liability should be considered extinguished (and derecognized) if "[t]he debtor is *legally* released [footnote omitted] from being the primary obligor under the liability, either judicially or by the creditor." If an ARS is restructured through an advance refunding transaction,³ because the debtor has not

³ In an advance refunding, the proceeds from the sale of the refunding bonds are used to purchase governmental securities, which are deposited into an escrow account. The escrow account is structured such that the principal and related earnings on the

paid the creditors (for instance, the holders of the ARSs), the debtor may need a legal opinion in order to conclude that it has been legally released as the primary obligor of the ARSs. While there is no direct auditing guidance as to the form and content of a typical legal letter governing a legal defeasance, the principles outlined in Auditing Interpretation No. 1, "The Use of Legal Interpretations As Audit Evidence to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Financial Accounting Standards Board Statement No. 140" of AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 9336), may be helpful in determining whether the letter obtained by the debtor is adequate audit evidence that the debtor has been legally released as the primary obligor of the ARSs.

FASB Statement No. 140 also provides guidance on accounting for assets that may be transferred to an escrow to advance refund the ARSs. Specifically, such assets should meet the isolation criterion of paragraph 9(a) of FASB Statement No. 140 in order for the assets placed into the escrow trust to be derecognized from the debtor's balance sheet. A legal opinion may be needed as audit evidence to support the assertion that the assets transferred to the trust have met the isolation criterion.

Emerging Issues Task Force (EITF) Issue No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments," provides guidance for evaluating whether a replacement of one debt instrument with another is, in essence, a refinancing of the debt with the same creditors (that is, a modification of the original debt terms), rather than an extinguishment of the old debt. EITF Issue No. 96-19 also provides guidance for reporting costs incurred by the debtor in connection with an exchange or modification, and addresses the consideration of the role played by an intermediary such as an investment bank in a modification/extinguishment as either an agent or a principal.

If the debtor's action with respect to its debt results in an extinguishment, it should account for that extinguishment pursuant to Accounting Principles Board (APB) Opinion No. 26, *Early Extinguishment of Debt*, as amended.

governmental securities are sufficient to pay all principal, interest, and any call premium on the auction rate securities up to the date at which they may be called.

Governmental Issuers of Tax-Exempt Debt

If the action results in or is an advance refunding that results in a defeasance, paragraphs 8–12 of Governmental Accounting Standards Board (GASB) Statement No. 7, *Advance Refundings Resulting in Defeasance of Debt*, provide guidance. GASB Statement No. 23, *Accounting and Financial Reporting for Refundings of Debt Reported by Proprietary Activities*, which includes guidance about the presentation that would occur in the statement of net assets and statement of activities, provides guidance for all refundings (current as well as advance refundings). On the balance sheet of the proprietary fund activity, or the statement of net assets of the government, any gain or loss resulting from the refunding should be deferred and reported as a deduction from or an addition to the new debt liability. The amortization period is the shorter of the term of the original debt or the new debt.

Derivatives

Entities with interest rate swaps may find that those swaps are no longer effective in economically hedging the risk of interest rate increases. Additionally, credit downgrades of insurers and entities issuing tax-exempt debt are resulting in increased exposure to the risk of needing to post collateral or, in some cases, involuntary termination of some swaps. Finally, debt restructuring may result in discontinuation of hedge accounting for related interest rate swaps.

Applicable Guidance

*Nongovernmental and Certain Governmental Proprietary Issuers of Tax-Exempt Debt*⁴

An issuer of ARSs may have hedged the variability of the future cash flows (variable interest payments) using a hedge characterized as a *cash flow hedge* under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.⁵

⁴ As used in this article, *certain governmental proprietary issuers* refers to governmental proprietary activities that apply paragraph 7 of GASB Statement No. 20.

⁵ Issuers and their auditors should note that subsequent to the effective date (the first day of the first fiscal quarter beginning after January 8, 2007) of Financial Accounting Standards Board (FASB) Statement No. 133 Implementation Issue G26, *Cash Flow Hedges: Hedging Interest Cash Flows on Variable-Rate Assets and Liabilities That Are*

Paragraphs 28–34 and 500–501 of FASB Statement No. 133 provide guidance on accounting for cash flow hedges, including accounting for hedge termination.

Governmental Issuers of Tax-Exempt Debt

GASB has not issued standards addressing the recognition or measurement of debt-related interest rate swaps.⁶

Proprietary funds/activities that apply paragraph 7 of GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, are required to apply the provisions of FASB Statement No. 133 (to the extent that they do not contradict or conflict with the provisions of existing GASB statements). They do not, however, apply FASB Statement No. 133's cash flow hedge accounting provisions, because the accounting required conflicts with the GASB's financial reporting model. (See GASB staff document *Comprehensive Implementation Guide* item 7.72.1).⁷

Unless an entity or fund applies paragraph 7 of GASB Statement No. 20, GASB Technical Bulletin 2003-1, *Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets*, paragraphs 10(d)1-3, requires that if a derivative exposes a government to termination risk, the government should disclose that exposure as termination risk and also disclose the following:

- a. Any termination events that have occurred
- b. Dates that a derivative may be terminated
- c. Out-of-the-ordinary termination events contained in contractual documents, such as “additional termination events” contained in the Schedule to the International Swap Dealers Association Master Agreement.

Not Based on a Benchmark Interest Rate, for a hedge to qualify as a cash flow hedge under FASB Statement No. 133, issuers have had to hedge the entire change in the variable rate and not just the benchmark component.

⁶ Appendix A to this article discusses a June 2007 Governmental Accounting Standards Board (GASB) exposure draft of a proposed standard, *Accounting and Financial Reporting for Derivative Instruments*.

⁷ Once GASB's proposed derivatives standard is issued and effective, FASB Statement No. 133 likely will no longer be applicable to governments that apply paragraph 7 of GASB Statement No. 20

Debt Covenants

A downgrade of the credit rating of the bond insurer insuring the debt, as well as other events, may trigger technical defaults under the debt agreements. If a default occurs, issuers of tax-exempt debt should consider whether that default triggers classification of the liability as current or cross defaults in other arrangements.

Replacement of ARSs classified as long-term liabilities with VRDOs classified as current liabilities (discussed further in the following) could trigger violations of liquidity covenants in other debt agreements.

Ratings downgrades of surety providers (for example, sureties provided to satisfy debt service reserve requirements) may trigger defaults.

Applicable Guidance

Nongovernmental and Certain Governmental Proprietary Issuers of Tax-Exempt Debt

Accounting Research Bulletin (ARB) No. 43, *Restatement and Revision of Accounting Research Bulletins*, chapter 3A, “Current Assets and Current Liabilities,” defines *current assets* and *current liabilities* for balance sheet classification purposes. FASB Statement No. 78, *Classification of Obligations That Are Callable by the Creditor—an amendment of ARB No. 43, Chapter 3A*, clarifies how the debtor should present obligations that are callable by the creditor in a balance sheet in which liabilities are classified as current or noncurrent.

Governmental Issuers of Tax-Exempt Debt

GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, requires that violations of finance related or legal covenants be disclosed in notes to the financial statements.

Failure to file a document required under a Rule 15c2-12 continuing disclosure covenant (such as a material event notice) may be considered a debt covenant violation that requires disclosure under GASB Statement No. 38.

Events Occurring Subsequent to the Balance Sheet Date

Events occurring subsequent to the balance sheet date but prior to the issuance of the financial statements, such as actions pertaining to extinguishing or modifying an ARS arrangement, may need to be reflected in the financial statements. For example, bond restructuring transactions occurring after the balance sheet date may have an effect on the debtor's current/noncurrent balance sheet classifications as of that balance sheet date. Also, other events occurring after the balance sheet date, such as failed auctions, potential or actual cancellation of a liquidity facility, or a mandatory tender of bonds may need to be disclosed in the financial statements as subsequent events.

Applicable Guidance

Nongovernmental and Governmental Issuers of Tax-Exempt Debt

Paragraphs .05–.06 of AU section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1), provide guidance pertaining to subsequent events. Paragraph .06 notes the sale of a bond subsequent to the balance sheet date as an example of an event that requires disclosure in the notes to the financial statements.

ARB No. 43, and FASB Statement No. 6, *Classification of Short-Term Obligations Expected to Be Refinanced—an amendment of ARB No. 43, Chapter 3A*, (and for governmental entities, National Council of Governmental Accounting [NCGA] Interpretation No. 9, *Certain Fund Classifications and Balance Sheet Accounts*), provide guidance for the classification of short-term obligations that are expected to be refinanced on a long-term basis.

EITF Issue No. 86-30, "Classification of Obligations When a Violation is Waived by the Creditor,"⁸ addresses the classification of obligations at the balance sheet date that are not callable at the balance sheet date but that become callable by violation of a debt agreement provision after the balance sheet date but before the financial statements are issued.

⁸ Consensus Opinions of the Emerging Issues Task Force represent *other accounting literature* for governmental entities other than proprietary entities or funds that apply paragraph 7 of GASB Statement No. 20, under current generally accepted accounting principles.

Balance Sheet Classification (Issues Not Discussed Elsewhere)

Issuers of VRDOs typically execute a standby bond purchase agreement, a letter of credit, or a similar liquidity facility with a bank to provide funding in the event that debt holders “put” the bonds to the debtor and the bonds are not remarketed. The terms of the liquidity facility and other relevant factors (such as any subjective acceleration clauses, material adverse event clauses, repayment terms/installment payment schedules associated with liquidity facilities or take out agreements, and the debtor’s ability and intent to refinance the debt) may affect the balance sheet classification of VRDOs. Typically, debt that contains a put option to the debtor should be classified as a current liability. In certain circumstances, however, the terms of the liquidity facility or other factors may lead to the conclusion that the debt should be classified as long-term.

Applicable Guidance

Nongovernmental Issuers of Tax-Exempt Debt

ARB No. 43 chapter 3A defines *current assets* and *current liabilities* for balance sheet classification purposes. FASB Statement No. 78 clarifies how obligations that are callable by the creditor should be presented in a balance sheet in which liabilities are classified as current or noncurrent.

EITF Topic No. D-23, “Subjective Acceleration Clauses and Debt Classification;” FASB Technical Bulletin 79-3, *Subjective Acceleration Clauses in Long-term Debt Agreements*; and FASB Statement No. 6 provide guidance pertaining to balance sheet classification in circumstances in which debt agreements include subjective acceleration clauses.

EITF Topic No. D-61, “Classification by the Issuer of Redeemable Instruments That Are Subject to Remarketing Agreements,” discusses the appropriate balance sheet classification of debt in the circumstances in which (1) the debt has a long-term maturity (for example, 30–40 years), (2) the debt holder may redeem or put the bond on short notice (7–30 days), (3) the debtor has a remarketing agreement that states that the agent will make its best effort to remarket the bond when redeemed, and (4) the debt is secured by a short-term letter of credit that provides protection to the debt holder in the event that the redeemed debt cannot be remarketed.

Governmental Issuers of Tax-Exempt Debt

NCGA Statement 1, *Governmental Accounting and Financial Reporting Principles*, as amended, provides that bonds and similar long-term liabilities of proprietary funds/activities should be reported by those funds/activities as current or noncurrent liabilities, as appropriate, in conformity with ARB Opinion No. 43, FASB Statement No. 6, and FASB Statement No. 78. All other unmatured indebtedness should be reported as general long-term debt. Unmatured principal of general long-term debt is not a specific fund liability of governmental funds. Matured principal of general long-term debt should be reported as a liability of the fund in which the proceeds were deposited or in a debt service reserve fund.

For demand bonds such as VRDOs, GASB Interpretation No. 1, *Demand Bonds Issued by State and Local Governmental Activities*, provides guidance that is similar (but not identical) to that of EITF Topic No. D-61. Generally, demand bonds are reported as general long-term debt of proprietary funds (or for proprietary funds/activities, excluded from current liabilities) if the following conditions are met:

- a. There is an arm's-length financing (take out) agreement to convert bonds "put" but not resold into some other form of long-term obligation.
- b. The take out agreement does not expire within one year from the date of the debtor's statement of net assets.
- c. The take out agreement is not cancelable by the lender or the prospective lender during that year, and obligations incurred under the take out agreement are not callable by the lender during that year (discussed further in the following).
- d. The lender or the prospective lender or investor is expected to be financially capable of honoring the take out agreement.

If these conditions are not met, demand bonds should be reported as fund liabilities of governmental funds or as current liabilities of proprietary funds/activities.

In evaluating condition (c), if the take out agreement is cancelable or callable because of violations that can be objectively determined by both parties but no violations have occurred prior to issuance of the financial statements, the demand bonds should be classified as long-term debt. Otherwise, the demand bonds should be classified as a fund liability of

governmental funds or as a current liability of proprietary funds/activities. If the take out agreement is cancelable or callable because of violations that cannot be objectively determined by both parties (for example, due to the existence of subjective acceleration clauses or material adverse change clauses whereby the lender has the unilateral ability, based on subjective information, to deem that a violation has occurred), then the agreement does not provide sufficient assurance of long-term financing capabilities to classify the bonds as long-term debt.

If a take out agreement has been exercised converting the bonds to an installment loan, the installment loan should be reported as general long-term debt and the payment schedule under the installment loan should be included as part of the schedule of debt service requirements to maturity.

Going Concern Considerations

Several events (some interrelated) could call into question the entity's ability to continue as a going concern. For example:

- As discussed earlier, a downgrade of the bond insurer or other events may trigger technical defaults of the debt agreements.
- Failed auctions for ARSs may indicate that future issuances of ARSs may no longer be an available source of funds, or that the higher failed-auction penalty interest rate may have a significant impact on liquidity.
- A downgrade of VRDOs could result in termination of a liquidity facility, a mandatory tender of the bonds, or an acceleration of the debt.
- Ineffective derivative arrangements, potential termination of derivatives, or collateral posting requirements can pose significant challenges to an issuer's liquidity.
- Overall market conditions may indicate that a debtor's access to the debt and derivative markets is constrained, which may lead to liquidity problems.
- Entities seeking to convert ARSs to VRDOs may find that the market for liquidity facilities is limited and, as a result, either (1) enter into facilities on less favorable terms than would otherwise be the case, or (2) be unable to obtain a liquidity facility (self-liquidity can expose the entity to significant liquidity strains).

The auditor should consider such events and circumstances in evaluating a debtor's ability to continue as a going concern.

Applicable Guidance

Nongovernmental and Governmental Issuers of Tax-Exempt Debt

AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1), provides guidance with respect to evaluating whether there is substantial doubt about the debtor's ability to continue as a going concern, as well as the impact on the auditor's report.

Summary

As noted earlier, each entity's situation with respect to its tax-exempt debt is different and should be evaluated based on its specific facts and circumstances. Therefore, it is important that the entity and its auditors carefully evaluate the facts and circumstances of each situation to determine the appropriate financial reporting and auditing procedures. In addition, applicable authoritative guidance, in addition to that listed in the preceding, should be consulted when necessary.

Appendix A—Governmental Accounting Standards Board's Proposed Guidance for Derivatives

At the time this article was written, no Governmental Accounting Standards Board (GASB) standard required recognition of derivatives in the statement of net assets. In June 2007, GASB issued an exposure draft of a proposed standard, *Accounting and Financial Reporting for Derivative Instruments*, which would require that the fair value of all derivatives be reported in the government-wide statement of net assets. The proposed GASB standard would mandate evaluation of all derivatives as potential hedging derivatives. The GASB model for hedge accounting differs from the Financial Accounting Standards Board model in many respects, most notably in that the GASB model provides that gains/losses associated with effective hedges would be reported in deferral accounts on the statement of net assets.

If a termination of a swap that was a hedging derivative occurs, hedge accounting would be discontinued. Termination events would include the disassociation of a hedge with a hedgeable item; the lack of hedge effectiveness using any one of GASB's proposed methods (consistent critical terms, creation of a synthetic instrument, dollar offset, regression analysis, and so on); the likelihood that a hedged expected transaction will occur is no longer considered probable; the retirement or sale of a bond; or the termination of the hedging instrument.¹

The impact of termination, modification, or extinguishment of a hedging derivative would be reflected in the statement of activities (or, for proprietary funds/activities, in the statement of revenues, expenses, and changes in net assets). Any associated deferral balance would be eliminated and reported as an element of investment income (loss).

Issuance of a final standard is expected in June 2008, and would be effective for fiscal years beginning after June 15, 2009.

¹ Governmental Accounting Standards Board, *Exposure Draft: Proposed Statement of the Governmental Accounting Standards Board—Accounting and Financial Reporting for Derivative Instruments*, paragraphs 18 and 21–53.