

2006 Midwestern Intergovernmental Audit Forum

GASB Update

The views expressed in this presentation are those of the speaker. Official positions of the GASB are determined only after extensive due process and deliberation.

Effective and Soon to be Effective Pronouncements

Recent Pronouncements

- Statement 42—Asset impairment
- Statement 44—Statistical section
- Statements 43 and 45—OPEB
- Statement 46—Restricted net assets
- Statement 47—Termination benefits
- Statement 48— Sales and Pledges
- TB 2006-1— Retiree Drug Subsidies (Medicare Part D)

Effective Dates

- June 30, 2006
 - Statement 34, Retroactive infrastructure—Phase I
 - Statement 42
 - Statement 44
 - Statement 46
 - Statement 47
- June 30, 2007
 - Statement 34, Retroactive infrastructure—Phase II
 - Statement 43—Phase I
- June 30, 2008
 - Statement 43—Phase II
 - Statement 45—Phase I
 - Statement 48—(Sales and Pledges-12/31/07)
 - Statement 49—(Pollution Remediation)

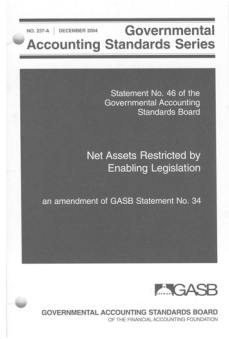
Due Process Documents

Currently (or soon to be) Outstanding

- Pollution remediation obligations (Final Statement in process)
- Derivatives (Exposure draft in process)
- Proposed Concepts Statement—Elements of Financial Statements
 - Comment deadline— November 17
- Fund balance reporting—ITC to be issued by the end of October

Statement 46— Net Assets Restricted by Enabling Legislation

Effective for periods
beginning after June 15,
2005



Background

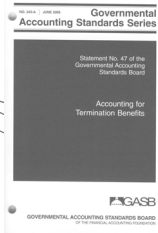
- Statement 34 identifies three sources of restrictions on net assets—external parties, constitutional provisions, and enabling legislation
- Enabling legislation is a type of legislation that authorizes the raising of a **new** revenue (i.e., it does not earmark existing revenues) and that contains a **legally enforceable** restriction on the purpose for which those revenues can be used

Legal Enforceability

- Legal enforceability means that an external party—such as citizens, a public interest group, or the judiciary—can compel a government to abide by the restriction
- Legal enforceability remains a matter of professional judgment, which may include reviewing determinations for similar legislation, obtaining the advice of legal counsel, or other actions

Statement No. 47

Accounting for Termination Benefits



Generally, effective for periods beginning after June 15, 2005

Statement No. 47

- Issued June 2005
- Establishes accounting and reporting requirements for *all* forms of termination benefits
- Supersedes guidance in NCGAI 8 for *special termination benefits*

Scope

- Voluntary termination benefits
 - Inducements to hasten the termination of services
 - Ex.: early-retirement incentives
- Involuntary termination benefits
 - Benefits provided as a consequence of the early termination of services
 - Ex.: severance pay
- Includes COBRA
- Excludes unemployment compensation
- Some disclosures required

Termination Benefits vs. OPEB

- Determine whether the nature of arrangement is to provide benefits:
 - In exchange for the early termination of services (a termination benefit)
 - As compensation for services (OPEB)
- Consider all relevant factors, including:
 - Employer's intent
 - Employees' view of the benefits
 - Whether conditioned on termination of employment prior to normal retirement age
 - Length of time benefits have been made available

Measurement

- Healthcare-related:
 - Projection of benefits
 - Healthcare cost trend rate
 - Discount rate
- Non-healthcare-related:
 - If specific amounts are payable at fixed times—Use discounted PV of expected future benefits
 - If not, option to use undiscounted total at current cost

Recognition Requirements— Accrual Basis

- Voluntary termination benefits
 - Liability and expense recognized when:
 - Employees accept the offer
 - Amounts can be estimated
 - Measurement updated at end of each subsequent reporting period

**Recognition Requirements—
Accrual Basis (cont.)**

- Involuntary termination benefits
 - Generally, liability and expense recognized when:
 - Plan of termination approved and communicated
 - Amounts can be estimated
 - Measurement updated at end of each subsequent reporting period
 - Additional provisions if plan required future service

**Recognition Requirements—
Modified Accrual Basis**

- Liabilities and expenditures recognized to extent the liabilities are normally expected to be liquidated with expendable available financial resources
- See paragraph 14 of Interpretation 6

Statement No. 48

**Sales and Pledges of
Receivables and Future
Revenues
and
Intra-Entity Transfers of
Assets and Future Revenues**

Sales and Pledges-Scope

- Government *receives proceeds* in exchange for the rights to future cash flows from:
 - Receivables:
 - Delinquent property taxes
 - Mortgages
 - Student loans
 - Future Revenues

Sales and Pledges-Scope

- Includes situations in which the government *does not receive proceeds*, but pledges future cash flows
 - Primary government pledges revenues to debt-issuing component unit

Sales and Pledges-Scope

- Guidance is provided for *all* transactions involving the transfer of assets (sold or donated) between components of a common reporting entity, including individual funds.
 - No new basis, carrying value is retained
 - Difference is a transfer/subsidy

Sales and Pledges

Is it a Sale or a Borrowing?

- Borrowing by default, unless you can prove otherwise, based on evaluation of
- Continuing involvement—control
 - Does the transferor government retain control, or is control relinquished?
 - Criteria provided for receivables
 - Criteria provided for future revenues

(Intent of the parties, terms of the agreement are not determinative)

Receivables

Are **receivables** sold or pledged?

- Is the transferee able to sell or pledge?
- Are the receivables and cash collected *isolated* from seller (and its creditors)
 - Legally separate
 - No access to cash
 - Source and timing of payments
 - Satisfaction of accounts
 - Bankruptcy protection
- No option or ability to replace or repurchase accounts

Receivables

If sale criteria are not met (collateralized borrowing):

- Pledging government:
 - Does not de-recognize receivables
 - Recognizes liability for the proceeds received
 - Payments reduce liability (G/F expenditure)
- Transferee government recognizes a receivable

Receivables

If the conditions for sale treatment are met:

- Selling government:
 - De-recognizes receivables
 - Recognizes revenue/gain (loss) in the government-wide statements or enterprise funds for the difference between proceeds and carrying value.
 - Proceeds are recognized as revenue in governmental funds (net carrying value assumed to be zero)
- Purchasing government:
 - Intra-entity--Purchased receivables are reported at carrying value
 - Outside of the reporting entity--receivables at cost

Future Revenues

Are **future revenues** sold or pledged?

- Is the transferee able to sell or pledge?
- Does the transferor continue to have **active** involvement in the generation of the revenues?
 - By nature, own-source revenues involve continuing active involvement.
 - Taxes
 - User charges
 - Some grants, entitlements, shared revenues, rents, royalties may meet the criteria for sale treatment, depending on **active** involvement
- Isolation—similar to receivables

Future Revenues

If sale criteria are not met (collateralized borrowing):

- Pledging government:
 - Continues recognition of revenues pledged
 - Recognizes liability for the proceeds received
 - Payments reduce liability (G/F expenditure)
- Transferee government recognizes a receivable

Future Revenues

If the conditions for sale treatment are met:

- **Selling government:**
 - Has no asset to de-recognize for future revenues
 - Proceeds will usually be recognized as deferred revenue and amortized over the life of the agreement
 - Deferral depends on why revenue had not been previously recognized by the seller
- **Purchasing government:**
 - Intra-entity--Payment to selling government for rights to future revenues is reported as a deferred charge (and amortized)
 - Outside of the reporting entity--asset (rights) reported at cost
- Applied prospectively

Other assets and liabilities

- **Assets:**
 - Residual interests—subordinate note or residual certificate that represents the rights to:
 - Excess receivable collections (probability of collection)
 - Excess future revenues (revenue recognition event)
- **Liabilities:**
 - Recourse and other obligations (FAS 5)

Sales and Pledges

- If the pledging government does not receive proceeds:
 - Usually occurs when government is limited in its ability to issue debt
 - Creates/uses component unit to issue debt
- **Pledges its revenues as security**
 - Pledge does not constitute a liability
 - Liability arises when pledged revenue is recognized

Sales and Pledges

Disclosures—Future Revenues:

For direct or indirect *pledges* (while debt is O/S)

- What revenue?
- Purpose of the debt
- For how long?
- Significance of pledged amount
- Coverage

For future revenues *sold* (year of the sale)

- What revenue?
- For how long?
- Significance of amount sold
- Present value

Sales and Pledges

Tax Incremental Revenues Pledged

The city has pledged a portion of future sales tax revenues to repay \$2.8 million in sales tax increment bonds issued in June 2003 to finance the refurbishing of the Southtown business district. The bonds are payable solely from the incremental sales taxes generated by increased retail sales in the refurbished district. Incremental sales taxes are projected to produce 128 percent of the debt service requirements over the life of the bonds. Total principal and interest requirements for the bonds are \$3,490,900, payable semiannually through June 2013. For the current year, principal and interest paid and total incremental sales tax revenues were \$395,150 and \$403,291, respectively.

Sales and Pledges

Sale of Future Rental Revenue

During the year, the city entered into an agreement with a private party under which the city relinquishes its rights to receive and retain future rental income from beachfront properties owned by the city. In July, the city received a lump-sum payment of \$13.1 million in exchange for 100 percent of its rights to the rental payments through December 2030. Total rental income from the beachfront properties during that period under normal occupancy conditions is estimated to be \$26.9 million. Based on this estimate, the city calculated the present value of the future rental payments to be \$12.9 million at the time of the sale.

Effective Date

- For Periods Ending After December 15, 2006
- Retroactive Application, Except:
 - Provisions for Future Revenue Sales to be Applied Prospectively

Pollution Remediation Obligations— Exposure Draft

Scope of ED

Pollution REMEDATION Obligations

- Excludes *prevention or control* obligations
- Excludes asset retirement obligations—including landfills (Statement 18)
- Excludes fines, penalties, toxic torts, product or process safety outlays (NCGA Statement 4)
- Some disclosures required

Types of Remediation Obligations

- Pre-cleanup activities: site assessment, feasibility study, design
- Cleanup activities: neutralization, containment, disposal activities
- Oversight and enforcement costs
- Operation and maintenance of the remedy and monitoring

Recognition Threshold

- Determine whether one or more components of a pollution remediation obligation are recognizable as a liability when . . .
 - Institution knows or reasonably believes that a site is polluted, and
 - Obligating event occurs

Obligating Events

- a. Compelled to take remediation action because of pollution-caused imminent endangerment
- b. Violate pollution-prevention permit—for example, RCRA permit
- c. Named, or evidence indicates govt. will be named, as responsible party or PRP for remediation (or cost sharing)

Obligating Events (continued)

- d. Named, or evidence indicates govt. will be named, in lawsuit to participate in remediation
 - Excludes lawsuits having no merit
- e. Govt. commences, or legally obligates self to commence
 - Limited to portion legally required to complete

Recognition

- Component approach
 - Recognize components of liability as they become reasonably estimable
 - Recognition benchmarks
- Cost accumulation, not fair value
- Current value, not present value
- Expected cash flow technique
 - Not FASB Statement No. 5, *Accounting for Contingencies*

Two Contingencies Neither is Probable

Potential payment	Probability	(a) x (b)
\$0	60%	\$0
\$200	40%	\$80
		\$80.00

Potential payment	Probability	(a) x (b)
\$0	60%	\$0
\$200	40%	\$80
		\$80.00

Two Contingencies— Expected Cash Flows

Permutations of Potential Payments			Joint Probabilities
Contingency 1	Contingency 2	Total	
\$0	\$0	\$0	36.0%
\$0	\$200	\$200	24.0%
\$200	\$0	\$200	24.0%
\$200	\$200	\$400	16.0%
			100.0%

Expense or Capitalize?

- Generally an expense
- Capitalize in certain situations
 - Do NOT record liabilities for capitalizable costs
- Take into account expected recoveries

Expected Recoveries

- Two types
 - Payments expected from other Potential Responsible Parties (PRPs)
 - Expected insurance recoveries
- Measurement—based on expected cash flows and current value

Expected Recoveries

- Reduce expense (and expenditure, if available) and . . .
- If not realized or realizable—
 - Net against remediation liabilities
- When realized or realizable
 - Increase liability and report separate recovery assets (cash or receivable)

Effective Date & Transition

- Periods beginning after June 15, 2007
- Measure liabilities at beginning of that period so beginning net assets can be restated
- But apply retroactively if you can
- No early application

Medicare Part D

Retiree Drug Subsidy Payments

Recognition

- Based on Statements 33 and 24
- Nonexchange transaction—Federal Government has not assumed the obligation
- Revenues and expenses should be reported versus netting

Technical Bulletin on Medicare D

- Basis for staff position is view that Medicare D retiree drug subsidy payments are transactions separate from the exchange of salaries and benefits for services received by the state or local government.
- Effective Immediately

Derivatives Preliminary Views

What Is the Objective of the Derivatives Project?

- To consider establishing additional financial reporting and disclosure requirements for derivatives accounting.
- Within the context of the governmental environment and the governmental reporting model

Derivatives

- What are they?
- FASB 133 definition used:
 - A derivative instrument is a financial instrument or other contract with all three of the following characteristics:
 - a. It has (1) one or more underlyings and (2) one or more notional [or face] amounts or payment provisions or both. Those terms determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required. [Footnote omitted.]

What is a Derivative? (cont'd.)

- b. It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- c. Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

Examples of Derivatives

- Interest rate swap
 - Variable-rate debt to fixed-rate debt
 - Fixed-rate debt to variable-rate debt
- Basis swap
 - Exchange payments based on the changes of two variable rates
- Swaption
 - Gives the purchaser the right, but not the obligation, to enter into an interest rate swap.

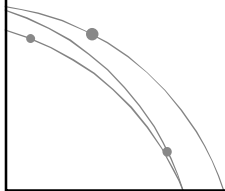
Examples of Derivatives

- Interest rate cap
 - Protection against rising interest rates
- Commodity swap
 - Reduce exposure to a commodity's price risk

How Should Derivatives Be Reported?

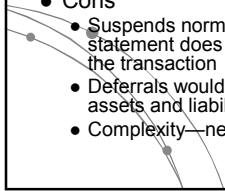
What Alternatives Has the GASB Explored?

- Historical cost without modification
- Context-based approach
- Fair value with hedge accounting
- Fair value without modification



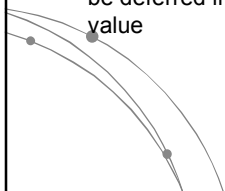
Fair Value with Hedge Accounting

- Pros
 - Fair value recognize the economic reality of the transactions
 - Deferrals recognize the effects of a mixed-attribute model
 - Reduces volatility in the change statements
- Cons
 - Suspends normal accounting conventions—change statement does not reflect the economic substance of the transaction
 - Deferrals would not meet the traditional definitions of assets and liabilities
 - Complexity—need to develop qualifying criteria



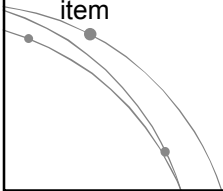
Tentative Decision

- Fair value with hedge accounting
 - Changes in fair value of derivative are deferred for qualifying transactions
 - Changes in fair value of derivative would not be deferred if the asset is reported at fair value



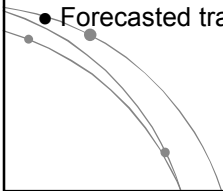
What is a Hedge?

- Management's objective is to establish a hedge—reduce a specified risk
- Hedging instrument is a derivative
- Derivative is associated with a hedgeable item



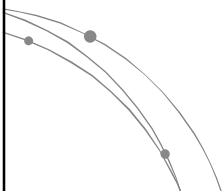
Hedgeable Item

- Single asset or liability
- Groups of similar assets or liabilities—same risk exposure
- Firm commitment
- Forecasted transaction—probable



Hedge Effectiveness

- Consistent critical terms
- Synthetic instrument
- Quantitative Techniques



Additional Disclosures

- Application of TB-2003 disclosures to all derivatives
- Summary of derivative activities by type
 - Beginning fair values
 - Fair value of derivatives acquired during the period (at time of acquisition)
 - Fair value of derivatives that matured or terminated
 - Changes in fair value during the period
 - Ending fair values
 - Ending notional amount

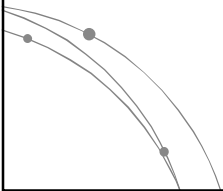
TB Note Disclosures

- Objective(s) of derivative
- Significant terms
- Risks
- Associated debt

Project Timetable

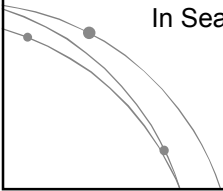
- Exposure Draft first quarter of 2007
- Final standard fourth quarter of 2007

What Will Be Issued Soon?



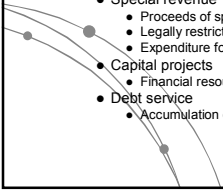
Fund Balance

In Search of Consistency



Fund Balance Reporting

- Separate project to reexamine fund balance reporting
 - User interviews and surveys
 - What are the needs?
 - What are the problems?
- Among the issues addressed:
 - Government as a whole, or "column" perspective?
 - Clarify fund type definitions
 - Special revenue
 - Proceeds of specific revenue sources
 - Legally restricted
 - Expenditure for specified purposes
 - Capital projects
 - Financial resources to be used for. . .
 - Debt service
 - Accumulation of resources for. . .



Fund Balance Reporting

Consider unspent motor fuel taxes received by a local government:

- In the government-wide statement of net assets
 - Restricted
- In the general fund
 - Reserved
- In a separate special revenue fund
 - Unreserved

Fund Balance Reporting

- Classification and display alternatives
- Two examples:
 - Restricted vs. unrestricted
 - Committed to specific uses vs. available for purposes of the fund

Distinguishing between restricted and unrestricted

Method 1	General Fund	Major Special Revenue Funds	Major Debt Service Fund	Major Capital Projects Fund	Other Funds	Total
Not available for appropriation						
Endowments	69,319	42,615	—	—	2,354	114,288
Long-term receivables	37,000	—	—	—	—	37,000
Inventory	104,500	50,763	1,095	—	2,042	156,400
Rainy-day resources	1,143,562	—	—	—	—	1,143,562
Restricted for purposes		459,796	—	—	—	459,796
Social services	241,563	—	—	—	—	241,563
Law enforcement	—	—	—	—	214,687	214,687
Parks and recreation	78,950	—	—	—	—	78,950
Education	54,125	—	119,155	—	—	173,280
Debt service	—	—	287,610	—	12,345	299,955
Capital projects	—	—	—	1,111,110	—	1,111,110
Other purposes	61,562	—	—	—	140,703	202,265
Unrestricted						
Assigned to:						
Library operations	21,125	—	—	—	—	21,125
Debt service	—	—	76,543	—	—	76,543
Public pool	—	—	—	73,256	—	73,256
City Hall renovation	—	—	—	51,562	—	51,562
Capital projects	—	—	—	99,518	—	99,518
Other purposes	33,275	—	—	—	12,700	45,975
Unassigned	129,708	—	—	—	—	129,708
Total fund balances	1,974,689	653,174	120,250	384,183	384,631	4,731,663

Other Current Projects

- Intangible Assets—ED in November
- Comprehensive Implementation Guide Update—September
- Recognition and Measurement Attributes—Concepts Statement
- Economic Condition Reporting
- Electronic Financial Reporting
- Intergovernmental Financial Risks
- Pension Accounting and Reporting
- Reporting Units/Statement 14 Revisited
- Service Efforts and Accomplishments Reporting

Questions?

krschermann@gasb.org
(203) 956-5206
Web site—www.gasb.org
