Accounting for Variable Rate Demand Obligations for GASB Higher Education institutions

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Balance Sheet classification and Note disclosures:

GASB requires proprietary funds to classify their balances sheets into current and noncurrent assets and liabilities. Regarding VRDO and other forms of short term debt obligations, presentation guidance is contained in GASB Interpretation 1, *Demand Bonds Issued by State and Local Governmental Entities.* Unless all four of the following conditions are met in paragraph 10, the institution should record VRDO as a current liability:

"Demand bonds, as the term is used in this Interpretation, are bonds that by their terms have demand provisions exercisable at the balance sheet date or within one year from the date of the balance sheet. Such bonds should be reported by state and local governmental entities as general long-term debt or excluded from current liabilities of proprietary funds if all of the following conditions are met. Unless these conditions are met, they should be reported as fund liabilities or, in the case of proprietary funds, as current liabilities.

a. Before the financial statements are issued, the issuer has entered into 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 issuer's balance sheet.
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.
d. The lender or the prospective lender or investor is expected to be financially capable of honoring the take out agreement.

With regard to condition (c), if the take out agreement is cancelable or callable because of violations that can be objectively determined by both parties and no violations have occurred prior to issuance of the financial statements, the demand bonds should be classified as long-term debt. If violations have occurred and a waiver has been obtained before issuance of the financial statements, the bonds should also be classified as long-term. Otherwise, the demand bonds should be classified as fund liabilities or, in the case of proprietary funds, as current liabilities. If the take out agreement is cancelable or callable because of violations that cannot be objectively determined by both parties, then the agreement does not provide sufficient assurance of long-term financing capabilities and the bonds should be classified as fund liabilities, or in the case of proprietary funds, as current liabilities."

The note disclosures required by the Interpretation are discussed in paragraph 11:

"In addition to debt disclosures required by NCGA Statement 1 and NCGA Interpretation 6, Notes to the Financial Statements Disclosure, state and local governmental entities with demand bonds outstanding (regardless of when the demand provisions are exercisable) should disclose a general description of the demand bond program; terms of any letters of credit or other standby liquidity agreements outstanding, commitment fees to obtain the letters of credit, and any amounts drawn on them outstanding as of the balance sheet date; and a description of the take out agreement including its expiration date, commitment fees to obtain that agreement, and the terms of any new obligation under the take out agreement. The notes should also disclose the debt service requirements that would result if the take out agreement were to be exercised."

The institution may reflect outstanding VRDO at the balance sheet date in the debt maturity schedules as the payments are expected to be paid. GASB 38 *Certain Financial Statement Note Disclosures* paragraph 10 states:

Governments should disclose the following details of debt service requirements to maturity:

a. Principal and interest requirements to maturity, presented separately, for each of the five subsequent fiscal years and in five-year increments thereafter. Interest requirements for variable-rate debt should be determined using the rate in effect at the financial statement date.

b. The terms by which interest rates change for variable-rate debt.

If the VRDO's are classified as current liabilities due to GASB Interpretation No. 1 and those obligations are reflected in the schedule as they are required to paid (i.e. stated maturity schedule vs. all due in the next year), the institution should add a disclosure to that fact.

Bonds without a Standby Purchase Agreement

Institutions may be able to use their own liquidity without incurring the cost of using a standby purchase or take out agreement. In this case, these VRDO's should be classified as a current liability.

In the event of a put, the institution would be required to purchase some or all of the bonds with their cash. If this occurs, the institution would record the put as a reduction of the debt liability. Upon a successful remarketing or permanent financing, the bonds would be reissued and recorded as a liability.

<u>Statement of Revenue, Expenses and Changes in Fund Balance</u>

During the time in which the institution holds their own bonds, the institution may be required to pay interest expense and also receive back the interest paid as the bond holder. In this case, the institution should record the payment as interest expense and the

receipt of interest as a reduction of interest expense and not interest income. A liability is defined in GASB Concepts Statement No. 4, *Elements of Financial Statements*:

"Liabilities are present obligations to sacrifice resources that the government has little or no discretion to avoid."

The institution paying and receiving the same from itself does not constitute a sacrifice of resources, and therefore should not gross up both interest income and expense as a result of the transaction.

Statement of Cash Flows

If bonds are put to the institution and those bonds were for capital or related financings, the bonds should be reflected as payment of principal, while any subsequent reissuance or remarketing of the debt should be reflected as debt issued within the Capital and Related Financing section of the Statement of Cash Flows (SCF).

The interest expense that is subsequently received by the institution would be reflected net as interest expense in the Cash Flows by Capital and Related Financing Activities section of the SCF.

Other Considerations

Recently, the GASB issued two Exposure Drafts (ED's) that may have an impact on the presentations related to VRDO, both of which will be effective upon issuance. The *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards* codifies existing AICPA guidance into the GASB standards. One of the AICPA standards addressed in the proposed Statement is subsequent events. In the event a VRDO put occurs after the balance sheet date but before the financial statement opinion, the institution should disclose the event in its footnotes. This event would be classified as a *Type Two* event, which consists of those events that provide evidence with respect to conditions that did not exist at the date of the statement of net assets but arose subsequent to that date. These do not result in an adjustment of the financial statements, however, are of such a nature that their disclosure is required to keep the financial statements from being misleading. If the put is material, the institution should disclose in its footnote the transaction or transactions and its impact.

The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments ED objective is to "identify the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements that are presented in accordance with GAAP (the GAAP hierarchy)." In the event a particular transaction is not specifically covered by the hierarchy provided in the Statement, the institution may consider other accounting literature. In paragraph 6, other accounting literature includes GASB Concepts Statements, as well as FASB Statements.

The accounting for treasury bonds (bonds purchased by the issuer but not retired) is described in APB Opinion 26 paragraph 3a, which was eventually superseded by SFAS *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities-a replacement of FASB Statement No. 125*, paragraph 16. In particular:

16. A debtor shall derecognize a liability if and only if it has been extinguished. A liability has been distinguished if either of the following conditions is met:

a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes the delivery of cash, other financial assets, goods, or services by the debtor of its outstanding debt securities whether the securities are canceled or held as so–called treasury bonds.

Once effective, your institution may rely on this and other post-November 30, 1989 FASB Statements for the proper recording and presentation on the statement of net assets, as long as it does not conflict with GASB Standards.