



Caught in the Middle

Issuer Accounting for Conduit Debt

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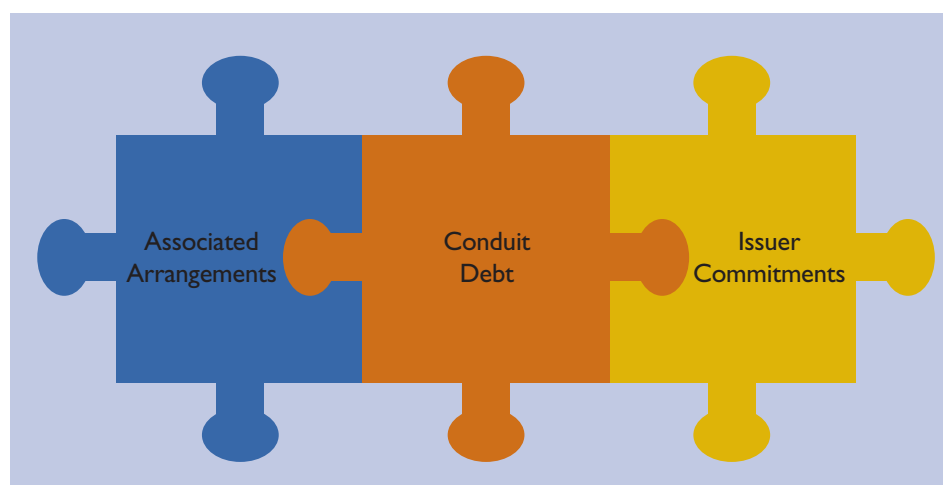
Issuers in conduit debt transactions primarily serve as channels between lenders and the third parties that receive the proceeds of loans and are primarily responsible for repaying them.

On May 13, 2019, the Governmental Accounting Standards Board (GASB) approved the issuance of GASB Statement No. 91, *Conduit Debt Obligations*, which replaces GASB Interpretation No. 2, *Disclosure of Conduit Debt Obligations*, as the source of generally accepted accounting principles (GAAP) for state and local governmental entities that issue conduit debt. The statement is effective for periods beginning after December 15, 2020, with early implementation encouraged.¹

As the name implies, issuers in conduit debt transactions primarily serve as channels between lenders and the third parties (other governments and non-profits such as colleges and hospitals are frequent beneficiaries) that receive the proceeds of loans and are primarily responsible for repaying them (“third-party obligors,” or simply “obligors”).

Because they can have virtually no “skin in the game,” issuers do not report liabilities for the conduit debt itself. However, some issuers make commitments associated with their conduit debt that may result in their needing to report liabilities and related outflows to support some or all of the debt service payments.²

Additionally, some issuers enter into lease-like “associated arrangements” in which they hold legal title to assets that are purchased or constructed with the conduit debt proceeds and receive payments from the obligor for its use of that underlying asset. Associated arrangements usually cover the time period during which the conduit debt is outstanding and, depending on the specifics of the agreements, they may or may not result in issuers recognizing the underlying assets and related inflows.



To be classified as conduit debt, debt must meet five criteria:

1. There must be at least three parties — an issuer, an obligor, and a debt holder or trustee — to the transaction. There may be more than one obligor or debt holder/trustee in a single conduit debt transaction.
2. The issuer and the obligor may not be in the same reporting entity; therefore, a primary government and a component unit, or two component units of the same primary government, may not be parties to a conduit debt transaction.
3. The debt cannot be a parity bond (one with equal rights to collateral as other bonds issued under a common indenture) or be cross-collateralized with other debt of the issuer.
4. The obligor or its agent must ultimately receive the proceeds of the debt.
5. The obligor must be primarily responsible for repayment of the debt.³

ISSUER COMMITMENTS

All issuers of conduit debt make certain limited commitments, such as to protect the tax-exempt status of the debt. Depending on the specifics of the debt agreement, they may also agree to receive funds from the obligor and make payments to debt holders or trustees. However, issuers sometimes make other commitments that can obligate them or otherwise result in their making debt service payments on the conduit debt, under certain circumstances, if the obligor cannot. These fall into two groups: additional and voluntary commitments. Additional commitments range from moral obliga-

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tion and appropriation pledges, both of which are dependent on annual budget appropriations, to financial guarantees and pledges of collateral assets or revenue streams. Voluntary commitments, on the other hand, arise when an issuer that has no legal obligation to do so requests a budget appropriation in order to pay, or actually makes a debt service payment on, its conduit debt. (See Exhibit 1.)

As previously mentioned, issuers do not recognize liabilities for conduit debt. However, issuers do need to recognize liabilities to support debt service *if they are more likely than not*

to support one or more debt service payments for the conduit debt, based on either additional or voluntary commitments. GASB defines *more likely than not* as being any probability greater than fifty percent.⁴ To determine whether they are more likely than not to support debt service payments, GASB Statement No. 91 requires governments to perform evaluations of likelihood, which are dependent on the type of commitment made:

- Governments that have made both limited and additional commitments in connection with a specific conduit debt issue must conduct an evaluation of the likelihood of support at least annually, and
- Governments that have made only limited commitments in connection with a specific conduit debt issue must conduct an evaluation when there is an event or circumstance that causes them to *consider supporting debt service payments* through a voluntary commitment, and then conduct a reevaluation annually

Exhibit 1: Issuer Commitments

Limited
(All Issuers)

- Maintain tax-exempt status
- Use obligor-provided resources (if any) for debt service
- May also facilitate payments from obligor to debt holders/bond trustees

Additional
(Some Issuers)

- Moral obligation pledge
- Appropriation pledge
- Financial guarantee
- Pledging own revenue or assets

Commitments to support debt if obligor is or will be unable.

Voluntary
(Some Issuers)

- Voluntarily requests status pledge appropriation for a debt service payment
- Voluntarily makes a debt service payment

Decisions to support debt — without having any obligation to do so — if obligor is or will be unable.

Source: GASB 91, paragraphs 7-9.

thereafter the occurrence of that event or circumstance.⁵

The evaluation requires the application of professional judgment based on qualitative factors, of which GASB Statement No. 91 provides a non-exhaustive list. The factors broadly fall into three groupings:

1. The first pertain to the obligor and its potential inability to pay debt service, as indicated by a variety of events such as initiating bankruptcy, failing to meet debt covenants, or other evidence of “significant financial difficulty.”⁶
2. The factors in the second group pertain to the viability of the project being financed with the conduit debt proceeds, if the project was expected to generate revenue to support debt service.
3. The final group is of factors pertaining to the issuer and its ability and motivation to support the debt if the obligor cannot, primarily aimed at assessing the likelihood of voluntary commitments.⁷

When the qualitative factors indicate that it is more likely than not that the issuer will support one or more debt service payments, the liability and related expense (for financial statements using the economic resources measurement focus) should be recognized, “measured as the discounted present value of the best estimate of ... future payments to support debt service.”⁸ In a governmental fund, that fund liability and expenditure should be recognized to the extent that debt service support payments the government is more likely than not to make are due and payable.⁹

All issuers with outstanding conduit debt should disclose general descriptions of their conduit debt obligations and of their limited and additional commitments,

ASSOCIATED ARRANGEMENTS

Conduit debt issuances are often accompanied by arrangements that are structured similarly to leases, although these are explicitly excluded from lease accounting treatment and are referred to in GASB Statement No. 91 as associated arrangements. To be considered an *associated arrangement*, all of the following four criteria must be met:

1. Proceeds from conduit debt are used to acquire or construct a capital asset.
2. From the beginning of the arrangement, the conduit debt issuer retains title to the capital asset.
3. The payments from the obligor are for the debt service on the conduit debt.
4. The payment schedule coincides with the debt service repayment schedule.

If an associated arrangement also meets the criteria to be a service concession arrangement, as established in GASB Codification Section S30, it should be accounted for and reported accordingly. Otherwise, the proper accounting and reporting for an associated arrangement depends on whether or not the issuer will relinquish or retain title to the asset at the end of the

arrangement, and whether or not the obligor has use of the entire asset or only portions of it during the arrangement, as summarized in Exhibit 2.

NOTE DISCLOSURES

GASB Statement No. 91 prescribes two sets of disclosures for conduit debt issuers. The first is required of all issuers with outstanding conduit debt, while the second applies only to issuers that report a liability to support debt service for their conduit debt. There are no specific disclosure requirements pertaining to associated arrangements; however, explanations of these arrangements may help financial statement users understand the expected repayment mechanisms, especially when the issuer has made additional commitments pertaining to the associated conduit debt.

All issuers with outstanding conduit debt should disclose general descriptions of their conduit debt obligations and of their limited and additional commitments, if any. For any additional commitments, the description should include the government’s legal authority and limits for extending commitments, the length of time of the commitments, and the arrangements, if any, for recovering payments from obligors. Additionally, issuers must disclose the aggregate amount outstanding at the end of the period of all conduit debt with the same type of commitments.¹⁰ If an issuer’s additional commitments on a conduit debt issue include the extension of a financial guarantee, it should follow the disclosure requirements for conduit debt rather than those applicable to non-exchange financial guarantees.¹¹

Exhibit 2: Issuer Accounting for Associated Arrangements

Issuer	Obligor	Issuer Recognizes
Relinquishes the title to the asset at end of the arrangement	(All cases)	<ul style="list-style-type: none"> ✗ No conduit debt liability* ✗ No receivable from the obligor ✗ No asset (GASB 91, paragraph 20)
Retains the title to the asset at the end of the arrangement	Has exclusive use of the entire asset during the arrangement	<ul style="list-style-type: none"> ✗ No conduit debt liability* ✗ No receivable from the obligor ✓ An asset at acquisition value and an inflow (revenue) of the same amount <i>at the end of the arrangement</i> (GASB 91, paragraph 21)
Retains the title to the asset at the end of the arrangement	Has exclusive use of part(s) of the asset during the arrangement	<ul style="list-style-type: none"> ✗ No conduit debt liability* ✗ No receivable from the obligor ✓ An asset at acquisition value and a deferred inflow of the same amount <i>at the beginning of the arrangement</i> ✓ An inflow (revenue) and amortization of deferred inflow in a rational and systematic manner <i>over the term of the arrangement</i> (GASB 91, paragraph 22)

*Of course, the issuer may need to recognize a liability to support conduit debt service based on additional or voluntary commitments associated with the conduit debt.

Issuers that recognize a liability to support conduit debt service should also disclose the timing of recognition and measurement of the liability, changes during the period to the recognized liability, the cumulative amounts that have been paid on recognized liabilities, if any, and amounts expected to be recovered from those payments, if any. Disclosures of changes during the period should include beginning balances, increases including recognition and adjustments increasing estimates, decreases including payments made and adjustments decreasing estimates, and ending balances.¹²

CONCLUSIONS

Arguably, GASB Statement No. 91 is less-aptly named than its predecessor, Interpretation No. 2, as conduit debt obligations themselves result only in disclosures. It is the associated issuer commitments and repayment arrange-

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ments that may yield recognition of assets, liabilities, deferred inflows, inflows, and outflows. Of course, “Conduit Debt Obligations” is easier to say than “Conduit Debt Disclosures and Accounting and Financial Reporting for Issuer Commitments and Other Arrangements Associated with Conduit Debt.” However, if you think GASB considers such things when naming standards, please direct your attention to the recently issued exposure draft on *Subscription Based Information Technology Arrangements*, the result of

a GASB project initially referred to simply as “Cloud Computing.”¹³ ■

Notes

1. GASB Statement No. 91, *Conduit Debt Obligations* (GASB Statement No. 91), paragraph 27.
2. GASB 91 paragraph 10.
3. GASB 91, paragraph 6.
4. GASB 91, paragraph 12 and footnote 2.
5. GASB 91, paragraphs 10 and 11.
6. GASB 91, paragraph 13 c.
7. GASB 91, paragraph 13.
8. If there is no best estimate, but a range can be established, and no amount within the range deemed to be more likely than the others, the minimum amount of that range should be discounted, and the present value of that amount should be recognized (GASB 91, paragraph 15).
9. GASB 91, paragraphs 16 and 17.
10. GASB 91, paragraph 25.
11. GASB 91, paragraph 4.
12. GASB 91, paragraph 26.
13. See the May 2019 of GAAFR Review newsletter for discussion of this exposure draft.

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