



Gentle Reminders for Times that Are Not

BY MICHELE MARK LEVINE

Recently, I received a call from a senior accounting official at a local government who had been asked to quickly assess the impact of a proposed financing transaction. The transaction involved trading revenue that the government would otherwise receive over many years for cash that would provide immediate budget relief. The government would not normally be permitted by state law to take such an action, but COVID-19 had precipitated an economic and financial crisis for the community and the state was, just possibly, going to make an exception under the circumstances.

Unfortunately, neither this pandemic nor the resultant financial distress is in any way contained in the United States as of the time of this

writing [mid-April 2020], and other governments may be forced to consider and undertake extraordinary measures above and beyond cost containment. Hence, it seems a good time to revisit the accounting rules that dictate how governments account for and report certain financing transactions that are designed to quickly provide additional cash, when reporting in accordance with generally accepted accounting principles (GAAP).

Sales versus Pledges

Whenever a government enters into a transaction to convert its receivables or future revenues into cash, the presumption in accounting is that the transaction constitutes a borrowing by the government, with the receivables or revenues pledged as collateral, rather than a sale. A transaction can be recognized as a sale of receivables or

future revenue only if government's subsequent involvement with the receivables or future revenue would be minimal, and specific criteria to that effect (discussed below) are met.¹ The criteria ensure that the determination is made based on the economic substance of the transaction, rather than the label it is given.

Collateralized Borrowings

The great majority of transactions in which a government generates cash using its receivables and future revenue will be properly recognized in accordance with GAAP as *borrowing* transactions, with the future receipts of cash from the underlying receivables or revenues pledged as collateral for the loan. This will most often be the case even when the timing of repayment by the government to the

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lender is based on the stream of actual collections from specifically identified pledged receivables or revenues.

In financial statements prepared using the economic resources measurement focus and the accrual basis of accounting, payments received from the counterparty (the lender, in the case of a collateralized borrowing) are offset by the borrowing government with liabilities, which are reduced by subsequent remittances to the lender. In governmental funds, with their current financial resources measurement focus and modified accrual basis of accounting, the payments received from the lender are treated as other financing sources, and subsequent remittances are treated as expenditures, as is the case with all long-term debt. The borrowing government continues to report pledged receivables as assets, or to recognize the future revenues in accordance with the revenue recognition guidance applicable to the specific type of revenue.

Sale of Receivables

Again, for accounting and financial reporting in accordance with GAAP, a sale of receivables is only considered to occur in transactions where the government's ongoing involvement with the receivables will be minimal. Specifically, all of the following criteria need to be met, based on the terms of the transaction or applicable law:

- The counterparty obtaining the right to the cash flows from the receivables (the "buyer" in the case of a transaction that qualifies as a sale) is allowed to subsequently pledge or resell them itself;
- The government giving up its right to the receivables ("selling") does not have the right to unilaterally substitute other receivables for those specifically included in the sale, although it may be required to do so if the original receivable ultimately proves to be invalid;
- The agreement must be noncancelable;
- The buyer has to be protected from the selling government's creditors; and
- The selling government must be isolated from collections.

The isolation requirement doesn't automatically preclude the selling government from continuing to service (make collections of) receivables under the terms of the transaction. However, in substance the selling government would have to be *collecting on behalf of the buyer*, who has the legal right to the receivables, rather than collecting amounts to which the government is itself legally entitled.

Specifically:

- Payments to the buyer are to be limited to actual collections on the sold receivables, and the selling government cannot advance funds to the buyer;
- Remittance to the buyer occur promptly upon collection;
- Earnings on unremitted collections accrue to the benefit of the buyer; and
- The proceeds of the sale are treated as payment-in-full of the sold receivables by the selling government.²

Unlike the factoring of receivables in the private sector, we rarely see transactions in which a government sells receivables (i.e., a transaction that meets the above requirements) to a party *outside of the government's reporting entity*. If that were to be the case, GAAP specifies that the receivables should be removed from the selling government's statement of net position and governmental fund balance sheet (if applicable) at their carrying value. Any difference between the carrying value and the amounts received should be treated either as a gain or loss (when reported using the economic resources measurement focus/full accrual basis of accounting), or as an adjustment to the revenue from the sale when recognized in a governmental fund (using the current financial resources measurement focus/modified accrual basis of accounting).

When governments sell receivables to a party within their own financial reporting entity, the buyer may be a pre-existing entity or a new entity may be created for that purpose.³ In accordance with GAAP, *the value of an asset cannot change simply as a*

result of it being moved within the same financial reporting entity. Therefore, if a discretely presented component unit were to purchase a receivable from the primary government for an amount in excess of the receivable's carrying value, the difference would need to be treated as an expenditure/expense by the component unit, and as a revenue by the primary government. If the component unit were blended rather than discretely presented, the difference would be reported as a transfer.⁴

Sale of Future Revenue

A sale of a future revenue has a different set of criteria than those for a sale of receivables, although a few criteria do appear in both lists. The criteria that need to be met for a sale of future revenue are:

- The government that will be transferring its rights to future revenue ("selling") must not be prohibited (such as by law or a grant contract) from transferring or assigning its rights to the future revenues that are being sold;
- The selling government must not have active involvement in generating the future revenues being sold;
- The party obtaining a claim to the future revenue (the "buyer") must be allowed to subsequently pledge or resell those claims itself;
- The agreement must be noncancelable; and
- The selling government must be isolated from collections.

As with receivables, governments sometimes will collect the future revenues even after they have been sold, and then transfer them to the buyer. If so, in order to meet the isolation requirement:

- Payments to the buyer are limited to amounts collected in connection with the sold revenue (that is, no advances are made for amounts not yet collected);

- Remittance of collections to the buyer occurs without delay; and
- Earnings on unremitted collections accrue to the benefit of the buyer.⁵

Again, the sale of future revenues can only occur if the generation of those revenues does not depend on the government's ongoing active involvement in revenue generation. By definition, all revenue from exchange and exchange-like transactions requires active involvement to be earned, and thus cannot be sold. Similarly, the levying and assessment of taxes and fees constitutes active involvement with those revenues. Even intergovernmental

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and other grants often require active involvement of recipient government in order to meet all of the eligibility requirements. Thus, the kind of future revenues that can be the subject of a sale is limited, as a practical matter, to a narrow group of intergovernmental grants and revenue, such as the tobacco settlement revenues that states are entitled to in accordance with the 1998 Master Settlement Agreement with tobacco companies, for which virtually no action by the recipient government is required.

Intergovernmental grants that may be sold are those for which the selling government does not need to apply, which are not expenditure-driven, have no matching requirements, and that

are not contingent upon performance. Eligibility requirements that can be met without active involvement include having required characteristics of recipients (simply being a certain type of entity, such as a school district entitled to state education aid that is formula-driven) and requirements that are met simply by the passage of time.

In summary, the following kinds of future revenue cannot be the subject of a sale in accordance with GAAP; transactions structured as such legally would nonetheless be recognized as collateralized borrowings:

- Revenue from the sales of goods and services;
- Revenue resulting from levies or assessments; and
- Revenue that depends upon the filing of applications or that is contingent upon performance (grants).

Conversely, purely passive involvement on the government's part (such as holding title to an asset, retaining contractual rights, or refraining from changing a name on a facility or from other specified actions) would not prevent recognition as a sale.⁶

Even when the criteria for a sale are met, the transaction *cannot result in the recognition of revenues earlier than would have been the case without the sale*.⁷ The amount received would need to be offset by the selling government with a deferred inflow of resources, both in financial statements that are prepared using the economic resources measurement focus and the accrual basis of accounting, and in those prepared for governmental funds (using current financial resources measurement focus and the modified accrual basis of accounting). The deferred inflow of resources would then be amortized as revenue over the duration of the agreement.

As with sales of receivables, revenue sales are generally intra-entity transactions. If a sale were to be made



to an external party, the selling government will recognize a deferred inflow of resources equal to the amount received from the buyer.⁸ The deferred inflow of resources would then be amortized, and the amounts recognized as revenue over the life of the agreement. For intra-entity sales of revenue, the buyer cannot recognize an asset for the future revenue, because no asset was recognized by the selling government and, as stated previously, *the value of an asset cannot change simply as a result of it being moved within the same financial reporting entity*. Therefore, the purchase price would be reported as a deferred outflow of resources by the buyer.⁹

When governments sell or pledge future revenues, special note

disclosures are required. For pledged revenue, the disclosures include information about the specific revenue, the portion and estimated amount thereof that is pledged, and the time during which the revenue will not be available to the government, as well as information comparing pledged revenue recognized in the period to debt service requirements. These disclosures would be required for all periods in which the debt that is secured by the future revenue is outstanding. In the case of a sale of future revenue, disclosures are required in the year of the sale, and include similar information about the sold revenue and a comparison of the proceeds of the sale with the present value of the future revenues sold.¹⁰

Conclusions

This article is not intended to encourage governments to enter into these transactions, and those considering using them should thoroughly assess their long-term costs and benefits. However, with state and local governments of all types and sizes dedicating virtually all available resources—indeed, sometimes using resources beyond their rapidly diminishing means—to contain the spread of the COVID-19 virus, to treating those infected, and to provide for the basic human needs of their communities, all options may need to be considered.

To see detailed examples including journal entries for sales and pledges of receivables and future revenues prepared as a companion to this article, go to gfoa.org/journal_entries. ■

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¹ Governmental Accounting Standards Board (GASB) Codification of Governmental Accounting and Financial Reporting 2019-2020 (Cod.) Section (Sec.) S20, "Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues," paragraphs .102.

² GASB Cod. Sec. S20, paragraphs .103-.104.

³ Often a general-purpose government will sell receivables to its own component unit, although intra-entity sales transactions might also occur between two component units of the same primary government.

⁴ GASB Cod. Sec. S20.112.

⁵ GASB Cod. Sec. S20.105.

⁶ GASB Cod. Sec. S20, paragraphs .106 -.107.

⁷ If the sole reason that a specific revenue had not previously been recognized by the selling government is that the amount was not measurable or collection had been in doubt, then that revenue would become measurable and realizable upon being sold to an external party. In that case, revenue, rather than a deferred inflow of resources, should be recognized the time of the sale to a buyer outside of the seller's reporting entity.

⁸ Except in the case described in footnote 6, above, where revenue would be recognized instead of a deferred inflow of resources.

⁹ GASB Cod. Sec. S20.112.

¹⁰ Detailed disclosure requirements are found in GASB Cod. Sec. S20, paragraphs .118 -.119.