Ready For GASB's New Conduit Debt Obligation Rules?

GASB Statement 91, Conduit Debt Obligations, establishes consistent recognition, measurement, and disclosure between governments. This newly effective guidance clarifies the existing definition of a conduit debt obligation, establishes a single method of reporting for issuers, and enhances note disclosures.

The rules clarify that a conduit debt obligation is not a liability of the issuer, a common source of current diversity in practice. Existing guidance permitted—but did not require—governments to report conduit debt obligations as liabilities along with related assets. Depending on current practice, government finance authorities could see a big change in their financial statement presentation.

Effective Date Statement 91, Conduit Debt (as amended)	Reporting periods beginning after December 15, 2021

Conduit Debt Obligations

The standard provides a list of defining characteristics that must be present to have a conduit debt obligation:

- At least three parties involved: an issuer, a third-party obligor, and a debt holder or a debt trustee. There may be more than one third-party obligor, debt holder, or debt trustee.
- The issuer and the third-party obligor are not within the same financial reporting entity, *e.g.*, a primary government and its component units
- The debt obligation is not a parity bond of the issuer, nor is it cross-collateralized with other debt of the issuer. This is most common in housing financing agencies, student loan financing, and revolving loan programs.
- The third-party obligor or its agent, not the issuer, ultimately receives the proceeds from the debt issuance.
- The third-party obligor, not the issuer, is primarily obligated for the payment of all amounts associated with the debt obligation (debt service payments).

Other Commitments

A conduit debt issuer inherently makes a limited commitment to maintain the issue's tax-exempt status but assumes no responsibility for debt service payments beyond the resources provided by the third-party obligor (see Appendix 1). Issuers also can make additional commitments—either implicit or explicit—to support debt service payments, including—but not limited to—the following:

- Extending a moral obligation pledge
- Extending an appropriation pledge

- Extending a financial guarantee
- Pledging their own property, revenue, or other assets as security

On a voluntary basis, an issuer may make a debt service payment or request appropriations for a debt service payment. The presence of any type of additional or voluntary commitment does not alter the conduit nature of the debt obligation but may create a separate contingent liability.

Recognition & Measurement

A government that issues a conduit debt obligation would not recognize a liability for the debt because GASB concluded that issuance does not meet the criteria for a present obligation. However, additional commitments are considered contingent obligations and an issuer must perform an annual evaluation to determine whether liability recognition criteria are met (see Appendix 2). The annual evaluation in subsequent fiscal years is required only for the issue for which a liability was recognized, not the entirety of an issuer's portfolio. An issuer that has made only a limited commitment should evaluate whether the recognition criteria are met when an event occurs that causes the issuer to re-evaluate its willingness or ability to support the obligor's debt service through a voluntary commitment.

An issuer should recognize a liability associated with an additional commitment to support debt service payments and an expense in financial statements prepared using the economic resources measurement focus if the qualitative factors below indicate it is more likely than not[1] (MLTN) that the issuer will support one or more debt service payments.

Under the current financial resources measurement focus, an issuer should recognize a fund liability and an expenditure, to the extent that the liability is normally expected to be liquidated with expendable available financial resources, if qualitative factors noted below indicate that it is MLTN that the issuer will support debt service payments associated with an additional commitment or through a voluntary commitment.

The statement includes—but is not limited to—the following factors to assess whether it is MLTN that an issuer will support one or more debt service payments:

- A third-party obligor initiating the process of entering into bankruptcy or financial reorganization
- A third-party obligor breaching a debt contract in relation to the conduit debt obligation, *e.g.*, failure to meet covenants or service coverage ratios, or default or delinquency in debt service payments
- A third-party obligor experiencing significant financial difficulty, such as failure to make payments to paying agents or trustees on a timely basis; drawing on a reserve fund to make debt service payments; initiation of a process to intercept receipts to make debt service payments; debt holder concessions; significant investment losses; loss of a major revenue source; significant increase in noncapital disbursements in relation to operating or current revenues; or commencement of financial supervision by another government, if the third-party obligor is a government
- Termination of the project that was to be the source of funding for debt service payments
- Litigation that would negatively affect the project
- The issuer's concern that its access to capital markets could be affected by a third-party obligor's default on an outstanding conduit debt obligation
- The issuer's history of fulfilling its additional commitments to support debt service payments for other conduit debt obligations, including voluntarily supporting debt service payments
- The issuer's ability or willingness to support debt service payments

[1] Likelihood of more than 50%

Special guidance is provided when the debt proceeds are used to construct or acquire a capital asset and the issuer retains title to the capital asset from the arrangement's inception, *i.e.*, payments from third-party obligors are intended to cover and coincide with debt service payments. GASB concluded that in these arrangements, the payments from third-party obligors are not lease payments, but rather debt service payments; therefore, there would be no recognition of the conduit debt obligation liability, the capital asset, or the payments receivable. (These arrangements also are specifically excluded from GASB lease guidance in Statement 87.) In these arrangements:

- Issuer relinquishes title at the end of the arrangement. In general, by this time the conduit debt obligation has been paid off; therefore, an issuer should not recognize a capital asset.
- Issuer retains title and third-party obligor has exclusive use of the entire capital asset. In this case, when the arrangement ends, the issuer should recognize the capital asset at acquisition value using guidance in Statement 72, Fair Value Measurement and Application.
- Issuer retains title and third-party obligor has exclusive use of portions of the capital asset. At inception, the issuer should recognize the entire capital asset at acquisition value and a deferred inflow of resources, which should be reduced in a systematic and rational manner over the arrangement term. This process often starts with the board of directors discussing strategy development and exploring efficiency opportunities.

Does title pass to third-party obligor at end of arrangement?	Does the issuer recognize a capital asset?	Does the issuer recognize a deferred inflow of resources?
Yes	No	No
No, and third party has exclusive use of entire capital asset	Yes, when the arrangement ends	No
No, and third party has exclusive use of only portions of the capital asset	Yes, at the inception of the arrangement	Yes, at the inception of the arrangement; deferred inflow recognized as revenue over the term of the arrangement

Disclosures

Required disclosures include a general description of the issuer's conduit debt obligations, limited and voluntary commitments, and the aggregate outstanding principal amount of all conduit debt obligations by commitment type. An issuer also is required to include a general description of additional commitment(s), including:

- The legal authority and limits for extending the commitment(s)
- The length of time of the commitment(s)
- Arrangements, if any, for recovering payments from the third-party obligor(s)

An issuer also is required to include a rollforward for any liabilities recognized, the cumulative payments made on the recognized liability at the reporting date, and amounts expected to be recovered from those payments.

Effective Date & Transition

Due to COVID-19, the statement was amended to be effective for reporting periods beginning after December 15, 2021, with earlier application encouraged. Changes should be applied by retrospectively restating financial statements, if practicable, for all prior periods presented.

Conclusion

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Contributors

Amy Shreck
Partner
amy.shreck@forvis.com

Anne Coughlan
Director
anne.coughlan@forvis.com

Appendix 1

An Issuer Makes a Commitment Limited to Resources Provided by the Third-Party Obligor & Maintains the Tax-Exempt Status of the Debt

Facts & Assumptions

To further economic development in the county, the County Development Authority has issued bonds that meet the definition of a conduit debt obligation. Those bonds have provided private-sector entities with access to capital for the acquisition and construction of industrial and commercial facilities. The bonds are secured by the property they finance and are payable solely from payments received from the private-sector entities on the underlying mortgage or promissory notes. The County Development Authority has not extended any additional commitments for the debt service payments of the bonds beyond the collateral and the payments from the private-sector entities on the underlying mortgage or promissory notes and maintenance of the tax-exempt status of the conduit debt obligation. At June 30, 20X7, the bonds have an aggregate outstanding principal amount payable of $37.5 million, none of which was recognized as a liability by the County Development Authority.

Illustrative Disclosure in the County Development Authority's Financial Statements

Note J. Conduit Debt Obligations

To further economic development in the county, the County Development Authority has issued bonds that provide capital financing to private-sector entities for the acquisition and construction of industrial and commercial facilities. The properties financed are pledged as collateral, and the bonds are payable solely from payments received from the private-sector entities on the underlying mortgage or promissory notes. In addition, no commitments beyond the collateral, the payments from the private-sector entities, and maintenance of the tax-exempt status of the conduit debt obligation were extended by the County Development Authority for any of those bonds. At June 30, 20X7, the bonds have an aggregate outstanding principal amount payable of $37.5 million.

Appendix 2

It Is More Likely than Not That an Issuer Will Make Payments as a Result of an Additional Commitment

Facts & Assumptions

On December 1, 20X1, a state issued $10 million of 10-year higher education facility bonds that meet the definition of a conduit debt obligation. The proceeds from the bonds were used to finance construction of dormitories of a private college. The bonds mature annually, beginning December 1, 20X2 through December 1, 20Y1, with semiannual interest payments. The dormitories are pledged as collateral for the bonds. There are underlying mortgage loans on those dormitories. The bonds are payable from payments received from the private college on those mortgages. The state made a moral obligation pledge in that if the private college defaults, a request will be made of the state's General Assembly to appropriate the amount of the deficiency from the state's capital reserve fund. There are no arrangements for recovering payments made by the state under this pledge.

In the second half of its fiscal year 20X7, the private college started to encounter financial difficulties. A significant decline of its tuition and dormitory revenue in the fall semester of 20X8 resulted in a violation of revenue coverage requirements contained in the bonds' covenants. The private college made its required June 1, 20X8 interest payment; however, it had to use a significant portion of the resources in a bond reserve account to do so. The use of those resources brought the balance of the private college's bond reserve account below its required level and constituted another violation of a bond covenant.

Based on the financial difficulties encountered by the private college, the state determined at June 30, 20X8, that it is MLTN that it will honor its moral obligation pledge and make a request to the General Assembly to appropriate the state's resources and the General Assembly will appropriate resources to replenish the private college's bond reserve account to its required level, thereby supporting the remaining debt service payments. The state determined that the present value of the future outflows of its moral obligation pledge was $3.05 million at June 30, 20X8.

The state replenished the private college's bond reserve account to its required level on November 28, 20X8, which then was used to make the December 1, 20X8 principal and interest payments. Total payments for the fiscal year ending June 30, 20X9 were equivalent to the debt service payments of the $1 million in principal and $175,000 in interest. The state determined that it was MLTN that it will continue to replenish the private college's bond reserve account so that the remaining debt service payments will be made as scheduled, until the bonds are paid off.

Illustration: Fiscal Years Ending June 30, 20X2 Through June 30, 20X7

Accounting for the Additional Commitment

The state does not record a liability related to its moral obligation pledge extended on the December 20X1 issuance of the conduit debt in the financial statements for the years ending June 30, 20X2–20X7.

Illustrative Disclosures: Fiscal Year Ending June 30, 20X2

Note L. Conduit Debt Obligations

In December 20X1, the state issued higher education facilities bonds to provide capital financing for a private college to construct dormitories. The bonds were issued under the authority of the state's Higher Education Financing Act. The dormitories are pledged as collateral for the bonds. There are underlying mortgage loans on those dormitories. The bonds are payable from payments received from the private college on those mortgages, and the state has committed to maintain the tax-exempt status of the bonds. The state made a moral obligation pledge that if the private college defaults, a request will be made to the state's General Assembly to appropriate the amount of the deficiency from the state's capital reserve fund pursuant to the state's moral obligation pledge. At June 30, 20X2, the conduit debt obligation has an outstanding principal amount payable of $10 million. The bonds mature on December 1, 20Y1.

Illustration: Fiscal Year Ending June 30, 20X8

Accounting for the Additional Commitment

In its financial statements prepared using the economic resources measurement focus as of June 30, 20X8, the state records a liability and an expense in the amount of $3.05 million, the present value of the expected future outflows of its moral obligation pledge.

In its financial statements prepared using the current financial resources measurement focus as of June 30, 20X8, no liability or expenditure is reported.

Note L. Conduit Debt Obligations

In December 20X1, the state issued higher education facilities bonds to provide capital financing for a private college to construct dormitories. The bonds were issued under the authority of the state's Higher Education Financing Act. The dormitories are pledged as collateral for the bonds. There are underlying mortgage loans on those dormitories. The bonds are payable from payments received from the private college on those mortgages, and the state has committed to maintain the tax-exempt status of the bonds. The state made a moral obligation pledge that if the private college defaults, a request will be made of the state's General Assembly to appropriate the amount of the deficiency from the state's capital reserve fund pursuant to the state's moral obligation pledge. The bonds mature on December 1, 20Y1.

As a result of the private college's financial difficulties, the state determined that it is MLTN that it will honor its moral obligation to replenish the private college's bond reserve account to its required level, thereby supporting the remaining debt service payments. The amount of the state's liability recognized for its moral obligation pledge is the best estimate of the discounted present value of the future outflows expected to be incurred as a result of this additional commitment.

The liability recognized by the state related to its moral obligation pledge at June 30, 20X8, is as follows:

Beginning of Year	Increases	Decreases	End of Year
$ 0	$ 3,050,000	$ 0	$ 3,050,000

Illustration: Fiscal Year Ending June 30, 20X9

Accounting for the Additional Commitment

In its financial statements prepared using the economic resources measurement focus as of June 30, 20X9, the state records a reduction in the liability related to its moral obligation pledge. The reduction includes the payments made by the state to replenish the private college's bond reserve account that supported the $1 million of principal payments and $175,000 of interest payments during that fiscal year. The state also records a $170,000 increase in the related liability to reflect an increase in the present value of the related liability due to the passage of time.

The state also reports the cumulative payments to replenish the private college's bond reserve account that supported the principal and interest payments of $1,175,000 as expenditures in its financial statements prepared using the current financial resources measurement focus.

Note L. Conduit Debt Obligations

In December 20X1, the state issued higher education facilities bonds to provide capital financing for a private college to construct dormitories. The bonds were issued under the authority of the state's Higher Education Financing Act. The dormitories are pledged as collateral for the bonds. There are underlying mortgage loans on those dormitories. The bonds are payable from payments received from the private college on those mortgages, and the state has committed to maintain the tax-exempt status of the bonds. The state made a moral obligation pledge that if the private college defaults, a request will be made of the state's General Assembly to appropriate the amount of the deficiency from the state's capital reserve fund pursuant to the state's moral obligation pledge. The bonds mature on December 1, 20Y1.

As a result of the private college's financial difficulties, the state determined that it is MLTN that it will fulfill its moral obligation pledge to replenish the private college's bond reserve account to its required level, thereby supporting the remaining debt service payments. The amount of the state's liability related to its moral obligation pledge is the best estimate of the discounted present value of the future outflows expected to be incurred as a result of this commitment.

On November 28, 20X8, the state began making payments to replenish the private college's bond reserve account that would support the remaining debt service payments. The cumulative payments through June 30, 20X9 were used to cover the $1 million in principal and $175,000 in interest of the debt service payments on the bonds.

The liability recognized by the state related to its moral obligation pledge at June 30, 20X9 is as follows:

Beginning of Year	Increases	Decreases	End of Year
$ 3,050,000	$ 170,000	$ 1,175,000	$ 2,045,000