PacificCPE

COURSE
21158A

Long-Term Obligations and Government Debt Reporting

From bonds and leases to conduit debt and lottery prizes, governments carry a wide range of long-term obligations that require careful accounting treatment. This course covers GASB and FASB standards for reporting long-term liabilities, the realities of municipal bankruptcy, bond ratings, and the nuances of conduit debt arrangements. Whether you audit government entities or advise on public finance matters, this course strengthens your ability to evaluate and accurately report complex governmental obligations.

CREDIT HOURS 2 | FIELD OF STUDY ACCOUNTING | EXAM QUESTIONS 10

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Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recognize characteristics of various long-term obligations and proper reporting treatment.

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Chapter 1: LONG-TERM OBLIGATIONS

Chapter Objective

After completing this chapter, you should be able to:

- Recognize characteristics of various long-term obligations and proper reporting treatment.

This chapter focuses on long-term obligations, including liabilities (such as bonds) that are accorded balance sheet recognition and other commitments (such as loan guarantees) that may only be disclosed in notes. Liabilities may be interpreted as negative long-lived assets. They present comparable issues of valuation and reporting, and for the most part, are accounted for as mirror images of their asset counterparts, which were discussed in Chapter 1 of course 21157F. Governments exclude long-term liabilities from governmental funds but report them in their government-wide statements (as well as the proprietary and fiduciary funds statements), just as both businesses and not-for-profits do—that is, on a *full accrual basis.* Long-term liabilities are important to governments and not-for-profits for the same reasons they are to businesses. They represent claims on the entity's resources; failure to satisfy them can seriously jeopardize the entity's ability to provide the services expected of it.

The first major section of this chapter sets forth the goals of long-term debt reporting. The next section raises the intriguing question of whether governments and not-for-profits can, like businesses, go bankrupt if they fail to meet their obligations. The third section is directed to the "*debits* and *credits*" of accounting for long-term debt by governments. The *fourth* section addresses the issue of which types of obligations should be included within the rubric **long-term debt** for reporting, legal, and analytical purposes. The *fifth* section discusses credit enhancements and other features of debt that are of concern to statement users. The concluding section pertains to bond ratings, a subject common to both governments and not-for-profits.

WHY IS INFORMATION ON LONG-TERM DEBT IMPORTANT TO STATEMENT USERS?

The issues addressed in this chapter are closely tied to a key objective of financial reporting. As stated by the Governmental Accounting Standards Board (GASB):

> Financial reporting should provide information about the financial position and condition of a government entity. *Financial reporting should provide information about resources and obligations, both actual and contingent, current and noncurrent. The major financial resources of most governmental entities are* derived *from the ability to tax and issue debt. As a result, financial*

> *reporting should provide information about tax sources, tax limitations, tax burdens and debt limitations.*[1]

The FASB has set forth similar objectives for not-for-profits, emphasizing the importance of information on liquidity and cash flows.

Information on long-term debt is especially important to financial statement users because an entity's failure to make timely payments of interest and principal can have profound repercussions for its creditors, its constituents, and itself. Creditors will obviously incur losses. But insofar as governments and not-for-profits rely on debt to fund acquisitions of infrastructure, buildings, and equipment, a loss of credit standing can seriously harm their ability to provide the services expected of them. It is fair to say that a significant majority of GASB pronouncements involve issues of debt either directly or indirectly.

CAN GOVERNMENTS AND NOT-FOR-PROFITS GO BANKRUPT?

An entity's failure to satisfy claims against it can produce dire results, including bankruptcy. In such a situation both governments and not-for-profits can seek protection under the Federal Bankruptcy Code, just as individuals and businesses can. Aspecial section of the code—Chapter 1 of course 21159F—covers governments.[2] Not-for-profits are covered under the same chapter of the code as businesses. However, creditors cannot force not-for-profits into bankruptcy as they can with businesses.

Until recently bankruptcy filings by major governments have been rare, although several cities such as New York; Yonkers (New York); Washington, DC; Pontiac and Benton Harbor (Michigan); and Bridgeport (Connecticut) avoided bankruptcy only by being brought under the authority of "financial control boards" by higher-level governments. Bankruptcies were confined mainly to smaller governments, especially utility districts. The economic downturn that started in 2007 temporarily changed that. According to the NationalAssociation of State Budget Officers, 239 municipalities declared bankruptcy between 1980 and 2010—8 per year.[3] Between 2010 and 2014 alone, however, 61 municipalities declared bankruptcy—12 per year.[4]

The largest of them were Jefferson County (Alabama), Harrisburg (Pennsylvania), Boise County (Idaho), Detroit (Michigan), San Bernardino and Stockton (California), and Puerto Rico[5]. Although general- purpose governments such as these receive the bulk of the popular press on the subject, most municipal bankruptcies are special districts that are created for particular purposes. For example, about 12 sanitary districts in Omaha (Nebraska) have declared bankruptcy since 2010.

One might have thought that the 2020 pandemic would have continued or exacerbated the trend. In reality, bankruptcy filings fell off after 2014, with just 43 from 2015 to 2023 (fewer than 5 per year) and 14 since the pandemic started (3.5 per year).[6] A likely reason the pandemic did not result in

more filings is the tsunami of federal grant programs in general and directed specifically at governments.

To put these trends in context, it should be noted that they are a miniscule fraction of the total number of state and local governments, which is well north of 90,000. Consider also that municipal bankruptcies pale in comparison with business filings (Chapter 1 of course 21151F of course 21157F, Chapter 1 of course 21151F of course 211511F), which were as high as 1,050,832 in just 2010.[7] Businesses filing for bankruptcy also have dropped steady since then, including in 2020–2022.

As suggested by the "**In Practice: It Is Not So Easy to Declare Municipal Bankruptcy**," the concept of municipal bankruptcy is elusive. Governments have the power to tax, and in return are expected to provide certain essential services. In a sense, their access to resources is limited only by the wealth of their population. Correspondingly, their expenditures can be reduced dramatically by cutting back on services. In reality, however, there are practical limits to both their taxing authority and the extent to which they can eliminate services. Raise taxes above a certain level and both residents and businesses flee the jurisdiction, thereby reducing overall revenues. Reduce services below a certain point and the safety and overall well-being of the community are impaired. In addition, state and federal laws narrowly define the conditions under which governments may declare bankruptcy. Moreover, many special districts do not have unlimited taxation power and are instead limited to charging fees that may be insufficient for their long-term financial health.

When a court does grant a government bankruptcy protection, it temporarily transfers control over the government's affairs to an independent trustee. The eventual outcome, with the court's approval, is that the government's debts are reduced, and as indicated in the accompanying "In Practice," the government may be permitted to void both its contracts with its labor unions, and in some cases, its pension promises to retirees.

GASB Codification Section Bn5—Bankruptcies requires that when a bankruptcy plan is approved by the bankruptcy court, the government should revalue all liabilities that the court has permitted it to restructure. Correspondingly, it should report a gain on the restatement. Governments that are not expected to emerge from bankruptcy as going concerns should also remeasure and restate their assets to reflect the amount they would expect to receive upon liquidation.

In Practice: It Is Not So Easy to Declare Municipal Bankruptcy

Municipal bankruptcy under Chapter 9 bears little resemblance to bankruptcy for businesses under Chapters 7 and 11, which entail either liquidating the entity or reorganizing it as a new legal entity. Municipalities filing for bankruptcy face neither liquidation nor reorganization. Instead, Chapter 1 of course 21159F protects a government from its creditors while negotiating a plan to adjust its debts by reducing the amount owed, reducing the interest charged, and/or extending the payment dates.

Governments filing for bankruptcy is a notable event in part because the federal law defers to the states regarding whether to allow their political subdivisions to file, and not all states do. Twenty-seven states allow certain governments to declare bankruptcy at all, 15 of which place additional restrictions or conditions on potential filers.[8]

In 1994 Orange County, California, filed for bankruptcy in what up until then involved the greatest amount of liabilities ($1.6 billion) in U.S. government history. Orange County was one of the wealthiest counties in the country and, owing to the strength of its underlying economy, was quickly able to regain a strong investment grade credit rating and issue new debt.

Ironically, in 1991, the U.S. Bankruptcy Court, in a precedent-setting decision, denied the petition of Bridgeport, Connecticut, one of the poorest cities in the country, to declare bankruptcy and thereby reduce some of its debts. Bridgeport officials testified that the city already had fewer police officers than required to provide adequate services, reduced garbage collections created a rodent and arson hazard, and closure of senior citizen centers was adversely affecting a large portion of the city's most vulnerable residents. Nevertheless, the court held that the key test for bankruptcy is whether the city is, in fact, **insolvent**—that is, it has either failed or is unable to pay its debts as they come due. Bridgeport, the court declared, had not yet failed to meet its required debt payments and, owing to a cash reserve, could likely meet its debts in the future.

In 2011, when Jefferson County, Alabama (which encompasses Birmingham), applied for bankruptcy, it surpassed Orange County as filing the largest municipal bankruptcy petition at that time ($4 billion). Jefferson County's troubles stemmed from both internal corruption and the 2008 nationwide credit crunch that caused the unraveling of the complex transactions that the county had used to finance certain sewer bonds. The bankruptcy court was initially unwilling to authorize bankruptcy as a means of reducing the county's debts but ultimately did so. The courts retained oversight of the county's plan of adjustment to ensure compliance even as the county moved out of formal bankruptcy in 2013.

Harrisburg, Pennsylvania, is another high-profile city that sought bankruptcy protection in 2011, but it has faced state laws that limit the ability of municipalities to take that route to fiscal

solvency. Harrisburg's financial difficulties could be attributed mainly to a misguided investment in an expensive, but decidedly environmentally unfriendly, trash incinerator.

The largest municipal bankruptcy to date occurred in 2013 when the city of Detroit filed for Chapter 9 bankruptcy. The city had long suffered a declining revenue base, shrinking population, oversized costs for retiree pensions and health care, corrupt elected officials, and borrowing to cover routine operating expenses. The initial application for bankruptcy was not accepted by the courts (as in Jefferson County), but successful appeals followed and Detroit was ruled eligible on nearly $19 billion in debt (made up of bonds and unfunded pension liabilities).

HOW DO GOVERNMENTS ACCOUNT FOR LONG-TERM OBLIGATIONS?

General long-term debt is defined in GASB Codification Section 1500—Reporting Liabilities, paragraph 103:

> . . . General long-term debt is *unmatured* principal of bonds, warrants, notes, special assessment debt for which the government is *obligated in some manner*, or other forms of noncurrent or long-term general obligation debt that is not a specific liability of any proprietary fund or fiduciary fund. General long-term debt is not limited to liabilities arising from debt issuances per se, but may also include non*current liabilities* on leases, compensated absences, claims and judgments, pensions, termination benefits, landfill closure and postclosure care and other *asset retirement obligation*s, and other commitments that are not current liabilities properly recorded in governmental funds. . . .

General long-term debt is the obligation of the government at large and is thereby backed by the government's general "full faith and credit" and **revenue-raising powers.** It is distinguished from (1) tax-backed debt, which is repaid with a specific tax, like a sales tax, and (2) revenue debt (or revenue-backed debt), which is secured only by designated operating revenues—such as from utility fees, highway tolls, rent, receipts from student loans, and patient billings.

The long-term debts of governments by no means include all their financial obligations, no more than do those of businesses. As a general rule, only debts resulting from past transactions for which the government *has already received a benefit* are recognized. Reported obligations thereby exclude commitments for payments of interest when the government has not yet enjoyed the use of the borrowed funds, the salary of a city manager that, although contractually guaranteed, has not been earned, future rent payments that are established by noncancellable operating leases, and amounts owed under long-term service contracts when the promised services have not yet been provided. What cannot be stressed strongly enough is that in assessing the fiscal wherewithal of a government, these "unrecorded" obligations can be as significant as those that are recorded. After all, the contractual commitment of a government to make timely payments of interest on a bond or

rent on an operating lease is no less of a legal obligation than to pay the principal on the bond or the installments on a lease.

Accounting for Long-Term Obligations in Governmental Funds

As previously emphasized, governmental funds focus on current financial resources. A long-term obligation does not require current-year appropriation or expenditure of governmental fund financial resources. Therefore, "to include it as a governmental fund liability would be misleading and dysfunctional to the current period management control (e.g. budgeting) and accountability functions."[9]

When the proceeds of long-term debt are received by governmental funds, the debit to cash (or other assets) is offset with a credit to "other financing sources—bond proceeds," or some comparable account signifying an inflow of resources, not by crediting a liability. Just as the existence of buildings, vehicles, and other long-term assets is ignored in governmental funds, so also are long-term debts, including the portion of bonds, notes, claims and judgments, and obligations for sick leave and vacations for which payment is not required out of resources appropriated for the current year. As a consequence, long-term debt includes amounts arising out of operating as well as capital transactions. As emphasized in previous chapters, the expenditures relating to these operating transactions will be charged in the periods in which the resources are appropriated for payment—in effect, when the long-term debts are liquidated—not necessarily in those in which the government reaped the benefits.

Differences in Government-Wide (Full Accrual) Statements

In their government-wide statements, governments should account for their general long-term obligations in a similar manner as businesses. They record debt either at face value, or if the debt is issued at a premium or discount, at the unamortized issue price. Debt issuance costs (except for prepaid insurance costs) are reported as an outflow of resources in the period in which the debt is issued rather than as an asset. Each period they must amortize the premium or discount, offsetting the unamortized premium or discount with a decrease or increase, respectively, in interest expense.

A bond premium or discount represents the difference between the face value of a bond and the amount for which it is issued. A bond is sold at a premium whenever its specified interest rate (its coupon rate) is greater than interest rates prevailing at the time of issuance (the yield rate). It is sold at a discount whenever the specified rate is less than the prevailing rates. The greater the difference between the coupon rate and the yield rate and the greater the number of years to maturity, the greater is the premium or discount. Just as a government must include a schedule of changes in capital assets in notes to its financial statements, so must it also present a corresponding schedule of changes in long-term obligations. This schedule of changes should incorporate not only debts— such as bonds, notes, and leases—but also other liabilities—such as compensated absences and claims and judgments. It should show the beginning and ending balances and the increases and decreases during the year.

The portion of the changes in a long-term liabilities note for Milwaukee, Wisconsin, pertaining to governmental activities is presented in Table 8-1 (next page).