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Statement No. 48 of the
Governmental Accounting
Standards Board

Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues

GASB

Governmental Accounting Standards Board
of the Financial Accounting Foundation

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Summary

Governments sometimes exchange an interest in their expected cash flows from collecting specific receivables or specific future revenues for immediate cash payments—generally, a single lump sum. The financial reporting question addressed by this Statement is whether that transaction should be regarded as a sale or as a collateralized borrowing resulting in a liability. Historically, guidance for reporting the effects of those transactions in governmental financial statements either has been provided in several standards or, in certain cases, was not specifically addressed in authoritative literature. In addition, little or no information about pledged revenues was being disclosed in the notes to the financial statements. As a result, there has been considerable diversity in the manner in which these transactions and information about them have been reported.

This Statement establishes criteria that governments will use to ascertain whether the proceeds received should be reported as revenue or as a liability. The criteria should be used to determine the extent to which a transferor government either retains or relinquishes control over the receivables or future revenues through its continuing involvement with those receivables or future revenues. This Statement establishes that a transaction will be reported as a collateralized borrowing unless the criteria indicating that a sale has taken place are met. If it is determined that a transaction involving *receivables* should be reported as a sale, the difference between the carrying value of the receivables and the proceeds should be recognized in the period of the sale in the change statements. If it is determined that a transaction involving *future revenues* should be reported as a sale, the revenue should be deferred and amortized, except when specific criteria are met. This Statement also provides additional guidance for sales of receivables and future revenues within the same financial reporting entity.

This Statement includes a provision that stipulates that governments should not revalue assets that are transferred between financial reporting entity components. Therefore, *any* assets (or future revenues) sold or donated within the same financial reporting entity should continue to be reported at their current carrying value when those assets or future revenues are transferred.

This Statement also includes guidance to be used for recognizing other assets and liabilities arising from a sale of specific receivables or future revenues, including residual interests and recourse provisions. The disclosures pertaining to future revenues that have been pledged or sold are intended to provide financial statement users with information about which revenues will be unavailable for other purposes and how long they will continue to be so. The requirements of this Statement are effective for financial statements for periods beginning after December 15, 2006.

How the Changes in This Statement Improve Financial Reporting

The requirements in this Statement improve financial reporting by establishing consistent measurement, recognition, and disclosure requirements that apply to both governmental and business-type activities. Those requirements alleviate the confusion that arises when there are multiple sources from which generally accepted accounting principles requirements may derive. Deferral requirements that are applicable to sales of future revenues are provided to contribute to the measurement and reporting of interperiod equity in accordance with the objectives set forth in Concepts Statement No. 1, *Objectives of Financial Reporting.* Specific provisions that address the effects of intra-entity transactions are provided so that governments retain consistent values for assets transferred between components of the same financial reporting entity. This Statement also improves the usefulness of financial reporting by requiring that specific relevant disclosures be made to inform financial statement users about the unavailability of future revenues that have been pledged or sold.

Unless otherwise specified, pronouncements of the GASB apply to financial reports of all state and local governmental entities, including general purpose governments; public benefit corporations and authorities; public employee retirement systems; and public utilities, hospitals and other healthcare providers, and colleges and universities. Paragraph 3 discusses the applicability of this Statement.

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September 2006

Governmental Accounting Standards Board
of the Financial Accounting Foundation
401 Merritt 7, PO Box 5116, Norwalk, Connecticut 06856-5116

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INTRODUCTION

1. Governments sometimes exchange an interest in their expected cash flows from collecting specific receivables or specific future revenues for immediate cash payments—generally, a single lump sum. The agreements that dictate the conditions under which those transactions take place include features that should be considered when determining, for financial reporting purposes, whether an agreement constitutes a sale or a collateralized borrowing resulting in a liability. The objective of this Statement is to provide financial statement users with consistent measurement, recognition, and disclosure across governments and within individual governments by developing specific guidance applicable to all activities of a government.

2. Prior to this Statement, guidance for reporting the effects of those transactions in governmental financial statements either was provided in several standards or, in certain cases, was not specifically addressed in authoritative literature. In addition, little or no information about pledged revenues was being disclosed in the notes to the financial statements.

STANDARDS OF GOVERNMENTAL ACCOUNTING AND FINANCIAL REPORTING

Scope and Applicability of This Statement

3. This Statement establishes accounting and financial reporting standards for transactions in which a government receives, or is entitled to, resources in exchange for

future cash flows generated by collecting specific receivables or specific future revenues.[1] It also contains provisions that apply to certain situations in which a government *does not* receive resources but, nevertheless, pledges or commits future cash flows generated by collecting specific future revenues. In addition, this Statement establishes accounting and financial reporting standards that apply to all intra-entity transfers of assets and future revenues. This Statement does not apply to a government's pledge of its "full faith and credit" as security for its own debt or the debt of a component unit. The requirements of this Statement apply to the financial statements of all state and local governments.

4. This Statement supersedes paragraphs 16–23 of Technical Bulletin No. 2004-1, *Tobacco Settlement Recognition and Financial Reporting Entity Issues,* and amends Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments,* paragraphs 58, 61, and 100.

Determining Whether a Transaction Is a Sale or a Collateralized Borrowing

5. A transaction within the scope of this Statement should be reported as a collateralized borrowing rather than a sale unless the criteria in paragraphs 6–9, as appropriate, are met. Determining whether a transaction should be reported as a sale rather than a collateralized borrowing requires an assessment of a government's continuing involvement with the receivables or future revenues transferred. A significant aspect of that assessment is the degree to which the selling/pledging government (the transferor) retains or relinquishes (to the transferee) control over the receivables or future revenues transferred.

[1]Future revenues do not include potential revenues from a source not in existence at the time of the transaction(for example, if the generation of future revenues requires the creation of the revenue-producing mechanism, such as constructing a metered parking lot).

Assessing a Government's Continuing Involvement

Receivables

6. A transaction in which a government receives, or is entitled to, proceeds in exchange for the future cash flows from receivables should be reported as a sale if the government's continuing involvement with those receivables is effectively terminated. A government's continuing involvement is considered to be effectively terminated if all the following criteria are met:

a. The transferee's ability to subsequently sell or pledge the receivables is not significantly limited by constraints imposed by the transferor government, either in the transfer agreement or through other means, for example, organizational or structural restrictions.
b. The transferor does not have the option or ability to unilaterally substitute for or reacquire specific accounts from among the receivables transferred. However, the ability or obligation to substitute for defective accounts, at the option of the transferee, would not violate this criterion. For example, accounts that do not possess the characteristics stipulated in a transfer agreement may be replaced with ones that do possess those traits. In addition, insignificant "clean-up" calls (by which the transferor may reacquire the remaining uncollected accounts when the outstanding secured debt reaches a specified minimum balance) would likewise not violate this criterion.
c. The sale agreement is not cancelable by either party, including cancellation through payment of a lump sum or transfer of other assets or rights.
d. The receivables and the cash resulting from their collection have been isolated from the transferor government, as discussed in paragraph 7.

7. Determination of whether receivables have been isolated from the transferor government should be based on the following criteria:

a. The transferee should have legal standing separate from the transferor. Legal separation should be assessed in a manner consistent with the approach for determining whether an organization is a legally separate entity in paragraph 15 of Statement No. 14, *The Financial Reporting Entity,* as amended.
b. Generally, banking arrangements should eliminate access by the transferor and its component units (other than the transferee) to the cash generated by collecting the receivables. Access is eliminated when payments on individual accounts are made directly to a custodial account maintained for the benefit of the transferee. However, if the transferor continues to service the accounts or if obligors misdirect their payments on transferred accounts to the transferor:

(1) The payments to the transferee should be made only from the resources generated by the specific receivables rather than from the transferor's own resources. The transferor should have no obligation to advance amounts to the transferee before it collects equivalent amounts from the underlying accounts.

(2) Cash collected by the transferor on behalf of the transferee should be remitted to the transferee without significant delay. In addition, earnings on invested collections should be passed on to the transferee.

(3) The transferor should consider proceeds received from the transferee as satisfaction of individual accounts. The transferor should indicate in its records which accounts have been transferred and which collections pertain to those accounts. For example, in a transaction involving delinquent taxes, the proceeds from the transferee should be accepted by the taxing body as satisfaction of the delinquent taxes owed by the individual property owners. Accordingly, the tax rolls should indicate that those taxes have been paid (or sold, or otherwise settled) and are no longer delinquent.

c. Provisions in the transfer agreement (or provided elsewhere in statutes, charters, or other governing documents or agreements) should protect the transferee from the claims of the transferor's creditors.

Future Revenues

8. A transaction in which a government receives proceeds in exchange for cash flows from specific future revenues should be reported as a sale if the government's continuing involvement with those revenues meets all of the following criteria:

a. The transferor government will not maintain an active involvement in the future generation of those revenues. Active involvement should be determined based on the provisions in paragraph 9.

b. The transferee's ability (or the ability of the ultimate holder/owner of the future cash flows) to subsequently sell or pledge the future cash flows is not significantly limited by constraints imposed by the transferor, either in the transfer agreement or through other means.

c. The cash resulting from collection of the future revenues has been isolated from the transferor government. Generally, banking arrangements should eliminate access by the transferor and its component units (other than the transferee) to the cash generated by collecting the future revenues. Access is eliminated when the revenues are received directly by the transferee or are deposited directly into a custodial account maintained for the benefit of the transferee. However, if the transferor is required to remain as the recipient, the stipulations in paragraphs 7b(1) and 7b(2) pertaining to receivables also should be applied to future revenues, in determining whether the cash collected is isolated from the transferor.

d. The contract, agreement, or other arrangement between the original resource provider (a grantor organization, for example) and the transferor government does not prohibit the transfer or assignment of those resources.

e. The sale agreement is not cancelable by either party, including cancellation through payment of a lump sum or transfer of other assets or rights.

9. Governments may cease active involvement in the generation of specific future revenues yet remain involved with those revenues in some manner. *Active involvement generally requires a substantive action or performance by the government.* Governments should determine whether the *primary* or *fundamental* activity or process that generates a specific revenue requires continuing active involvement. That is, when considering whether it maintains an active involvement in the generation of specific future revenues, a government should distinguish those activities that *generate* a specific revenue from those that, although associated with that revenue, are tangential, or incidental, or are undertaken to protect the revenue. Manifestations of a government's active involvement in the future generation of revenues include the following:

a. The government produces or provides the goods or services that are exchanged for the revenues.
b. The government levies or assesses taxes, fees, or charges and can directly influence the revenue base or the rate(s) applied to that base to generate the revenues. For example, the revenue bases for property, sales, and income taxes are taxable real estate parcels, taxable retail sales, or taxable income, respectively. The taxing government can directly influence any of those bases by establishing minimum taxable levels, granting exemptions, providing credits, or excluding certain transactions. The taxing government may initiate, activate, or determine tax rates pertaining to each revenue base.
c. The government is required to submit applications[2] for grants or contributions from other governments, organizations, or individuals to obtain the revenues.
d. The government is required to meet grant or contribution performance provisions to qualify for those revenues.

10. Governments may remain associated with specific revenues in ways that do not constitute the primary or fundamental activity that generates the revenues and thus would

[2]This criterion refers to ongoing requirements that qualify the government to continue to receive grants or contributions in future years, rather than an initial application or qualification process that remains effective without further effort by the government.

not be considered to be actively involved in the generation of those revenues. Activities that would not be considered manifestations of active involvement in the generation of specific revenues include the following:

a. Holding title to revenue-producing assets (for leases, rents, or royalty income, for example)
b. Owning a contractual right to a stream of future revenues (rights to tobacco settlement revenues, for example)
c. Satisfying the "required characteristics" eligibility criterion in paragraph 20 of Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*
d. Agreeing to refrain from specified acts or transactions (for example, agreeing to noncompetition restrictions).

Accounting for Transactions That Do Not Qualify as Sales

11. If the criteria required for sale reporting in paragraphs 6–9, as appropriate, are not met, a transaction should be reported as a collateralized borrowing. The receivables or future revenues should be considered for financial statement purposes as pledged rather than sold. Proceeds received by the pledging government should be reported as a liability in its statements of net assets and as an other financing source in its governmental funds statement of revenues, expenditures, and changes in fund balance, if governmental funds receive the proceeds. Similarly, a transferee government should recognize a receivable for the amounts paid to the pledging government.

12. Pledged *receivables* should continue to be recognized as assets in the pledging government's balance sheet or statements of net assets. Pledged *revenues* should continue to be reported as revenue by the pledging government in accordance with recognition and measurement criteria appropriate to the specific type of revenue pledged. Collections of the pledged revenues or receivables that are subsequently paid to the transferee reduce the liability in the pledging government's statements of net assets. Those payments also

should be reported as expenditures, rather than reductions of revenue, in the pledging government's governmental funds statement of revenues, expenditures, and changes in fund balance, if governmental funds are used to report the transaction. Payments received from the pledging government reduce the governmental transferee's receivable. Pledged receivables collected and paid to the transferee after the liability has been liquidated should be reported as expenditures/expenses (by the pledging government) and revenues (by the governmental transferee) when the pledging government becomes obligated to make the payments.

Accounting for Transactions That Meet the Criteria to Be Reported as Sales

13. If the criteria for sale reporting in paragraphs 6–9, as appropriate, are met, a transaction should be reported as a sale. In a sale of receivables, the transferor government should no longer recognize as assets the receivables sold, removing the individual accounts at their carrying values. Except for reporting in governmental funds, the difference between the proceeds (exclusive of amounts that may be refundable) and the carrying value of the receivables sold should be recognized as a gain or loss in the period of the sale. In governmental funds, the difference between the proceeds received and the receivables sold (net of allowances and deferred revenues) should be recognized as revenue. If the transferee is a government outside of the transferor government's financial reporting entity, the transferee government should recognize the receivables acquired at the purchase price. Recognition by transferees within the same financial reporting entity as the transferor is addressed in paragraph 15.

14. In a sale of future revenues, the transferor government should report the proceeds as deferred revenue or revenue, in both the government-wide and fund financial statements.

Generally, revenue should be deferred and recognized over the duration of the sale agreement; however, there may be instances wherein recognition in the period of the sale is appropriate. For transactions with parties outside the financial reporting entity, deferral is required if the future revenue sold was not recognized previously because the event that would have resulted in revenue recognition had not yet occurred (for example, tobacco settlement revenues). Except as noted in the following sentence, consummation of the future revenue sale transaction is not a substitute for a revenue recognition event and, consequently, revenue from the sale should be deferred. Revenue should be recognized at the time of the sale only if the revenue sold was not recognized previously because of uncertainty of realization or the inability to reliably measure the revenue. If the transferee is a government outside of the transferor government's financial reporting entity, the transferee government should recognize the acquisition at cost and amortize the balance over the life of the transfer agreement. The transferee government, as owner of the future revenues, should recognize receivables and revenue when the recognition criteria appropriate to the specific type of revenue acquired are met. Recognition by transferors and transferees within the same financial reporting entity as the transferor is addressed in paragraph 15.

Intra-Entity Transfers of Assets and Future Revenues

15. When accounting for the transfer of capital and financial assets and future revenues within the same financial reporting entity, the transferee should recognize the assets or future revenues received at the carrying value of the transferor. For example, in an intra-entity sale of receivables, the transferee government should recognize the receivables acquired at the carrying value of the transferor government. The difference between the amount paid (exclusive of amounts that may be refundable) and the carrying value of the

receivables transferred should be reported as a gain or loss by the transferor and as a revenue or expenditure/expense by the transferee in their separately-issued statements, but reclassified as transfers or subsidies, as appropriate, in the financial statements of the reporting entity.[3] In an intra-entity sale of future revenues, the transferor government has reported no carrying value for the rights sold because the asset recognition criteria have not been met. Therefore, the transferee government should not recognize an asset and related revenue until recognition criteria appropriate to that type of revenue are met. Instead, the transferee government should report the amount paid as a deferred charge to be amortized over the duration of the transfer agreement. The transferor government should defer the recognition of revenue from the sale in its government-wide and fund financial statements and recognize it over the duration of the sale agreement.[4]

Amortization of Deferred Revenues and Charges

16. Deferred revenues and charges arising from a sale of future revenues should be amortized over the life of the sale agreement using a systematic and rational method. For example, periodic amortization could be determined by applying, to the revenues recognized during the period by the transferee, the ratio of the resources received from the sale by the transferor to the estimated total future revenues sold by the transferee.

[3]Application of the provisions of this Statement should be the same for both discretely presented and blended component units. That is, the standard should first be applied in the separate financial statements of the component unit.

[4]Deferred revenues and charges resulting from intra-entity sales of future revenues and the periodic amortization of those balances should be accounted for similarly to internal balances and intra-entity activity within the financial reporting entity.

Recognizing Other Assets or Liabilities Arising from a Sale of Specific Receivables or Specific Future Revenues

Residual Interests

17. Often, as part of the proceeds received, a transferor government acquires a subordinate or junior note or a residual certificate representing the right to collections that exceed a stipulated level—generally, the annual or total debt service requirements of the transferee. A transferor government should recognize a note or residual certificate as an asset, representing a residual interest in:

a. *Excess receivable collections,* giving consideration to the likelihood of realization. Residual interests recognized in the period in which the sale occurred should be treated as an adjustment of the gain or loss (or revenues in governmental funds). Residual interests recognized in subsequent periods should be reported as revenues.
b. *Excess future revenues,* when the asset recognition criteria appropriate to the specific type of revenue that underlies the note or certificate have been met. Revenue recognition of the residual interest also would occur at that time.

A transferee government should recognize a liability for its obligation to remit residuals to the transferor government, based on the recognition criteria in paragraph 18 pertaining to recourse and other obligations.

Recourse and Other Obligations

18. A transferor government should recognize estimated liabilities arising from the purchase and sale agreement—for example, recourse obligations or repurchase commitments—when information available prior to the issuance of the financial statements indicates that it is probable that a liability has been incurred at the date of the financial statements *and* the amount of the obligation can reasonably be estimated.

Pledges of Future Revenues When Resources Are Not Received by the Pledging Government

19. Some governments pledge the future cash flows of specific revenues but do not receive resources in exchange for that pledge. For example, due to charter, statutory, or

constitutional requirements, some governments may be prohibited from issuing debt or limited in the extent to which they may issue debt. Those governments, nevertheless, may be empowered to create separate component units or use existing component units to issue debt on their behalf that will benefit their constituencies, programs, or functions. As security for the debt issued by a component unit, the government pledges all or a portion of a specific future revenue stream to the debt-issuing component unit without establishing itself as primarily or secondarily obligated for the component unit's debt. The debt-issuing component unit then pledges those future payments from the pledging government as security for its debt.

20. At the time the pledge agreement is made, the pledging government should not recognize a liability, and the debt-issuing component unit should not recognize a receivable for the future revenues pledged. The pledging government should continue to recognize revenue from the pledged amounts and should recognize a liability to the debt-issuing component unit and an expenditure/expense simultaneously with the recognition of the revenues that are pledged. The debt-issuing component unit should recognize revenue when the pledging government is obligated to make the payments.

Disclosures Related to Future Revenues That Are Pledged or Sold

21. For purposes of the following disclosures,[5] pledged revenues are those specific revenues that have been formally committed to directly collateralize or secure debt of the

[5]The disclosures in this paragraph are not required for legally separate entities that report as stand-alone business-type activities whose operations are financed primarily by a single major revenue source.

pledging government, or directly or indirectly collateralize[6] or secure debt of a component unit. For each period in which the secured debt remains outstanding, pledging governments should disclose, in the notes to financial statements, information about specific revenues pledged, including:

a. Identification of the specific revenue pledged and the approximate amount of the pledge. Generally, the approximate amount of the pledge would be equal to the remaining principal and interest requirements of the secured debt.
b. Identification of, and general purpose for, the debt secured by the pledged revenue
c. The term of the commitment—that is, the period during which the revenue will not be available for other purposes
d. The relationship of the pledged amount to the total for that specific revenue, if estimable—that is, the proportion of the specific revenue stream that has been pledged
e. A comparison of the pledged revenues recognized during the period to the principal and interest requirements for the debt directly or indirectly collateralized by those revenues. For this disclosure, pledged revenues recognized during the period may be presented net of specified operating expenses, based on the provisions of the pledge agreement; however, the amounts should not be netted in the financial statements.

22. In the year of the sale, governments that sell future revenue streams, as determined by applying the criteria in paragraph 8, should disclose in the notes to financial statements information about the specific revenues sold, including:

a. Identification of the specific revenue sold, including the approximate amount, and the significant assumptions used in determining the approximate amount
b. The period to which the sale applies
c. The relationship of the sold amount to the total for that specific revenue, if estimable—that is, the proportion of the specific revenue stream that has been sold
d. A comparison of the proceeds of the sale and the present value of the future revenues sold, including the significant assumptions used in determining the present value.

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[6]In an indirect collateralization, the pledged revenue agreement is not directly between the pledging government and the bondholders. That is, the pledging government's revenues do not secure the debt; rather, the debt is secured by its payments to the component unit that are financed by that revenue. In essence, the pledging government makes an annual debt service "grant" to the component unit, which, in turn, pledges that revenue as security for its debt.

EFFECTIVE DATE AND TRANSITION

23. The provisions of this Statement are effective for financial statements for periods beginning after December 15, 2006. Earlier application is encouraged. In the first period that this Statement is applied, changes made to comply with this Statement, except those that would result from applying the deferral provisions in paragraphs 14 and 15 relative to sales of future revenues, should be treated as an adjustment of prior periods, and financial statements presented for the periods affected should be restated. The deferral requirements in paragraphs 14 and 15 may be applied prospectively. If restatement of the financial statements for prior periods is not practical, the cumulative effect of applying this Statement should be reported as a restatement of beginning net assets (or equity or fund balance, as appropriate) for the earliest period restated (generally, the current period). In the first period that this Statement is applied, the financial statements should disclose the nature of the restatement and its effect.

The provisions of this Statement need not be applied to immaterial items.

This Statement was issued by unanimous vote of the seven members of the Governmental Accounting Standards Board:

Robert H. Attmore, *Chairman*
Cynthia B. Green
William W. Holder
Edward J. Mazur
Marcia L. Taylor
Richard C. Tracy
James M. Williams

Appendix A

BACKGROUND

24. This project initially was proposed for addition to the technical agenda largely in response to comments made to the Board during the due process related to Technical Bulletin No. 2004-1, *Tobacco Settlement Recognition and Financial Reporting Entity Issues.* Some constituents urged the Board to broaden the scope of that project to include all securitizations and securitization-like transactions, rather than proceed with a focus only on the tobacco settlement issues. The Board believed, however, that issuance of timely guidance on the tobacco settlement issues was a priority and agreed that other, similar issues would be addressed in a broader scope project. This Statement is a product of the project, added to the technical agenda in 2004, which represents that broader scope approach.

25. Prior to this standard, the provisions of Financial Accounting Standards Board (FASB) Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse,* determined whether a transaction within the governmental activities category and most business-type activities (BTAs) was a sale or a collateralized borrowing. In addition, the FASB's Emerging Issues Task Force (EITF) Issue No. 88-18, "Sales of Future Revenues," addressed certain debt versus deferred revenue issues. Enterprise funds and BTAs that elected to apply paragraph 7 of GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting,* were required to apply the provisions of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.*

26. Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, paragraph 100, states that the statement of revenues, expenses, and changes in net assets for proprietary funds "should identify revenues used as security for revenue bonds." A nonscientific sample of financial statements indicates that many governments are not aware of this requirement or are unsure how to implement it. The standard implies "face of the statement" information, but compliance through display on the face of the statement is cumbersome in a multi-columnar setting or when revenues are aggregated. Paragraph 122, as amended, imposes a segment disclosure requirement—again, applicable only to enterprise funds or BTAs. The definition of a *segment,* however, is restrictive; therefore, few governments actually are required to make those disclosures, even though they may have several pledged revenues. As a result, users have been able to derive little information from a government's basic financial statements about pledged revenues of enterprise funds or BTAs and virtually no information about pledged revenues of governmental activities.

27. In early 2005, a task force was assembled comprising 12 persons broadly representative of the GASB's constituency. The task force members reviewed and commented on papers prepared for the Board's deliberations and on drafts of this Statement.

28. In September 2005, the Board issued an Exposure Draft (ED), *Sales and Pledges of Receivables and Future Revenues*. Thirty-three organizations and individuals responded to the ED. As discussed throughout Appendix B, Basis for Conclusions, the comments and suggestions from the respondents to the ED contributed to the Board's deliberations and helped the Board finalize the requirements in this Statement.

Appendix B

BASIS FOR CONCLUSIONS

29. This appendix summarizes factors considered significant by the Board members in reaching the conclusions in this Statement. It includes discussion of alternatives considered and the Board's reasons for accepting some and rejecting others. Individual Board members may have given greater weight to some factors than to others.

Scope and Applicability

30. Initially, the objective of this project was to address financial reporting for securitizations, including securitization-like transactions, and other transfers ("other transfers" was intended to include pledged revenue streams) entered into by state and local governments. Securitizations and securitization-like transactions remain within the scope. However, during its early deliberative sessions, the Board concluded that the project should focus specifically on financial reporting issues associated with sales and pledges of receivables and future revenues. Also, as discussed in paragraphs 66–68, the Board included within the scope of this standard all intra-entity transfers of assets and future revenues.

31. This Statement does not apply to a government's pledge of its "full faith and credit" as security for its own debt or the debt of a component unit. In general obligation debt situations, a government pledges its full faith and credit toward repayment of its own debt and can make a similar pledge as security for debts of a component unit. By backing debt with its full faith and credit, a government makes an *unconditional commitment* to pay principal and interest on that debt without specifying the resources that will be used for repayment. The Board concluded that because specific revenues are not identified as the

source of repayment, pledges of full faith and credit should not be included in the scope of pledged revenues in this Statement.

Criteria to Determine Whether Proceeds Received by a Transferor Government Should Be Reported as a Liability or as Revenue

32. The Board believes that terminology used in a transfer agreement document is not controlling; that is, a transaction should be reported as a collateralized borrowing or a sale based on its economic substance, rather than on the labels attached to it. Even though documents may stipulate that a transaction is a sale, the facts and circumstances may indicate that it is a collateralized borrowing and not a sale. The Board believes that there are two general approaches that could be used to analyze transactions to determine whether resources received by a transferor government constitute a borrowing or a sale. Under the first approach, the analysis starts from the perspective that all transactions of this type are borrowings for financial reporting purposes, unless certain criteria are satisfied indicating that the underlying transaction should be reported as a sale. Alternatively, a broader set of criteria could be established so that some criteria would indicate that a transaction should be reported as a borrowing and others would indicate that a transaction should be reported as a sale. Using that approach, any transaction in which a government receives proceeds (a typical utility revenue bond sale secured by future customer revenues, for example) would be subjected to the application of the determinative criteria. In the first approach, a transaction would be regarded as a borrowing *unless* it meets certain criteria, whereas in the latter approach, a transaction would be regarded as a borrowing *if* it meets certain criteria. The Board believes that the first approach will result in more consistent reporting of these transactions and can be more efficiently applied by governments. As a result, the Board established that a

transaction should be reported as a collateralized borrowing unless it meets the criteria to be reported as a sale.

33. The Board's objective in developing criteria is not to compile a checklist of factors that would be applied in a borrowing versus sale analysis but, rather, to assemble criteria that, when considered together, form the basis of an approach. The Board believes that such an approach should be the extent to which a transferor government maintains *continuing involvement* with the relevant receivables or future revenues. Research indicates that there are two established approaches embodied in past and present financial reporting standards that could be used to guide the sale or borrowing decision-making process—a *risks and rewards* approach and a *control* approach. The Board considered the key factors in each approach to ascertain whether, generally, a risks and rewards approach or a control approach is better for determining a government's continuing involvement.

A Risks and Rewards Approach

34. A risks and rewards approach to assessing the extent of a government's continuing involvement would examine whether the risks of loss and the opportunities for gain associated with the receivables or future revenues have been transferred or retained. Risks and rewards issues have been considered in U.S., foreign, and international financial reporting standards for assessing whether certain asset transfers qualify as revenue or debt transactions, but generally the sale or borrowing distinction has been based on control considerations. The notion of risks and rewards transfer or retention has played a significant role in many court decisions about whether certain transactions are sales or secured borrowings. Court decisions have been influenced by determinations regarding the transfer of credit risk—that is, whether the risk that the payments will not be paid by

the obligors has been shifted from the transferor to the transferee. Two common types of credit risk are recourse and a requirement for a transferor to reacquire certain assets transferred.

35. Some would consider recourse provisions to be an important aspect of risk transfer or retention because it suggests that the parties intended a loan and not a sale. That is, if the parties had intended a sale, the buyer, rather than the seller, would assume the risk of default. They believe that the greater the recourse the transferee has against the transferor, the more the transfer resembles a loan rather than a sale. Similarly, some contend that if a transferee can require the transferor to repurchase certain receivables for reasons other than to replace those accounts that do not possess the characteristics stipulated in the transfer agreement, the possibility of the transferee's exercising its option and thereby reversing the transfer implies that the risks remain with the transferor.

36. The converse to the question of whether the risks of loss have been transferred or retained is whether the opportunities for gain have been similarly disposed. In that regard, one important consideration in assessing a purported sale of receivables is whether the transferor has the option to repurchase the receivables or to substitute accounts in certain circumstances. With that ability, the transferor could benefit from any increase in the value of the transferred receivables and thus would have retained the opportunity for gain. Similarly, if there is an obligation on the part of the transferee to remit to the transferor collections in excess of the purchase price paid for the receivables or future revenues (for example, a residual interest arrangement), one could conclude that the opportunity for gain appears to have been retained by the transferor.

A Control Approach

37. At the heart of a control approach is the determination of whether the transferor or the transferee controls the future economic benefits that arise from the receivables or future revenues transferred.

Control Approach Preferred over Risks and Rewards Approach

38. The Board believes that the most significant risks in a risks and rewards approach—recourse or an obligation to reacquire certain receivables—on their own are not sufficient to cause the entirety of the proceeds received by a transferor to be reported as a liability. The Board believes that a transferor's potential future sacrifice is limited to the probable payments under recourse or reacquisition provisions. That is, the transferor does not have a present obligation to return the transferred proceeds (as if repaying a loan); rather, the transferor has an obligation only to perform under the recourse or reacquisition provisions. To the extent specified by those provisions, the transferor has a contingent liability based on whether the underlying debtors will pay the amounts when due. The Board concluded that the substance of recourse or reacquisition provisions is that a transferor government is not obligated to repay the entire amount of the proceeds and, therefore, should recognize a liability only for the portion likely to become payable.

39. Similarly, the Board concluded that the presence of the most significant item on the reward side of a risks and rewards approach—a residual interest—is not by itself sufficient evidence to preclude reaching a sale determination. Instead, the Board believes that the instruments representing residual interests should be evaluated for recognition as assets separate from, but related to, the underlying receivables or future revenues that are sold.

40. Ultimately, the Board concluded that a concept of continuing involvement should be based on a control notion in preference to one that focuses on risks and rewards. The Board acknowledges, however, that risks and rewards and control concepts are not mutually exclusive and that some risks and rewards features also could be informative in analyzing the transfer or retention of control. If a risks and rewards concept were instead embraced in this Statement, the Board would be concerned about the influence of risk-related recourse and reacquisition provisions, and residual interests. Their presence, the Board believes, would be persuasive in reaching a "no-sale" conclusion because they could be construed as indications that the risk of loss and the opportunity for gain are not completely transferred. If that were the case in a risks and rewards-based approach, the transferor would classify proceeds as debt and continue to recognize the receivables as assets. The Board believes that in such situations, to recognize the total receivables as assets and the total proceeds as debt would overstate both assets and liabilities. Instead, a transferor should measure and report only the value of a residual interest as an asset and recourse or reacquisition obligations as liabilities and thus present a more representative picture of what the transferor is expected to receive or pay. Factors that the Board believes should be considered in assessing the extent to which control is retained or relinquished are discussed in the following paragraphs.

41. An important consideration is whether the transferee's rights or abilities to pledge or exchange the receivables or rights to future revenues are constrained by the transferor. If significant limitations on the transferee's freedom to pledge or sell the receivables or rights to future revenues are imposed by the transferor, one could infer that control has not been transferred and that the proceeds received by the transferor should be reported as a

liability. Generally, those constraints or limitations are imposed through provisions in the transfer agreement; however, the criteria in paragraphs 6a and 8b are equally applicable to organizational or structural restrictions that may have been imposed by the transferor government when the transferee government was created. The Board believes that from the perspective of a transferee, control encompasses not only physical control but also control over the future economic benefits that are expected to derive from the receivables or resources from future revenues. The future economic benefit associated with owning receivables or resources from future revenues is primarily the cash inflow that will result from their ultimate collection. Therefore, the Board believes that the extent to which a transferee can sell or pledge those future cash flows (and thus control the amount and timing of them) free from transferor-imposed constraints is an important measure of whether control is transferred or retained.

42. Another critical factor in assessing a possible sale transaction is whether the assets (the receivables and the cash from collecting the receivables or future revenues) are *isolated* beyond the reach of the transferor and its creditors. This determination extends beyond the physical segregation and isolation of the assets transferred; it also requires assessing the extent to which a transaction is structured to be "remote from bankruptcy." Bankruptcy is far more significant in the private sector; however, the Board believes that for purposes of making a sale or borrowing decision, the most relevant aspect is the degree to which the transferee is "remote" from the perspective of the transferor government (regardless of the improbability of actual bankruptcy). The probability assessment is intended to be measured by applying the criteria in paragraph 7.

43. In order to adequately protect the receivables or rights to future revenues from the transferor's bankruptcy estate and from the reach of the transferor generally, it is necessary to establish a legally separate entity (a component unit) to acquire the receivables or future revenues and issue securities backed by the cash flows from collecting the receivables or future revenues. It is important that the component unit acquire the receivables or future revenues in what bankruptcy law refers to as a "true sale"; that is, the assets will not become a part of the transferor's bankruptcy estate should it become the subject of a bankruptcy proceeding. Protection is enhanced through the observance of all necessary formalities consistent with the transferee's existence as a legally separate entity. This measure is intended to prevent a bankruptcy court from "substantively consolidating" the assets and liabilities of the transferor with that of the transferee, similar to the way a court may "pierce the corporate veil" in some private-sector situations. To accentuate the "isolation" of the transferee component unit, its organizational documents usually require that it maintain separate accounts and records, prepare separate financial statements, and avoid commingling its assets with those of others.

44. Sometimes governments continue to service individual accounts that are purported to have been sold. (For example, a municipality may continue to service delinquent tax liens, or a state housing finance authority may retain the servicing responsibility for mortgages sold.) The Board believes that the extent to which servicing arrangements perpetuate a government's control over those receivables should be assessed. An important element to consider when assessing isolation when the transferor acts as servicer is whether banking arrangements are designed to eliminate the access of the

transferor (or its component units, other than the transferee) to the cash generated by the receivables or future revenues sold.

45. Typically, payments from the underlying obligors (delinquent taxpayers, for example) would be paid (a) directly to an account maintained for the benefit of the security holders with a custodian or (b) to the transferor or servicer, as agent for the transferee, with a requirement that amounts relating to the specific receivables be paid promptly into an account with the custodian, maintained for the benefit of the security holders. In a sale of future revenues, the revenue provider generally is instructed to make payments directly to the transferee or to a separate custodial account maintained for the transferee's benefit.

46. The Board believes that the *source* of the funds to be received by a transferee is an important consideration when evaluating isolation. That is, do the payments come from the transferor's own resources or from the resources generated by the receivables and future revenues that were transferred? If the transferor can use cash from any source to pay the transferee, it would be an indication that the transaction is a loan. Do the payments come *directly* from the individual account obligors, or do they pass through the transferor government? If payments are received by the transferor, are they remitted on a timely basis to the transferee? The Board believes that answers to those questions are informative in an analysis of continuing involvement.

47. Of similar importance is the determination of whether a transferor government considers proceeds received as satisfaction of individual account balances. That is, does a transferor government that continues to service the accounts transferred indicate in its

records which accounts have been transferred and which collections pertain to those accounts? The Board believes that a key consideration when determining whether a transfer of delinquent taxes, for example, should be reported as a sale or as a borrowing is whether the proceeds from the transferee are taken by the taxing body as satisfaction of the delinquent taxes owed. Stated as a question, is the government collecting from a delinquent taxpayer an amount to which it has legal claim, or is it collecting and passing through an amount to which the transferee or lien holder has legal claim? The Board believes that the latter is evidence that the transfer of the receivables may be a sale, and the former is characteristic of a borrowing. In a mortgage or student loan setting, this determination may not be as informative because the loan transferred is not simply an installment or annual charge. In the property tax situation, the transferring government continues to maintain a tax receivable account for the taxpayers whose delinquencies have been transferred. Only the installments transferred (annual charges that have become delinquent) are considered paid. In the mortgage and student loan instances, the proceeds from a securitization are not applied against individual accounts; that is, the accounts are not considered "paid" but rather are considered "sold" for record-keeping purposes.

48. Another criterion that is indicative of who has control of receivables that are purported to have been sold is whether a transferor has the option or ability to reacquire specific accounts from among those transferred. Sometimes this ability is called a removal of accounts provision. The Board believes that an unconditional removal of accounts provision or a reacquisition agreement that allows the transferor government to specify the accounts that may be removed or reacquired provides compelling evidence that control of the receivables remains with the transferor government. However, the

Board acknowledges that a transferor government's *right of first refusal* to reacquire accounts that are being offered to others does not constitute an option to repurchase for purposes of determining whether transferor control exists. Similarly, the transferor may have the ability to reacquire transferred accounts through a "clean-up" call option, wherein the transferor may purchase remaining accounts after the secured debt balance falls below a predetermined minimum—often in the 5 to 10 percent range. The Board concluded that insignificant "clean-up" call options should not be considered violations of the reacquisition criterion in paragraph 6b.

49. Regarding the transfer of future revenues, the Board believes that a transferor government generally will remain actively involved in the future generation of the majority of its revenues and thus *cannot* relinquish control of those revenues to a transferee. The Board developed criteria to indicate active involvement in the future generation of revenues based on that notion. As a result, transactions involving the rights to future revenues that the government will continue to generate by (a) producing goods or providing services in exchange for the revenues; (b) levying or assessing taxes, fees, and charges to generate the revenues; or (c) applying or qualifying for grants or contributions to obtain those revenues always will be reported as collateralized borrowings. A transferee may have control over how the revenues obtained are ultimately used, but that ability comes only after the transferor government has taken the requisite steps to generate the revenues and pass them on to the transferee. The transferor government retains the ability to control its future own-source revenues by having control over the underlying revenue base and the rates that are applied to that base. Even if the transfer agreement includes a pledge by the transferor to refrain from actions that would adversely affect the

base or rates, the transferor government nevertheless retains the *power* to do so and remains in a unique position as the generator of those revenues through its own authority and initiative. Similarly, the transferor government continues as the applicant or qualifier in obtaining many grants and contributions and retains control of the generation of those future revenues from that perspective.

50. Some respondents to the ED urged the Board to sharpen the distinction between active and passive involvement in the generation of future revenues. The active involvement criterion is a key factor in determining whether a transaction should be regarded as a sale or as a collateralized borrowing. In response to those comments, the Board concluded that the specific criteria as proposed in the ED were appropriate and should be retained for the final Statement; however, the Board agreed that the broader concept of active involvement could be clarified. As a result, the discussion of active involvement in paragraph 9 was enhanced to emphasize the importance of distinguishing those activities that generate a specific revenue from those that, although associated with that revenue, are tangential, incidental, or are undertaken to protect the revenue. The Board believes that the ultimate determination should be based on whether the primary or fundamental activity or process that generates a specific revenue requires continuing active involvement by the government. By limiting the involvement analysis to the primary revenue-generating activity, more clarity and consistency should result. The Board also agreed to eliminate the ED's proposed separate passive involvement criteria, as suggested by some respondents. The Board concluded that the passive criteria was superfluous because failure to meet the criteria for active involvement automatically results in that classification of the transaction without the need to apply additional criteria.

Thus, the factors discussed in the ED as evidence of passive involvement are cast in this Statement as activities that do not indicate active involvement.

Accounting for Transactions That Meet the Criteria to Be Reported as Sales

51. In a sale of receivables, the extent to which a selling government has realistically evaluated the collectibility of the individual accounts to be sold, including accrued penalties and interest, will have a direct effect on the gain or loss recognized. That is, if the carrying value of the receivables sold is not assessed prior to the sale, any expense relative to uncollectibility or revenue from earned penalties and interest may obscure the amount that should represent the gain or loss on the sale of the receivables. Evaluation of the collectibility of the receivables to be sold is especially important in an intra-entity transaction because the transferee component unit is required to recognize the receivables purchased at their carrying value.

52. The provisions in this Statement that pertain to transactions involving the transfer of future revenues generally are based on two fundamental beliefs held by the Board. First, the Board believes that, by their nature, most future revenues would not meet the criteria to be regarded as sold; and second, the Board believes that accelerating revenue recognition ahead of the point at which those revenues would otherwise meet the appropriate criteria for recognition does not result in a faithful representation of the government's financial position or changes in financial position. As a result, transactions involving the transfer of future revenues will rarely qualify as sales, and in those rare instances, the resulting revenue generally will be deferred rather than recognized in the period of the sale.

53. Regarding future revenue sales transactions within the same financial reporting entity, the Board does not believe that existing uncertainties about realization or measurement can be appropriately resolved without the objectivity provided by an arm's-length transaction with parties outside the reporting entity. Based on that determination, deferral of revenue is required by this Statement for *all* intra-entity sales of future revenues, regardless of the reason recognition previously had not taken place. Similarly, the Board concluded that the component unit's expense of the acquisition also should be deferred. The Board believes that the amount paid to acquire the rights is comparable to an unexpired cost that is applicable to future revenue entitlements and should be charged to the periods over which those revenues will be recognized. The Board concluded that deferring recognition of the expense is consistent with the deferral concept discussed in paragraphs 62–65. That is, without deferral, the cost of acquiring the future revenues is expensed immediately and therefore is charged to one period, rather than ratably over the same periods in which the revenues will be realized. The concept of interperiod equity implies that the cost of acquiring the future cash flows should be attributed to the future periods benefiting from those cash flows in order to show "whether current-year revenues are sufficient to pay for current-year services." Otherwise, one period absorbs all the cost, whereas others enjoy the benefits with no reported costs. The Board also was persuaded by the fact that unless both parties to an intra-entity transaction recognize the effect of that transaction in a similar manner, the reporting entity, as a whole, would be depicted as being either better off or worse off as a result of an "internal" transaction.

54. In deliberating the prospect for deferral, the Board considered the types of revenues that are subject to deferral under current standards. Generally, most types of revenue are

not subject to deferral. In the private sector, revenues such as warranty or product maintenance contracts, franchise fees, revenues arising from the licensing of films to TV, loan origination fees, subscriptions, and rent paid in advance are subject to deferral. The common basis for those deferrals is the notion that resources received represent advance payments in exchange for goods or services yet to be provided. In Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions,* paragraph 21 calls for deferral of revenues transmitted before eligibility requirements have been met.

55. One significant factor the Board considered when developing a deferral rationale was the contention that the proceeds related to a future revenue transaction represent a gain on the sale of an unrecognized asset, rather than the receipt of prepaid revenue that otherwise would have been recognized pursuant to specific criteria over a longer period of time. Based on that contention, the sale proceeds would not inherit the characteristics of the underlying revenues, nor would they be subject to the same recognition requirements as the revenues sold. Similarly, the sale proceeds likely would not be restricted, as defined in paragraph 34 of Statement 34, nor would they likely be subject to time or period limitations, and no specific performance requirements would be required for the government to "earn" the proceeds. Some respondents to the ED believe that a sale of future revenues is tantamount to the government's selling a contingent asset that was not recognized in the statement of net assets. Current standards require gains or losses on the sale of assets to be recognized in the period that the sale takes place. For the reasons noted earlier, the Board concluded that deferring the recognition of future revenue sale proceeds could not be supported based on existing deferral standards.

56. Technical Bulletin 2004-1 required that in a sale of future tobacco settlement revenues, the transferor government recognize revenue and the transferee government report an expense for the amount of the sale proceeds. As discussed in the preceding paragraph, there was no basis in previous standards to require deferral.[7] However, the deferral concept established in this Statement and discussed in paragraphs 62–65 provides a basis for deferring recognition of the revenue resulting from the sale of future revenues. Therefore, pursuant to the provisions in paragraph 14 of this Statement, revenue from sales of future tobacco settlement payments should be deferred, rather than recognized in the period of the sale.

57. Proceeds from an intra-entity sale of future tobacco settlement revenues under Technical Bulletin 2004-1 would have been recognized in the period of the sale by the transferor/primary government as revenue and by the transferee/component unit as an expense. Those revenues and expenses were to be reclassified as *transfers* in the reporting entity's financial statements if the component unit was blended but reported as revenues and expenses if the component unit was discretely presented. Under the deferral provisions of this Statement, however, the transferor government will defer recognition of the revenue and the transferee government will defer recognition of the expense. Although revenue and expense recognition in this Statement differs significantly from the requirements in Technical Bulletin 2004-1, the Board emphasizes that the overall effect on the financial position and changes in financial position of the financial reporting entity *as*

[7]The GASB has authorized its staff to issue Technical Bulletins in certain situations—for example, if GASB staff can provide timely guidance to clarify, explain, or elaborate on the application of existing standards, provided that such clarification, explanation, or elaboration does not conflict with a broad fundamental principle or create a novel accounting practice. Thus, when the question of immediate recognition or deferral was raised during the preparation of the Technical Bulletin, there was no alternative but to provide for immediate revenue recognition even though deferral may have been preferred.

a whole remains neutral as a result of the intra-entity transaction, regardless of whether the component unit is blended or discretely presented.

58. Some ED respondents disagreed with the proposal to report the resources received in an exchange for future revenues as deferred revenues in governmental funds. They argued that the proceeds received from a transaction should be reported in the same way—as other financing sources—regardless of whether the transaction is recognized as a sale or as a collateralized borrowing in the government-wide statements. The basis for their argument, generally, is that under the modified accrual basis of accounting, the substance of the transaction is the same—the transaction produces an inflow of current financial resources that are available to finance the expenditures of the current period. They contended that the deferral is appropriate for reporting in an economic resources/accrual basis environment but not in a current financial resources/modified accrual model.

59. In response to those comments, the Board redeliberated the proposed deferral approach in general and the resulting effect on governmental funds specifically. The Board reaffirmed its belief in, and support for, a deferral concept based on interperiod equity considerations, as discussed in paragraphs 62–65, and proceeded to reexamine the proposal for governmental fund reporting given that reaffirmation.

60. Even after extended deliberations, the Board was unable to resolve the issue without introducing major changes to the current governmental fund model. For example, except for the different lengths of deferral periods, a convincing distinction could not be made between property taxes received in advance of the period for which levied, and thus

deferred in accordance with paragraph 18 of Statement 33, and the proceeds from a sale of future revenues received in advance of the periods to which they should be attributed, based on the proposed interperiod equity deferral approach, discussed in paragraphs 62–65. In addition, no precedent could be found in current authoritative literature for recognizing revenue under the modified accrual basis *before* that revenue would be recognized under the accrual basis. The Board did not want to propose ad hoc financial reporting treatment for governmental funds while the broader concepts of elements of financial statements and recognition and measurement are currently, or soon will be, under review in separate projects on financial reporting concepts. Rather than establish standards in this Statement that may ultimately be inconsistent with the yet-to-be-issued concepts, the Board agreed to retain the proposed requirements in the ED for sales of future revenues until governmental fund recognition issues could be reexamined within a more stable and enduring conceptual environment.

61. Before reaching that conclusion, however, the Board considered several alternatives including one which would have characterized the sale proceeds received as proceeds from the sale of an asset (albeit one that does not meet financial statement recognition criteria). Under that scenario, a gain would be recognized in the government-wide statements and the proceeds would be reported as other financing sources in the governmental funds, in the same manner as gains/proceeds from the sale of capital assets. Gains on intra-entity sales would have been deferred in the government-wide statements through an extension of the provisions in paragraph 15 of the ED regarding intra-entity transfers of assets. The Board ultimately decided against that approach because the deferral would have been limited to intra-entity sales and would not be based explicitly on

interperiod equity considerations. The Board also considered a proposal that would have required a collateralized borrowing conclusion to be reached for all transfers of future revenues, thereby avoiding the revenue recognition question entirely. The Board rejected that notion because it would not provide for a faithful representation of those transactions that possess all the discriminating characteristics of sales rather than borrowings. Finally, the Board also considered eliminating all future revenue sale recognition provisions from the final Statement, but it rejected that alternative because it believed that the resulting final Statement would lack needed government-wide reporting guidance.

Deferral Based on Public Accountability or Interperiod Equity Considerations

62. Concepts Statement No. 1, *Objectives of Financial Reporting,* discusses interperiod equity and observes that "balanced budget and debt limitation statutes are examples of laws designed to achieve fairness from one year, one term of office, or one generation to another. In practice, however, partly because of the lack of precision in defining what constitutes resource inflows and outflows, fairness is not always achieved. In fact, the appearance of balance may be misleading in some cases" (paragraph 59). As previously noted, the Board believes that immediate recognition of revenue from the sale of future revenues would not be a faithful representation of the transaction. Indeed, the Board believes it would provide financial statement readers with a "misleading appearance of balance." Paragraph 61 of the Concepts Statement states:

> The Board believes that interperiod equity is a significant part of accountability and is fundamental to public administration. It therefore needs to be considered when establishing financial reporting objectives. In short, financial reporting should help users assess whether current-year revenues are sufficient to pay for the services provided that year and whether future taxpayers will be required to assume burdens for services previously provided.

63. That notion is manifested in the first financial reporting objective in paragraph 77a:

> *Financial reporting should provide information to determine whether current-year revenues were sufficient to pay for current-year services.* This also implies that financial reporting should show whether current-year citizens received services but shifted part of the payment burden to future-year citizens; whether previously accumulated resources were used up in providing services to current-year citizens; or, conversely, whether current-year revenues were not only sufficient to pay for current-year services, but also increased accumulated resources.

64. Even though the concept that current-year citizens and service recipients have "shifted the payment burden" to future-years' citizens generally has been connected to the issuance of debt, the Board believes that the diminution of future revenues caused by a sale has identical "shifting the burden" aspects. That is, even though a sale of future revenues does not result in a claim on future resources, it has the same effect by creating an *absence* of future revenues. In substance, the unavailability of resources is the same whether those resources are used for debt service related to operating debt or whether they have been sold and therefore are unavailable for *any* purpose. Furthermore, the objective in paragraph 77a implies that financial reporting should show "whether current-year revenues were not only sufficient to pay for current-year services, but also increased accumulated resources." The Board concluded that it is likely that year-of-sale recognition (as current-year revenues) would impair a reader's ability to make that assessment.

65. Based on the considerations discussed in the preceding paragraphs, the Board concluded that, in most instances, it was appropriate to require deferral of revenue that resulted from the sale of future revenues. The Board believes that immediate recognition is appropriate only if the revenues sold were not recognized prior to the sale because they

either were not realizable or could not be reliably measured. In either of those situations, the conditions that prevented recognition no longer exist after the sale is completed and, therefore, revenue should be recognized in the period of the sale. In contrast, the Board believes that proceeds received in excess of the carrying value of receivables (exclusive of amounts that may be refundable) should not be deferred but, instead, should be reported as a gain (or as revenue in governmental funds) in the period of the sale. Those excess proceeds represent the recovery of amounts previously written off as uncollectible, rather than revenues that had not met recognition criteria.

Valuation of Transferred Assets and Future Revenues

66. The provisions in paragraph 15 expressly establish, in a GASB standard, the concept applied in Technical Bulletin 2004-1 for intra-entity tobacco settlement revenue sales. That guidance was based on the "continuing authoritative guidance" of Accounting Principles Board (APB) Opinion No. 16, *Business Combinations,* interpreted in Appendix D of FASB Statement No. 141, *Business Combinations*. In addition, the requirements in this Statement apply to intra-entity "donations" of assets, which previously were required to be reported at fair value, as determined at the date of the donation. The Board believes that the provision in Technical Bulletin 2004-1—that is, that governments should not revalue assets by transferring them among financial reporting entity components—is appropriate for all assets and should not be limited to future revenues. As a result, the intra-entity guidance provided in this Statement applies to all intra-entity *transfers* of assets and future revenues and therefore expands the applicability of the "carrying value" concept to both sales and donations and thus should be applied in lieu of the fair value provisions as they relate to intra-entity capital asset donations.

67. Some respondents were concerned that the ED's treatment of transactions with discretely presented component units as *internal* was inconsistent with the provisions in Statement 34, paragraph 61, which states that resource flows (except those that affect the balance sheet only, such as loans and repayments) between a primary government and its discretely presented component units should be reported as if they were external transactions—for example, as revenues and expenses. The Board notes that paragraph 61 of Statement 34 was not intended to suggest that transactions between a primary government and its discretely presented component unit *were* external transactions; rather, it explains that those transactions should be reported (that is, classified) *as if* they were external, rather than reclassified as interfund items, as would be the case if the component unit were to be blended. Thus, activity with discretely presented component units should be regarded as internal from the perspective of the financial reporting entity, but the transactions should be labeled as revenues and expenses rather than transfers.

68. If the transferee in a sale of future revenues is outside of the transferor's financial reporting entity, it has acquired a recognizable asset that should be reported at cost. That asset, however, is not a receivable but, rather, is the intangible right to future revenues. The transferee government should recognize a receivable only when the asset recognition criteria appropriate to the particular revenue have been met. The asset representing the rights should be amortized as an expense over the life of the purchase and sale agreement representing the allocation of the cost of obtaining the revenues to the periods during which the revenues will be recognized.

Pledged Revenues

69. In other than general obligation debt-issuing situations, governments identify and pledge specific revenue streams as security for repayment, thereby making at least a portion of those pledged revenues legally or contractually unavailable for other purposes. BTAs and governments with enterprise fund operations frequently borrow to build or expand revenue-generating capital facilities and pledge the revenues generated by those facilities as security for repayment of the underlying debt. General or special-purpose governments that have the ability to tax often issue debt that is secured by a pledge of revenues that will be raised through the levy or imposition of an additional or dedicated tax. Similarly, debt issued to provide financing for many economic development projects often is secured by a pledge of *incremental* sales or property taxes that are projected to be generated by the expanded or enhanced tax bases within redevelopment boundaries. In addition, some governments pledge portions of existing revenue streams as security for certain debt issuances.

70. In what could be termed a "plain vanilla" pledged revenue transaction, a government issues debt, receives the proceeds, and pledges a specific future revenue against that debt. The pledged revenues are collected and used to make debt service payments.

71. In other situations—for example, when ordinance, statute, or constitutional provisions restrict a government's ability to issue debt—the government may create a legally separate entity (or use an existing one) to issue the debt. The government pledges its future revenue stream to the separate entity (a component unit), which in turn pledges those future payments as security for its debt. The debt-issuing component unit generally makes program disbursements directly from the debt proceeds, but it may remit the debt

proceeds to the pledging government. Paragraph 61 of Statement 34 provides that resource flows between the primary government and blended component units should be reported as internal activity in the financial statements of the reporting entity. That paragraph further stipulates that resource flows (except those that affect the balance sheet only, such as loans and repayments) between a primary government and its discretely presented component units should be reported as if they were external transactions—for example, as revenues and expenses.

72. The Board believes that when a government pledges a revenue, in which resources are received by the pledging government, that transaction should not be accorded expense/revenue treatment because the agreement is not purported to be a sale. There is no abdication of rights to future revenues; rather, there is the imposition of a binding restriction on the use of those future revenues. That is, the pledging government has proclaimed that the first priority[8] with regard to the use of the pledged revenues is to transmit those revenues to the debt-issuing component unit to be used to repay its debt.

73. If the debt-issuing component unit transfers resources to the primary government in a pledged revenue transaction, the Board believes that the substance of that transaction is that the primary government is borrowing from the component unit to finance its program expenses and that a liability to the component unit should be recognized. That liability will be liquidated over time as the primary government forwards the pledged revenues to the component unit to retire its debt. The Board believes that reporting the resources remitted to the pledging government as revenue (even if deferred) would ignore the fact

[8]In some cases, a particular revenue stream is pledged as security for multiple debt issuances, and the debt service claims generally are prioritized with the earliest issuance having first priority and so forth.

that the primary government has agreed to repay those resources borrowed by the component unit to finance its program expenses. Furthermore, the Board believes that to recognize the payment from the component unit as revenue would be tantamount to accelerating recognition of the underlying pledged revenues simply because the government is able to borrow against those revenues.

74. During the due process period of the proposed standard, the question of how remitted receipts of the transferred item should be applied to a liability/receivable balance was asked. In most situations in which resources are received by a pledging government, the total receivables or future revenues to be collected and remitted will exceed the resources received. The Board considered whether the remittance of the collected pledged amounts should reduce the pledging government's liability on a dollar-for-dollar basis, or whether some consideration should be given to recognizing, separately as an expenditure/expense, an imputed interest component and/or an estimated "excess" collections component. APB Opinion No. 21, *Interest on Receivables and Payables,* paragraph 3f exempts intra-entity transactions from its requirements. Therefore, because a large portion of receivable and future revenue sale transactions occur within the reporting entity, that guidance generally will not be applicable. With regard to the "excess" receipts, the Board concluded that primarily because of the inherent uncertainty of the collectibility of the specific receivables pledged, it would not be practical nor useful to require governments to estimate the extent to which receipts of those specific receivables will exceed the reported liability and allocate each period's payments between liability reduction and expenditure/expense.

Pledged Revenues When the Pledging Government Does Not Receive Proceeds

75. As discussed above, a pledging government generally does not receive proceeds from a debt-issuing component unit. The Board deliberated the substance of a pledge in those situations—that is, whether it is a guarantee, a contingency, or something else. The Board concluded that if a primary government "guarantees" the debt of a component unit, it generally would do so by pledging its full faith and credit as additional security for repayment of the component unit's debt. As stated in paragraph 3, full faith and credit pledges are not within the scope of this Statement. The security arrangements that the Board has observed generally do not place the primary government in a position of directly guaranteeing the debt of the component unit. Rather, the component unit is the sole obligor and secures the debt by pledging the payments that the primary government has pledged and appropriated to it from a specific revenue stream. The debt is characterized as payable solely from those appropriations with no explicit recourse to the primary government.

76. The Board believes that, generally, pledged revenue security arrangements are not guarantees of the debts of others but rather constitute separate agreements between a primary government and its debt-issuing component units. The Board believes that there is not a single liability with primary and secondary obligors; rather, there are two separate commitments, each with a sole obligor. The debt-issuing component unit is solely responsible for repaying amounts owed to the holders of its bonds, and similarly, the primary government is solely responsible for making the agreed-upon payments to the component unit. If, however, a primary government pledges future revenues to guarantee the repayment of the debts of others, the guidance from paragraph 14 of National Council

on Governmental Accounting Statement No. 4, *Accounting and Financial Reporting Principles for Claims and Judgments and Compensated Absences*, as amended, would be applicable. That is, a liability related to guarantees of the indebtedness of others should be recognized when information available prior to the issuance of the financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements *and* the amount of the loss can be reasonably estimated. Payment by the primary government in those instances would be contingent upon the failure to pay by the primary obligor.

77. The nature of pledged revenue agreements between debt-issuing component units and pledging governments generally stipulates that amounts sufficient to cover annual principal and interest requirements of the component unit are irrevocably pledged and appropriated from a specific revenue source. The Board believes that the pledging government is obligated only to the extent that the pledged revenues of the period are adequate to meet the debt service requirements of the period. Hypothetically, if there are no revenues, the pledging government is not liable to make payments because those payments are appropriated from those specific revenues, rather than from a broader resource pool. Stated differently, the pledging government only has a *commitment* until the pledged revenues that have been appropriated are available. Hence, the Board believes that the recognition of a liability is a year-to-year proposition. The pledging government is obligated to pay, *from this year's revenues,* amounts sufficient to pay the current principal and interest maturities of the component unit's debt. Unless explicitly stated in the pledged revenue agreement, annual revenues in excess of that requirement

are not pledged and therefore are not required to be paid to the component unit (for example, to provide a sinking fund for future years' maturities).

78. The Board considered whether a pledging government should recognize a liability to acknowledge the claim against its future revenues. Supporters of that position do not believe it is appropriate for a pledging government to recognize a liability only if it receives resources from the debt-issuing component unit. They note that the government's pledge is the same in either situation. Supporters of that position would suggest that, in substance, the pledging government is obligated for (and will provide resources to pay) the debt of the component unit and, accordingly, should recognize a liability to the component unit in an amount equal to the component unit's outstanding debt. In essence, they would "look through" the debt-issuing component unit.

79. The Board finds more persuasive, however, the notion that the pledging government incurs a *new* obligation each year as pledged revenues are earned and, through the continuing annual appropriation, commits a portion of those revenues to be paid to the debt-issuing component unit. In effect, the pledging government is making a debt service *grant* to the component unit each year. The Board does not believe that the pledging government has agreed to pay the component unit's debt directly or that it has guaranteed the debt. It simply has agreed to pay a portion of a specific revenue stream to the component unit each year and thus is obligated to do so only on a year-to-year basis.

Reporting Pledged Revenues by the Pledging Government

80. Some pledging governments have reported their revenues net of the amounts pledged and paid to the debt-issuing component units, with no corresponding expenditure/expense reported. Others have reported the revenues earned at gross with a

related expenditure/expense for the payment of the pledged revenues to the component unit. In the first case, the debt-issuing component unit reports a revenue item that identifies the character of the pledged revenues—"sales tax revenues," for example—whereas in the latter instance, the component unit reports a "payment" from the primary government. The Board discussed whether the manner of reporting should be standardized and concluded that the "net" approach to reporting would parallel the financial reporting that would occur if the revenues were *sold* rather than pledged and may imply that the government no longer receives or is entitled to the revenue payments. Additionally, the Board believes that net reporting would be inconsistent with the approach used in Statement No. 24, *Accounting and Financial Reporting for Certain Grants and Other Financial Assistance*, which requires that "pass-through" grants be recognized as revenues and expenditures or expense, unless the conduit government has no administrative involvement with the grant program. Even though pass-through grant receipts are not comparable to a government's own pledged revenues, the Board believes that the notion that resources "passed through" to another entity require revenue and expenditure/expense recognition is a persuasive argument that pledged revenues should be reported as revenues by the pledging government, and the subsequent payment of those revenues to the debt-issuing component unit should be reported as an expense or expenditure.

Disclosures Regarding Pledged Revenues

81. Currently, no specific disclosures about pledged revenues are required. However, Statement 34, paragraph 100, states that proprietary funds "should identify revenues used as security for revenue bonds," and paragraph 30 of Statement No. 44, *Economic*

Condition Reporting: The Statistical Section, requires a schedule of pledged revenue coverage to be included in a statistical section, if one is presented.

82. The Board recognized that this standard, with its focus on pledged revenues, provided an opportunity to consider a requirement for disclosing information about pledged revenues in the notes to the financial statements. Historically, research results, due process respondent comments, and anecdotal evidence have indicated that users consider information about pledged revenues to be very important, although not commonly found in the notes to financial statements. The pledged revenue disclosures required by this Statement are based on the Board's contention that, at a minimum, the notes to the financial statements should identify the revenues that are pledged, the purposes for which they are pledged, the duration of the commitment, and some measure of the relationships of the pledged portion to the total revenue and of the actual revenues to the amount pledged. In other words, the Board believes that readers should be able to ascertain, generally, how much of a particular revenue source is not available for other purposes, how long it will remain that way, and the adequacy of the pledged revenues compared to the related debt service requirements.

83. The Board believes that disclosure of information about pledged revenues is essential for readers to be able to "assess the level of services that can be provided by the governmental entity," as implied by paragraph 79 of Concepts Statement 1. In addition, paragraph 79c of that Statement sets forth that "financial reporting should disclose legal or contractual restrictions on resources." Thus, the Board believes that disclosure of information about pledged revenues is responsive to the needs of users and is in harmony with the financial reporting objectives in Concepts Statement 1. Furthermore, the

disclosure requirements meet the criteria for disclosing information items in notes to financial statements discussed in paragraphs 36 and 37 of Concepts Statement No. 3, *Communication Methods in General Purpose External Financial Reports That Contain Basic Financial Statements.*

84. Several respondents to the ED commented on the proposed disclosures about pledged or sold revenues. Some respondents expressed concern that the requirement to disclose the approximate amount of the pledged or sold revenue was tantamount to requiring a *projection* of revenue and that some amounts may not be determinable. Other respondents asked for clarification regarding the periods in which the disclosures would be required, and still others questioned whether the disclosures were necessary because the information was available elsewhere in the financial statements and notes, was too costly to obtain and provide, or was too voluminous.

85. The Board addressed the respondents' concerns about projecting revenues by clarifying in paragraph 21a that, generally, the approximate amount of the pledge is equal to the remaining debt service requirements of the secured debt. The Board believes that the most likely impediments to making reasonable determinations of the approximate amount of the revenues pledged would be variable-rate debt service requirements or debt issuances that include accelerated redemption features, making the calculation of total interest costs difficult. Nevertheless, the Board believes that estimates of the approximate amount of revenues pledged or sold could be made based on assumptions that could be stated in the disclosures. The Board resolved the disclosure period question by stating in paragraph 21 that the disclosures should be made as long as the secured debt is outstanding.

86. The Board acknowledges that it may be possible for financial statement users to gather the information about pledged revenues required in paragraph 21, but it believes that users interested in a specific revenue likely would not have the wherewithal to do so because they would need to analyze the long-term debt disclosures that may not contain adequate detail. The Board maintains that the objective of the required disclosures is to provide information about the *revenue*—to bring all the pertinent information together in one place so that the reader can assess how much of a particular revenue source is not available for other purposes, how long it will remain that way, and the adequacy of that revenue relative to its committed use. However, the Board did agree with respondents who suggested that legally separate stand-alone BTAs with a single major revenue source should be exempt from the pledged revenue disclosure requirements because the information disclosed would not significantly enhance the assessments that a reader could make from the financial statements themselves and other existing disclosures. The Board emphasized the legally separate entity aspect of the exemption to clarify that an enterprise *fund* with user charges pledged as security for revenue bonds is not comparable because a fund is not a legally separate entity, and other resources of the governmental entity are available to the fund through operating subsidies or a full faith and credit enhancement.

Recognizing Other Assets or Liabilities Arising from a Sale of Specific Receivables or Specific Future Revenues

Residual Interests

87. Often, a transferor government retains or obtains a beneficial or residual interest in the receivables or revenues sold to the extent that those collections exceed the amounts necessary to liquidate the transferee's debt, compensate the servicer, and pay any other costs stipulated in the agreement. Sometimes that residual interest is certified or is

evidenced by a subordinate note issued to the government by the transferee. As discussed earlier in paragraphs 38–40, the Board considered whether a residual interest in collections of the underlying receivables or future revenues indicates that the transaction is not a sale.

88. In deliberating whether the existence of a residual interest should preclude a transaction from sale reporting treatment, the Board considered, among other factors, the substance of a typical delinquent tax lien transfer transaction. In such a transaction, the transferor government exchanges an asset (a group of individual tax liens) for cash and sometimes a document (a subordinate note or residual certificate that represents a claim on collections in excess of a certain amount). After the transfer, the government no longer owns any of the individual tax liens and cannot enforce their collection, even though it can continue to bill and collect current taxes and file additional liens pertaining to those same properties. The individual delinquent account balances included in the transaction are considered *paid* by the proceeds from the transfer. The Board concluded that those facts appear to characterize a sale rather than a collateralized borrowing and that the residual interest document (the note or certificate) represents a *new* asset rather than a continuing ownership of pieces of the old asset.

89. In addressing the question of whether that new asset has a value that should be recognized in the government's financial statements, the Board acknowledged that governments may sell receivables that range from those with a low expectation of collectibility (such as some delinquent taxes, for example) to those with a much higher expectation of collection (mortgage loans, for example). The Board concluded that the

standard should provide for recognition of a residual interest as an asset, giving consideration to the likelihood of realization.

Recourse and Reacquisition Requirements

90. As discussed earlier in paragraphs 38–40, the presence of recourse or reacquisition provisions does not preclude recognition of a transfer transaction as a sale and thus would not cause a transferor to recognize a liability for the entirety of the proceeds received in the transaction. Rather, the Board believes that if the transaction qualifies as a sale, obligations that arise from recourse or reacquisition provisions should be recognized by applying the same criteria used in the consideration of any contingency or potential liability.

Servicing

91. Sometimes governments continue to bill, collect, and otherwise service the accounts that were included in a sale of receivables. There may or may not be a fee for that service stipulated in the sale agreement. The Board considered two situations related to service fees—first, in certain circumstances, whether a government should recognize an amortizable asset (or liability) at the time of the transfer when there is an explicit servicing fee arrangement; and second, whether a government should impute a service fee (at least to the extent of the estimated costs) and recognize deferred servicing revenue in the absence of a stated agreement. The first situation arises when a stated fee is more than what could be considered "adequate compensation." In the private sector, an entity would recognize the value (the difference between the contractually specified fees and what is considered adequate compensation) of that servicing contract as an asset (with the credit side of the entry as a gain) and would amortize the amount recognized over the life of the servicing contract to recognize servicing contract income within an industry-standardized

"adequate compensation" range.[9] The second situation arises when an entity agrees to service the transferred receivables for no specified fee or for a fee that is significantly below adequate compensation for similar servicing arrangements. The implication in these latter situations is that a "market-valued" servicing agreement should be imputed and a portion of the proceeds of the transfer should be attributed to the imputed servicing contract fee, rather than a gain on the transfer.

92. After debating the existence and significance of servicing fee arrangements in the governmental environment, the Board concluded that this Statement need not require an analysis of servicing arrangements. Governments should recognize servicing fees that are stipulated in the transfer agreement as revenue when earned, that is, as the servicing takes place. If no fee is provided for in the agreement, no revenue would be recognized. The Board believes that, generally, private-sector standards are intended to be responsive to industries in which fees for servicing loans (auto loans, credit cards, mortgages, and so forth) are a significant revenue source in an active market and, consequently, there is a greater need for standards that would minimize the extent to which gains, losses, and revenues might be affected by values attributed to servicing contracts. For governments generally, and with respect to delinquent taxes specifically, the Board believes that clearly is not the case.

Financial Reporting Entity Issue—Blending Requirements

93. It was brought to the Board's attention—chiefly during the due process leading to the issuance of Technical Bulletin 2004-1—that there may be reasons to reexamine the criteria in paragraph 53 of Statement 14. That paragraph, as amended, sets forth the

[9]Alternatively, a servicer could measure servicing assets and liabilities at fair value at each reporting date and report changes in fair value in earnings in the period in which the changes occur.

circumstances under which a component unit should be blended. After initially considering this issue, the Board determined that it would be more appropriate to address the issue as part of the future full-scope reexamination of Statement 14.

Effective Date and Transition

94. In the ED, the Board proposed that the provisions of this Statement be applied retroactively, with the changes made to comply reported as an adjustment of prior periods. Several respondents expressed concerns about governments that had previously entered into transactions involving the sales of future tobacco settlement revenues and reported those transactions pursuant to the guidance in Technical Bulletin 2004-1. If this Statement were to be applied retroactively, those governments would be required to significantly change the reporting of those prior transactions. The Board was persuaded by those concerns and decided that the provisions regarding sales of future revenues could be applied on a prospective basis. In reaching that conclusion, the Board also considered the possibility that the future revenue sale provisions could be applied prospectively from the date this Statement was issued, rather than its stated effective date, but rejected that alternative primarily due to concerns about transactions that may have been in process at that time.

Appendix C

ILLUSTRATIONS OF ACCOUNTING FOR SALES OF RECEIVABLES AND FUTURE REVENUES

95. The examples presented in this appendix are intended to illustrate how the requirements of this Statement would be applied in two hypothetical situations. The first example illustrates a sale of receivables, and the second example portrays an intra-entity sale of future revenues. The examples are for illustrative purposes only and are nonauthoritative. Application of this Statement to individual governments and in different situations would require consideration of the circumstances specific to those governments and situations. Use of the specific ratios and amortization methods in these illustrations are not required—other methods may be used.

Illustration 1: Sale of Delinquent Property Tax Liens

Facts and assumptions: A city enters into an agreement to sell delinquent property tax liens to an agency of the state. The state agency has formed a Tax Lien Finance Trust specifically for the purpose of purchasing tax liens from municipalities and issuing bonds to finance the acquisitions. The city received $2,065,900 in exchange for tax liens totaling $4,394,520. The city's allowance for uncollectibles pertaining to those liens is $1,098,630, resulting in a net carrying value of $3,295,890. The agreement stipulates that the liens are sold without recourse, except that the city has an obligation with respect to liens found to be defective. For defective liens, the city is required to (a) perfect the liens, (b) reacquire the liens from the trust, or (c) deliver to the trust substantially equivalent liens in substitution. The city has determined that the transaction meets the criteria in paragraph 6 to be recognized as a sale.

Accounting in the year of the sale:

1. The city would reduce property taxes receivable by $4,394,520, reduce the allowance for uncollectibles by $1,098,630, and recognize a loss on the sale of $1,229,990 (the carrying value of $3,295,890 less the proceeds of $2,065,900) in the government-wide statement of activities. In its governmental funds prior to the sale, the city was reporting a zero net carrying value for the delinquent taxes receivable because they were either deemed to be uncollectible ($1,098,630) or were deferred under the availability criterion ($3,295,890). Therefore, the entire amount of the proceeds ($2,065,900) would be recognized as revenue, and the remaining net receivable and related deferred revenue amounts would be eliminated.
2. The city has determined that if any liens are found to be defective, it would first attempt to perfect the liens and, if unable to do so, would then provide acceptable substitutions. The city believes it is not probable that it would repurchase defective liens and therefore would not recognize a liability under the provisions of paragraph 18.

Accounting in future years:

If liens are subsequently found to be defective and it is probable that the city would reacquire those liens, a liability and an expenditure/expense would be recognized, provided that the amount of the repurchase obligation is measurable. At the same time, the city would add back the reacquired tax liens receivable and would reduce the expense by the estimated collectible value of those liens. In the governmental funds, either the expenditure would be reduced if the receivable were considered available or a related deferred revenue would be established.

Illustration 2: Sale of Future Tobacco Settlement Revenues

Facts and assumptions: The primary government (the county) received $200,000 from its component unit, the Tobacco Settlement Authority (TSA), in exchange for its future tobacco settlement revenues (TSRs) for the next 10 years, which, based on projected annual payments, are expected to total $320,000. Those TSRs are the sole security for the TSA's bonds, which will require $249,500 to make all principal and interest payments over the 10-year life of the debt. The county is the sole beneficiary of a residual trust, into which excess TSRs will be deposited by the TSA. The county has determined that the transaction meets the criteria in paragraph 8 to be recognized as a sale.

Conditional facts or assumptions:

- The TSA and the county both have June 30 fiscal year-ends.
- The TSA issued the bonds on July 1, with a fixed interest rate of 4.5 percent, payable each June 30 in equal maturities over 10 years.
- The county spent the $200,000 proceeds during the year for noncapital purposes in its health and welfare programs.
- The annual payment of TSRs received by the TSA on April 15 was $36,000.
- Principal and interest paid on the TSA's bonds for the current year were $20,000 and $9,000, respectively.
- TSRs receivable for the period from January 1 through June 30 are estimated to be $16,500 (for purposes of this illustration, the county's TSR receivable from the prior year is not taken into account).
- Deferred revenues and charges will be amortized by applying the ratio of the bond proceeds ($200,000) to the total estimated TSRs sold ($320,000). Therefore, deferred balances will be reduced by amounts that represent 62.5 percent of TSRs recognized.
- The county's estimated residual interest in the TSRs receivable is determined by applying the ratio that the projected total residuals bear to the total TSRs sold. The projected total residuals is equal to the difference between the total debt service requirements ($249,500) and the total TSRs sold ($320,000), or $70,500. Therefore, residuals are estimated to be 22 percent ($70,500/$320,000) of TSRs receivable.

Accounting in the year of the sale:

1. The TSA issues the bonds at par and recognizes a liability for the bonds payable in its government-wide statement of net assets and an other financing source in its governmental funds.
2. Upon receipt by the county of the proceeds from the TSA, the county would recognize $200,000 as deferred revenue and the TSA would recognize a deferred charge for the same amount.
3. The county would report the use of the proceeds as expenditures/expenses.
4. The TSA would recognize TSRs for $52,500 ($36,000 received and $16,500 receivable).
5. The TSA would recognize expenditures/expenses for the $9,000 interest and $20,000 principal payments. Bonds payable would be reduced by $20,000 in its government-wide statement of net assets.
6. The county would reduce deferred revenue and recognize revenue for $32,812 (TSRs recognized by the TSA of $52,500 × the amortization rate of 62.5 percent). The TSA would reduce the deferred charge balance and would recognize an expenditure/expense (payment to the county, for example) for the same amount.
7. The county would recognize, as an asset (residual trust account, for example) and revenue, its interest in the residual trust of $10,630 (a combination of the excess TSRs received over the TSA's debt service requirements [$36,000 – $29,000 = $7,000] and the estimated residual portion of the TSR receivable [$16,500 × 22 percent = $3,630]). The TSA would report the $10,630 as an expenditure/expense

(payment of residual TSRs, for example), representing the $7,000 cash paid into the trust and the $3,630 payable to the trust.

(Illustrative Disclosures and Financial Statements for Illustration 2 follow.)

Illustrative Disclosures

Note X: Sale of Future Tobacco Settlement Revenues

During the year, the county entered into an agreement with a component unit, the County Tobacco Settlement Authority (TSA), under which the county relinquishes to the TSA its future tobacco settlement revenues (TSRs) for the next 10 years. The county received from the TSA a lump-sum payment of $200,000 and a residual certificate in exchange for the rights to receive and retain 100 percent of the county's TSRs through 2016. The residual certificate represents the county's ownership interest in excess TSRs to be received by the TSA during the term of the sale agreement. The total TSRs sold, based on the projected payment schedule in the Master Settlement Agreement, adjusted for historical trends, is estimated to be $320,000. Residuals are expected to be approximately $70,500. The estimated present value of the TSRs sold, net of the expected residuals, assuming a 4.8 percent interest rate, at the time of the sale of was $195,850.

Illustrative Financial Statements

Exhibit 1 shows how the transactions in Illustration 2 would be reported in the separate financial statements of the TSA.

Exhibit 1

Component unit separate report	Component Unit Governmental Funds	Reconciliation	Component Unit Government-wide Statements
Balance sheet/statement of net assets			
Cash	$ —		$ —
TSR receivable	16,500		16,500
Deferred charges	167,188		167,188
Total assets	183,688		183,688
Bonds payable	—	(180,000)	180,000
Due to residual trust account	3,630		3,630
Total liabilities	3,630		183,630
Fund balance/net assets	$ 180,058	180,000	$ 58
Change statements			
TSRs	$ 52,500		$ 52,500
Total revenues	52,500		52,500
Amortization of deferred charge	32,812		32,812
Payment of residual TSRs	10,630		10,630
Debt service—principal	20,000	(20,000)	—
Debt service—interest	9,000		9,000
Total expenditures/expenses	72,442		52,442
Other financing sources—bond proceeds	200,000	200,000	—
Change in fund balance/net assets	$ 180,058	(180,000)	$ 58

This column contains the data that is included in the reporting entity's financial statements if the component unit is blended. (See Exhibit 2.) As explained in footnotes 3 and 4 to paragraph 15, some balances and transactions will be reclassified.

This column contains the data that is included in the reporting entity's financial statements if the component unit is discretely presented. (See Exhibit 3.)

Exhibit 2 shows how the data from the financial statements of the TSA in Illustration 2 would be blended into the county's financial reporting entity.

Exhibit 2

Blended TSA component unit	**Primary Government Governmental Funds**	**Blended Component Unit**	**Total Govt'l. Funds**	**Reconciliation**	**Elimination of Internal Balances and Transactions**	**Governmental Activities Primary Government**
Balance sheet/statement of net assets						
Cash	$ —	$ —	$ —			$ —
TSR receivable	—	16,500	16,500			16,500
Due from other funds	—	167,188	167,188		(1) (167,188)	—
Residual trust account:						
Cash	7,000	—	7,000			7,000
Due from TSA	3,630	—	3,630		(2) (3,630)	—
Total assets	10,630	183,688	194,318			23,500
Bonds payable	—	—	—	(180,000)		180,000
Due to residual trust account	—	3,630	3,630		(2) 3,630	—
Due to other funds	167,188	—	167,188		(1) 167,188	—
Total liabilities	167,188	3,630	170,818			180,000
Fund balance/net assets	$ (156,558)	$ 180,058	$ 23,500	(180,000)		$ (156,500)
Change statements						
TSRs	—	$ 52,500	52,500			$ 52,500
Total revenues	—	52,500	52,500			52,500
Operating expenditures	200,000	—	200,000			$ 200,000
Debt service—principal	—	20,000	20,000	20,000		—
Debt service—interest	—	9,000	9,000			9,000
Total expenditures/expenses	200,000	29,000	229,000			209,000
Transfers	43,442	(43,442)	—			
Other financing sources—bond proceeds	—	200,000	200,000	(200,000)		
Change in fund balance/net assets	$ (156,558)	$ 180,058	$ 23,500	(180,000)		$ (156,500)

Some primary government and component unit balances and transactions have been reclassified (in accordance with paragraph 61 of Statement 34) as if they were internal balances and *interfund transfers,* as defined in paragraph 112 of Statement 34. For example, deferred charges and deferred revenues have been reclassified as due to/from other funds. (See footnotes 3 and 4 to paragraph 15.)

Exhibit 3 Demonstrates how the TSA in Illustration 2 would be included in the county's financial reporting entity by discrete presentation.

Exhibit 3

Discretely presented TSA component unit	Total Primary Government	(From Exhibit 1) Discrete Component Unit		(Optional) Total Reporting Entity (After Eliminations)
Statement of net assets				
Cash	$ —	$ —		$ —
TSR receivable	—	16,500		16,500
Deferred charges	—	167,188	(1)	—
Residual trust account:				
Cash	7,000	—		7,000
Due from TSA	3,630	—	(2)	—
Total assets	10,630	183,688		23,500
Bonds payable	—	180,000		180,000
Due to residual trust account	—	3,630	(2)	—
Deferred revenue	167,188	—	(1)	—
Total liabilities	167,188	183,630		180,000
Net assets	$ (156,558)	$ 58		$ (156,500)
Change statement				
Revenue from sale of TSRs	$ 43,442	—	(3)	—
TSRs	—	$ 52,500		$ 52,500
Total revenues	43,442	52,500		52,500
Operating expenditures	200,000	—		200,000
Amortization of deferred charge	—	32,812	(3)	—
Payment of residual TSRs	—	10,630	(3)	—
Debt service—interest	—	9,000		9,000
Total expenses	200,000	52,442		209,000
Change in net assets	$ (156,558)	$ 58		$ (156,500)

Intra-entity balances and transactions have been eliminated/netted in the optional total reporting entity column. Elimination for a total reporting entity column is consistent with the requirement in paragraph 58 of Statement 34 pertaining to the total primary government column.

Appendix D

ILLUSTRATIVE DISCLOSURES—PLEDGED REVENUES

96. This appendix illustrates disclosures required by paragraph 21 of this Statement. The facts assumed in these examples are illustrative only and are not intended to modify or limit the requirements of the Statement or to indicate the Board's endorsement of the situations or specific methods illustrated. Application of the provisions of this Statement may require disclosures and formats other than those illustrated here. Paragraph 21 requires governments to disclose, in the notes to financial statements, information about specific revenues pledged. The following examples illustrate how those disclosure requirements may be met in a variety of situations. (Note: If a specific revenue stream is pledged as security for multiple debt issuances, the required disclosures may be combined in a single note.)

Example 1: Utility Revenues Pledged

The city has pledged future water customer revenues, net of specified operating expenses, to repay $5.7 million in water system revenue bonds issued in December 2003. Proceeds from the bonds provided financing for the construction of the 17th Street filtration plant. The bonds are payable solely from water customer net revenues and are payable through 2028. Annual principal and interest payments on the bonds are expected to require less than 22 percent of net revenues. The total principal and interest remaining to be paid on the bonds is $8,849,250. Principal and interest paid for the current year and total customer net revenues were $470,250 and $2,612,500, respectively.

Example 2: Tax Increment Revenues Pledged

The city has pledged a portion of future sales tax revenues to repay $2.8 million in sales tax increment bonds issued in June 2003 to finance the refurbishing of the Southtown business district. The bonds are payable solely from the incremental sales taxes generated by increased retail sales in the refurbished district. Incremental sales taxes were projected to produce 128 percent of the debt service requirements over the life of the bonds. Total principal and interest remaining on the bonds is $3,490,900, payable through June 2013. For the current year, principal and interest paid and total incremental sales tax revenues were $395,150 and $403,291, respectively.

Example 3: Revenues Pledged in Connection with Component Unit Debt

The state has pledged, as security for bonds issued by the State Public School and Higher Education Authority, a portion of the state's 1 percent supplemental sales tax that is restricted for educational purposes. The bonds, issued by the Authority in 2001 in the amount of $1.2 billion to provide financing for various capital projects of the public schools and state colleges, are payable through 2031. The state has committed to appropriate each year, from the supplemental sales tax revenues, amounts sufficient to cover the principal and interest requirements on the Authority's debt. The Authority has pledged, as the sole security for the bonds, the annual appropriations from the state. Total principal and interest remaining on the debt is $2.037 billion with annual requirements ranging from $94 million in 2007 to $41.8 million in the final year. Supplemental sales taxes, from which the appropriations will be made, have averaged $124.5 million per year over the last 10 years. For the current year, principal and interest paid by the authority and the total supplemental sales tax revenue recognized by the state were $88.6 million and $124.8 million, respectively.

Appendix E

CODIFICATION INSTRUCTIONS

97. The sections that follow update the June 30, 2006, *Codification of Governmental Accounting and Financial Reporting Standards* for the effects of this Statement. Only the paragraph number of the Statement is listed if the paragraph will be cited in full in the Codification.

* * *

SUMMARY STATEMENT OF PRINCIPLES SECTION 1100

.112 [Delete *and should identify revenues used as security for revenue bonds* from the first sentence of subparagraph c.] [NCGAS 1, pp. 2–4, as amended by GASBS 6, ¶15 and ¶25, and GASBS 34, ¶15, ¶80, and ¶82; GASBS 14, ¶11, ¶12, ¶19, ¶43, ¶65, and ¶66; GASBS 34, ¶6, ¶13–¶16, ¶18, ¶21, ¶22, ¶30, ¶53, ¶63, ¶75, ¶79, ¶80, ¶82, ¶88, ¶89, ¶92, ¶101, ¶106–¶108, ¶112, ¶125, and fn53; GASBS 34, ¶100, as amended by GASBS 48, ¶21; GASBS 34, ¶130, as amended by GASBS 41, ¶3; GASBS 37, ¶6 and ¶10; GASBS 42, ¶9]

* * *

Sources: [Add GASB Statement 48]

Statements of Principle
Transfer, Revenue, Expenditure, and Expense Account Classification

[Delete *and should identify revenues used as security for revenue bonds* from the first sentence of subparagraph c.] [NCGAS 1, ¶99; GASBS 34, ¶6, ¶53, ¶88, ¶89, ¶101, and ¶112; GASBS 34, ¶100, as amended by GASBS 48, ¶21; GASBS 37, ¶10]

.103 [Revise second sentence as follows:] As a result, amounts reported in the funds as interfund receivables and payables, or as deferred revenues and charges resulting from intra-entity transactions, should be eliminated in the governmental and business-type activities columns of the statement of net assets, except for the net residual amounts due between governmental and business-type activities, which should be presented as internal balances. [GASBS 34, ¶58; GASBS 48, fn4]

.106 [Revise second sentence as follows:] Resource flows (except those that affect the balance sheet only, such as loans, repayments, and deferred revenues and charges resulting from intra-entity transactions) between a primary government and its discretely presented component units should be reported as if they were external transactions—that is, as revenues and expenses. [GASBS 34, ¶61; GASBS 48, fn4]

* * *

COMPREHENSIVE ANNUAL FINANCIAL REPORT **SECTION 2200**

Sources: [Add GASB Statement 48]

.146 [Revise second sentence as follows:] As a result, amounts reported in the funds as interfund receivables and payables, or as deferred revenues and charges resulting from intra-entity transactions, should be eliminated in the governmental and business-type activities columns of the statement of net assets, except for the net residual amounts due between governmental and business-type activities, which should be presented as internal balances. [GASBS 34, ¶58; GASBS 48, fn4]

.149 [Revise second sentence as follows:] Resource flows (except those that affect the balance sheet only, such as loans, repayments, and deferred revenues and charges resulting from intra-entity transactions) between a primary government and its discretely presented component units should be reported as if they were external transactions—that is, as revenues and expenses. [GASBS 34, ¶61; GASBS 48, fn4]

.169 [Delete *and should identify revenues used as security for revenue bonds* from the second sentence.] [GASBS 34, ¶100, as amended by GASBS 48, ¶21]

* * *

NOTES TO FINANCIAL STATEMENTS **SECTION 2300**

Sources: [Add GASB Statement 48]

.107 [Add new subparagraph jj as follows:] Future revenues that are pledged or sold. (See paragraphs .122 and .123, below.)

[Insert new paragraphs .122 and .123 as follows:]

Future Revenues That Are Pledged or Sold

.122 [GASBS 48, ¶21]

.123 [GASBS 48, ¶22]

* * *

REPORTING ENTITY AND COMPONENT UNIT PRESENTATION AND DISCLOSURE **SECTION 2600**

Sources: [Add GASB Statement 48]

.116 [Revise second sentence as follows:] Resource flows (except those that affect the balance sheet only, such as loans, repayments, and deferred revenues and charges resulting from intra-entity transactions) between a primary government and its discretely presented component units should be reported as if they were external transactions—that is, as revenues and expenses. [GASBS 34, ¶61; GASBS 48, fn4]

* * *

PROPRIETARY FUND ACCOUNTING AND FINANCIAL REPORTING **SECTION P80**

.115 [Delete *and should identify revenues used as security for revenue bonds* from the second sentence.] [GASBS 34, ¶100, as amended by GASBS 48, ¶21]

* * *

[Create new section as follows:]

SALES AND PLEDGES OF RECEIVABLES AND FUTURE REVENUES AND INTRA-ENTITY TRANSFERS OF ASSETS AND FUTURE REVENUES **SECTION S20**

Source: GASB Statement 48

See also: Section T50, "Tobacco Settlement Recognition"

.101 [GASBS 48, ¶3, including heading and footnote; change *Statement* to *section.*]

.102–.119 [GASBS 48, ¶5–¶22, including headings and footnotes; change *Statement* to *section* and update cross-references.]

* * *

TOBACCO SETTLEMENT RECOGNITION **SECTION T50**

[Add the following:]

See also: Section S20, "Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues"

.601 [Delete questions 2, 3, and 4 and the associated responses.]

* * *

Sources: [Delete GASB Technical Bulletin 2004-1]

.601 [Delete paragraph and related headings and renumber subsequent paragraph.]

* * *