PHA GAAP FLYER

January 2000 Volume 1 Issue 4

Accounting for PHA Debt

In this GAAP Flyer, the focus will be on the treatment of HUD-guaranteed debt (third party) and HUD-held debt (direct debt) under generally accepted accounting principles (GAAP). This flyer has been prepared for HUD by the firm of Arthur Andersen LLP.

With the transition to the GAAP basis of accounting, PHAs who use the enterprise model should remove this debt from their books and reclassify it as contributed capital. PHAs who employ the governmental model should remove the debt from the General Long-Term Debt Account Group (GLTDAG) on the balance sheet. Third party debt that is not HUD-guaranteed or HUD-held should remain on the PHA's books as an obligation of the PHA.

The reclassification only applies to debt being repaid back to the Department from the application of Annual Contribution (ACC) payments. Examples of direct debt <u>not</u> being paid back from ACC payments include off-site facility loans, preliminary loans, etc.

The treatment of debt is a complex issue due to the multiple debt instruments employed by PHAs and the related HUD accounting guidelines.

This flyer will provide:

- An understanding of the various debt instruments affected by the reclassification.
- A description of HUD-guaranteed and HUD-held debt and their treatment under current HUD accounting guidelines.
- HUD's justification for reclassification under GAAP, and a discussion of the applicable GAAP literature used by HUD to reach this decision.
- Examples of journal entries to facilitate the reclassification of the debt. (Due to the complexity and uniqueness of each PHA and the classification of this debt, REAC recommends that PHAs consult with their fee accountants and/or independent auditors to determine the proper accounting treatment for their particular transactions)

"For the purposes of our discussion, we identified the debt that is to be reclassified as any debt in which HUD makes all the payments of principal and interest."

For the purposes of our discussion, we have identified the debt that is to be reclassified as any debt in which HUD is obligated for all principal and interest payments. This encompasses both HUD-guaranteed debt (third party) and HUD-held debt (direct debt), which are described below.

Exhibit 1: PHA DEBT

HUD-Guaranteed (Third Party):

New Housing Authority Bonds
Federal Financing Bank Notes

HUD-Held (Direct Debt):

Permanent Notes (HUD)
Project Loan Notes (HUD)

I. HUD-Guaranteed Debt (Third Party)

HUD-guaranteed debt is defined by the following characteristics: 1) the PHA issues the debt instrument; 2) the instrument is held by an entity other than HUD (a third party); 3) the debt is carried on the PHA's books as a liability; and 4) HUD is ultimately responsible for the debt and makes the debt service payments to the fiscal agent who pays the investors.
As HUD pays the investors, the PHA records the interest expense, reduces the principal portion of the debt recorded on its books, and recognizes a debt service contribution from HUD. Currently, there are two types of third party debt on the PHA's books: A) New Housing Authority Bonds, and B) Federal Financing Bank Permanent Notes. These debt instruments are further described below.

"Under the Housing and Community Development Reconciliation Amendments of 1985 (enacted through Public Law 99-272), the Secretary of HUD was authorized to forgive outstanding principal and interest on HUD-held notes. "

Types of HUD-Guaranteed Debt (Third Party)

A. New Housing Authority ("NHA") Bonds

New Housing Authority ("NHA") bonds were issued to the public by PHAs to provide long-term financing for the development of new housing projects. Prior to 1951, these bonds were called Series A bonds. The last of the NHA bonds were issued in 1974. The bonds, in coupon form, were sold to the highest bidder. The bonds are secured by annual contributions unconditionally payable by HUD and are exempt from Federal income taxes.[1] The balance for these bonds resides in <u>HUD Account 2341:</u> *New Housing Authority Bonds – Issued*. The offsetting entry when these bonds are retired is <u>HUD Account 2342:</u> *New Housing Authority Bonds – Retired*.

B. Permanent Notes - Federal Financing Bank ("FFB")

In the early 1980's, the prevailing interest rate was higher than what HUD wanted to pay. As a result, new PHA debt became unmarketable. Between 1980 and 1983, FFB agreed to purchase outstanding debt obligations that had been certified by HUD as the actual development or modernization cost for a project.[2] HUD repays FFB annually. Other third party obligations were eventually bought back by HUD, as described below. *The balance for Permanent Notes – F.F.B resides in <u>HUD Account: 2312</u>*.

II. HUD-held Debt (Direct Debt)

HUD-held debt, also known as direct debt, is owed by the PHA to HUD. HUD paid debt service for direct debt until the Debt Forgiveness Act of 1986, as described below.

Under the Housing and Community Development Reconciliation Amendments of 1985 (enacted through Public Law 99-272), the Secretary of HUD was authorized to forgive outstanding principal and interest on HUD-held notes. In 1986 with the issuance of the Public and Indian Housing Notice 87-12, HUD implemented forgiveness of HUD-held notes. However, this forgiveness was limited to notes financed through HUD Annual Contributions.[3] Thus, debt that is financed through other means, such as Administrative Notes (HUD), must be repaid to HUD. The Notice also **excluded** debt financed through the sale of bonds (i.e., the New Housing Authority Bonds) and the Federal Financing Bank ("FFB"). HUD also required that the PHA remit the portion of HUD-held notes representing excess financing.

Furthermore, HUD stipulated that debt forgiveness would be granted if the PHA met the following requirements: 1) Submission of an Actual Development Cost Certificate (ADCC) or Actual Modernization Cost Certificate (AMCC); 2) Remitting back to HUD any excess financing related to the Modernization or Development project; and 3) Adding a debt forgiveness amendment to the PHA's Annual Contributions Contract (ACC). Item number three was mandated by PIH Notice 87-12 and subsequently superceded by PIH Notice 89-16.

Until the PHA met the above requirements, the HUD-held debt remained on the PHA's books as a liability. Today there are still many PHAs with an outstanding debt balance for HUD-held debt. The balance for this debt resides in the following HUD accounts: A) Permanent Notes-HUD and B) Project Loan Notes-HUD.

Types of HUD-Held Debt (Direct Debt)

A. Permanent Notes - HUD

Starting in 1984, all loans provided by HUD to the PHAs were in the form of permanent notes. *The HUD Account for this balance is Account 2311.*

Included in the Permanent Note balance are **Project Notes**. Project notes, issued by the PHA, were originally sold to the private market, as HUD-guaranteed debt (third party), to finance development and modernization. New notes were issued to repay prior notes. In 1985 and 1986, the remaining balance of all private market project notes (those not sold to FFB) issued for development and modernization funding were purchased by HUD and converted to ***HUD Permanent Notes***. *No PHA should have an outstanding balance in HUD Account 2126: Project Notes – Non-HUD.*

B. Project Loan Notes - HUD

HUD provided funding to PHAs for development through Project Loan Notes in between project note sales. While some PHAs still have this balance on their books, these notes should have been reclassified into the permanent note balance. *The balance for Project Loan Notes (HUD) resides in HUD Account 2122.*

III. Treatment of Debt Under HUD Accounting

Under the current HUD accounting guidelines, PHAs are required to record HUD-guaranteed debt and the related accrued interest liability and expense on their financial statements. The applicable treatment under HUD accounting is outlined in Exhibit 2.

A. HUD-Guaranteed Debt (Third Party) – Current HUD Accounting Treatment

HUD accounting requires that NHA Bonds and Permanent Notes-FFB (HUD accounts 2341 and 2312 respectively) be recorded as liabilities of the PHA even though HUD guarantees payment of both principal and interest. As HUD pays investors, the debt is amortized yearly.

Assume a PHA has NHA bonds in the amount of \$75,000 and FFB notes in the amount of \$25,000. The PHA accrues interest and retires a portion of the principal annually with the following entries shown below in Exhibit 2.

Note: No money is exchanged at the PHA level; HUD

Exhibit 2: HUD-Guaranteed Debt (Third Party) – HUD Accounting Treatment

		Dr.	Cr.
1.	**To recognize the interest expense:**		
	5610 – Interest Expense on bonds and notes payable	\$10,000	
	2132 – Interest Payable – Notes		\$2,500
	2133 – Interest Payable – Bonds		7,500
2.	**To accrue the HUD debt service payment:**		
	1176 – HUD Annual Contributions Receivable	110,000	
	2840 – Cumulative HUD Annual Contributions		110,000
3.	**To amortize the debt, as HUD makes the debt service payment to the fiscal agent:**		
	2132 – Interest Payable – Notes	2,500	
	2133 – Interest Payable – Bonds	7,500	
	2342 – New Housing Authority Bonds – Retired	75,000	
	2312 – Permanent Notes – F.F.B.	25,000	
	1176 – HUD Annual Contributions Receivable		110,000

is responsible for paying the principal and interest payments to the investors/FFB.

B. HUD-Held Debt (Direct Debt) – HUD Accounting Treatment

Currently, HUD-held debt remains on the PHA's books until forgiven per *Notice PIH 87-12*. HUD periodically forgives the debt, upon request by the PHA, after an ADCC/AMCC has been submitted.

Exhibit 3: HUD-Held Debt (Direct Debt) – HUD Accounting Treatment

	Dr.	Cr.
1. To record the remittance of excess financing over ADCC or AMCC:		
2122 – Project Loan Notes (HUD)	$5,000	
2311 – Permanent Notes (HUD)	5,000	
1111.1 – General Fund (Development/Operations) - CASH		$10,000
2. Once the debt is forgiven, the PHA removes the liability and records the capital contribution:		
2122 – Project Loan Notes (HUD)	35,000	
2131.1 – Interest Payable – Development Notes and Bonds (HUD)	10,000	
2311 – Permanent Notes (HUD)	45,000	
2840 – Surplus – Cumulative HUD Annual Contributions		90,000

Assuming a PHA has outstanding balances for $40,000 in Project Loan Notes, $50,000 in Permanent notes, $10,000 in interest payable and an excess financing of $10,000, the entries, shown in Exhibit 3, would apply once the PHA has submitted the ADCC/AMCC. The PHA reconciles the total funds provided by HUD with the development/modernization cost on the ADCC/ AMCC.

Note: The PHA must remit the excess financing be fore proceeding with the reclassification of the re maining debt balance.

IV. Justification for Reclassification

With the conversion to the GAAP basis of accounting, HUD's interpretation of GASB Interpretation No. 2 requires that PHAs reclassify both the HUD-guaranteed (third party) and HUD-held debt (direct debt) as contributed capital for those PHAs electing the enterprise basis of accounting (which HUD prefers). For those PHAs electing the governmental basis of accounting, they would just remove the HUD-guaranteed and HUD-held debt from their GLTDAG.

Under both HUD guaranteed and HUD-held debt, PHAs are liable for both principal and interest, and this liability is recorded on their balance sheet. However, HUD is ultimately responsible for repaying the debt and makes the actual cash payment to the bond and note holders. This results in a non-cash transaction between PHAs and HUD.

Upon analyzing the structure of the debt transactions between HUD and PHAs for HUD-guaranteed and HUD-held debt, it is HUD's position that they are very similar to the structure of conduit debt obligation transactions. The treatment of conduit debt obligations is addressed in GASB Interpretation No. 2 - Disclosure of Conduit Debt Obligations.

According to GASB Interpretation No. 2, Par. 6,

"A governmental entity may issue certain debt bearing its name to lower the cost of borrowing for specific governmental or non-governmental third parties. This debt is commonly referred to as conduit (or no-commitment) debt."

It also says, *"Generally, the issuing government assumes no responsibility for repayment of this debt."*

This definition is very similar to HUD-held and HUD-guaranteed debt, where PHAs issue various bonds and notes on HUD's behalf and upon HUD's approval but are not responsible for its repayment.

GASB Interpretation No. 2 defines conduit debt obligations as: "certain limited-obligation revenue bonds, certificates of participation, or similar debt instruments issued by a state or local governmental entity for the express purpose of providing capital financing for a specific third party that is not part of the issuer's reporting entity. Although conduit debt obligations bear the name of the governmental issue, the issuer has no obligation for such debt beyond the resources provided by a lease or loan with the third party on whose behalf they are issued." In the case of the debt discussed, this debt was being issued upon HUD's request to provide funding for projects approved and to be funded by HUD. HUD is also obligated to fund the debt service required through its annual contribution contract payments. Since the bond agreement states "the full faith and credit of the Local Authority are hereby pledged for the payment of the principal of and interest on the Bond", an argument is present that the PHA has an obligation for this debt; however, it is HUD's opinion that the PHA is not obligated for this debt in reality because HUD's annual contribution contract obligates HUD to pay the debt. An obligation to pay the debt by the U.S. government does not present a risk of non-payment to the PHA, and the PHA does not have non-HUD obligated assets to secure the debt. The PHA can not sell the assets or turn over the assets in satisfaction of any of the debt because HUD controls the disposition of the assets or the use of proceeds from the sale of the assets. HUD also believes that if any entity is evaluating the financial health of a PHA, this debt obligation should not be considered in the equation. The PHA's present assets or future operations are not needed to pay this debt because HUD is completely obligated to pay the principal and interest on this debt.

"While there is no accounting standard that specifically addresses the debt instruments discussed, this GASB Interpretation describes a relationship that is similar to that of the PHA and HUD. "

While there is no accounting standard that specifically addresses the debt instruments discussed, this GASB Interpretation describes a relationship that is similar to that of the PHA and HUD. The GASB pronouncements are used as guidance for HUD's transition to GAAP.

It should be noted that the reclassification of the debt to equity for the enterprise model and the elimination of the debt under the governmental model is based on HUD's interpretation of GAAP. However, HUD is not a standard setting body and does not establish GAAP reporting for PHAs. PHAs should consult with their independent auditors to determine the interpretation of the classification of the debt for the PHA's audited financial statements.

V. Reclassifying the Debt Under GAAP

Specific reclassification examples for the conversion to GAAP for both Enterprise and Governmental accounting are provided in Exhibits 5 through 8.

Exhibit 4: Footnote for Financial Statements Under GAAP

To provide for the development and modernization of low-rent housing units, the PHA issued New Housing Authority Bonds and Permanent Notes – F.F.B. These bonds and notes are payable by HUD and secured by annual contributions. The bonds and notes do not constitute a debt by the Authority and accordingly have not been reported in the accompanying financial statements.

All transactions to reclassify the debt should be adequately disclosed within the footnotes to the financial statements. A sample is shown above.

A. HUD-Guaranteed Debt (Third Party) Under the

A. HUD-Guaranteed Debt (Third Party) Under the Enterprise Model

The PHA has two types of HUD-guaranteed debt on its balance sheet: New Housing Authority Bonds and FFB

For FFB Notes, there is a credit balance for both the notes and the interest payable. For NHA Bonds, there is a credit balance for the bonds and accompanying interest payable, and there is a debit balance for the NHA bonds that have been retired. HUD accounting requires the PHA to record the accrual of debt service as a debit to HUD Annual Contributions Receivable and a credit to Cumulative HUD Annual Contributions.

As shown in Exhibit 5: The PHA should debit the related outstanding principal and interest payable accounts and credit Contributed Capital Account 2802. The debt service, accompanying annual contribution balance and interest expense should also be reversed.

Exhibit 5: HUD-Guaranteed Debt Under the Enterprise Model - Reclassification to Contributed Capital

Assume a PHA has balances in the following accounts as related to HUD Guaranteed Debt:

General Ledger Account Balances Prior to Reclassification

		Account	Dr.	Cr.
1.	**FFB Notes**	2312 – Permanent Notes		$700,000
		2132 – Interest Payable		50,000
		5610 – Interest Expense	$50,000	
2.	**NHA – Bonds**	2341 – New Housing Authority Bonds – Issued		2,000,000
		2342 – New Housing Authority Bonds – Retired	400,000	
		2133 – Interest Payable – Bonds Non-HUD		120,000
		5610 – Interest Expense	120,000	
3.	**ACC Contributions**	1176 – HUD Annual Contributions Receivable	300,000	
		2840 – Cumulative HUD Annual Contributions		300,000

GAAP Adjusting Entries: Enterprise Model. See Exhibit 7 for Governmental Model.

		Account	Dr.	Cr.
1.	**FFB Notes**	2312 – Permanent Notes – FFB	$700,000	
		2132 – Interest Payable – Notes Non-HUD	50,000	
		2802 – Contributed Capital		$700,000
		5610 – Interest Expense		50,000
2.	**NHA – Bonds**	2341 – New Housing Authority Bonds – Issued	2,000,000	
		2133 – Interest Payable – Bonds Non-HUD	120,000	
		2342 – New Housing Authority Bonds – Retired		400,000
		2802 – Contributed Capital		1,600,000
		5610 – Interest Expense		120,000
3.	**ACC Contributions**	2840 – Cumulative HUD Annual Contributions	300,000	
		1176 – HUD Annual Contributions Receivable		300,000

B. HUD-Held Debt (Direct Debt) Under the Enterprise Model

The PHA has a related outstanding credit balance for Project Loan Notes, Permanent Notes, Project Notes and the related interest payable. As shown in Exhibit 6, to reclassify this outstanding debt as a capital contribution, the PHA should debit the related principal/interest accrual accounts and credit Contributed Capital 2802 and the related interest expense.

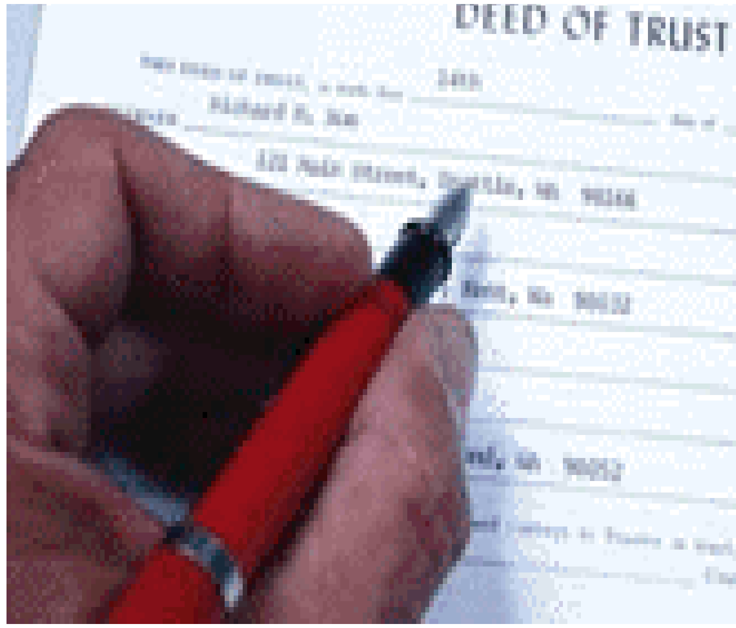

Exhibit 6: HUD-Held Debt (Direct Debt) Under the Enterprise Model – Reclassification to Contributed Capital

General Ledger Account Balances Prior to Reclassification:

		Dr.	Cr.
HUD-Held	2122 – Project Loan Notes – HUD		$250,000
	2311 – Permanent Notes – HUD		500,000
	2126 – Project Notes – Non-HUD		50,000
	2131.1 – Interest Payable – Dev. Notes & Bonds (HUD)		64,000
	5610 – Interest Expense	$64,000	

GAAP Adjusting Entries: Enterprise Model. See Exhibit 8 for Governmental Model.

		Dr.	Cr.
HUD-Held	2122 – Project Loan Notes – HUD	$250,000	
	2311 – Permanent Notes – HUD	500,000	
	2126 – Project Notes – Non-HUD	50,000	
	2131.1 – Interest Payable – Dev. Notes & Bonds –HUD	64,000	
	2802 – Contributed Capital		800,000
	5610 – Interest Expense		64,000

C. HUD-Guaranteed Debt (Third Party) Under the Governmental Model

As with the Enterprise Example in Exhibit 5, the PHA has two types of HUD-guaranteed debt on its balance sheet: New Housing Authority Bonds and FFB Notes.

For FFB Notes, there is a credit balance for both the notes and the interest payable. For NHA Bonds, there is a credit balance for the bonds and accompanying interest payable, and there is a debit balance for the NHA bonds that have been retired. HUD accounting requires the PHA to record the accrual of debt service as a debit to HUD Annual Contributions Receivable and a credit to Cumulative HUD Annual Contributions.

As shown in Exhibit 7, to remove FFB notes, NHA bonds, and related interest from the balance sheet, the PHA must debit the FFB notes, NHA bonds, and related interest. Then the PHA credits amounts to be provided in the general long term debt account group (GLTDAG).

Exhibit 7: HUD-Guaranteed Debt Under the Governmental Model - Reclassification to Equity

General Ledger Account Balances Prior to Reclassification

			Dr.	Cr.
1.	**FFB Notes**	2312 – Permanent Notes (FFB)		$700,000
		2132 – Interest Payable – Notes Non-HUD		50,000
		5610 – Interest Expense	$50,000	
2.	**NHA – Bonds**	2341 – New Housing Authority Bonds – Issued		2,000,000
		2342 – New Housing Authority Bonds – Retired	400,000	
		2133 – Interest Payable – Bonds Non-HUD		120,000
		5610 – Interest Expense	120,000	
3.	**ACC Contribution**	1176 – HUD Annual Contributions Receivable	300,000	
		2840 – Cumulative HUD Annual Contributions		300,000

GAAP Adjusting Entries: Governmental Model. See Exhibit 5 for Enterprise Model.

			Dr.	Cr.
1.	**FFB Notes**	2312 – Permanent Notes – FFB (GLTDAG)	$700,000	
		2132 – Interest Payable – Notes Non-HUD (Govt. Fund)	50,000	
		Amount to be provided (GLTDAG)		$700,000
		5610 – Interest Expense (Govt. Fund)		50,000
2.	**NHA – Bonds**	2341 – New Housing Authority Bonds – Issued (GLTDAG)	2,000,000	
		2133 – Interest Payable – Bonds Non-HUD (Govt. Fund)	120,000	
		2342 – New Housing Authority Bonds–Retired (GLTDAG)		400,000
		Amount to be provided (GLTDAG)		1,600,000
		5610 – Interest Expense (Govt. Fund)		120,000
3.	**ACC Contribution**	2840 – Cumulative HUD Annual Contributions	300,000	
		1176 – HUD Annual Contributions Receivable		300,000

D. HUD-Held Debt (Direct Debt) Under the Governmental Model

The PHA has a related outstanding credit balance for Project Loan Notes, Permanent Notes, Project Notes and the related interest payable.

As shown in Exhibit 8, to remove the debt balance, the PHA must debit Project Loan Notes, Permanent Notes, Project Notes and the related interest. The accompanying entry is crediting Equity.

Exhibit 8: HUD-Held Debt (Direct Debt) Under the Governmental Model – Reclassification to Equity

General Ledger Account Balances Prior to Reclassification:

		Dr.	Cr.
HUD-Held	2122 – Project Loan Notes – HUD		$250,000
	2311 – Permanent Notes – HUD		500,000
	2126 – Project Notes – Non-HUD		50,000
	2131.1 – Interest Payable – Dev. Notes & Bonds (HUD)		64,000
	5610 – Interest Expense	$64,000	

GAAP Adjusting Entries: Governmental Model. See Exhibit 6 for Enterprise Model.

		Dr.	Cr.
HUD-Held	2122 – Project Loan Notes – HUD (GLTDAG)	$250,000	
	2311 – Permanent Notes – HUD (GLTDAG)	500,000	
	2126 – Project Notes – Non-HUD (GLTDAG)	50,000	
	2131.1 – Interest Payable – Dev. Notes & Bonds (HUD) (Govt. Fund)	64,000	
	Amount to be Provided (GLTDAG)		800,000
	5610 – Interest Expense (Govt. Fund)		64,000

[1] *Public and Indian Housing Development and Modernization Fund*, HUDClips, 7560.1 Rev-1.
[2] *Ibid.*
[3] Public Law 99-272- April 7, 1986 sec. 3004 Public Housing Financing Reforms