The George Washington University
WASHINGTON DC

DEPARTMENT OF ACCOUNTANCY

May 15, 2000

Ms. Hae Han
Office of Government Services
Arthur Andersen LLP
1150 17th Street, NW
Suite 900
Washington, DC 20036

Dear Ms. Han:

We were engaged by you to provide an independent expert opinion concerning the proper accounting treatment of certain types of debt of Public Housing Authorities (PHAs) conducting business with the U.S. Department of Housing and Urban Development (HUD). This letter summarizes our work and our conclusions.

Each of us is a member of the faculty of the Department of Accountancy at The George Washington University and of the consulting firm Singleton Associates. We also have extensive experience in governmental accounting and auditing. A summary resume for each of us is attached. All parties recognize that the views expressed herein are ours, and are not those of The George Washington University or its Department of Accountancy.

In connection with this engagement we reviewed several HUD documents, including Consolidated Annual Contributions Contracts – Form HUD-53012A and Form HUD 53012B, both dated 7/95, and certain loan agreements, in order to obtain a better understanding of the issues involved. We also examined the PHA GAAP Flyer Volume 1 Issue 4, *Accounting for PHA Debt,* dated January 2000. We referred to applicable authoritative accounting and auditing guidance for the public and private sectors in the United States.

<u>Overview</u>
PHAs use many types of debt instruments to finance their capital acquisitions and operations. Two specific types of debt instruments are relevant to this issue. One is HUD-guaranteed, third party debt that exhibits the following characteristics: (1) a PHA issued the debt; (2) the debt instrument is held by a third party (i.e., someone other than HUD); (3) the debt is carried by the PHA as a liability; and (4) HUD, who is ultimately responsible for the debt, makes the debt service payments to the fiscal agent who then

pays the investors. With respect to this third party debt, no money is exchanged at the level of an individual PHA. HUD is responsible for paying, and actually does pay, the principal and interest payments on these loans.

The other is HUD-held debt, also referred to as direct debt. This is debt owed by the PHA to HUD. HUD made the debt service payments for this direct debt until the Debt Forgiveness Act of 1986. With respect to this HUD-held debt, the Debt Forgiveness Act of 1986 provides that the debt must remain on the PHA's books as a liability until the debt is formally forgiven. Debt forgiveness occurs only after the PHA performs certain procedures and meets certain criteria. Debt that has not been forgiven is properly reported as debt on the books and records of the PHA.

Under current HUD accounting guidelines, PHAs are required to record these debt instruments and their related accrued interest liability and expense on their financial statements.

The issue we have been asked to address is the proper accounting for these debt instruments under generally accepted accounting principles. Specifically, should HUD guaranteed (third party) and HUD-held debt (direct debt) be accounted for on the books and records of a PHA as a liability, or should their treatment as debt be reclassified or eliminated altogether?

<u>Specific Authoritative Guidance</u>
We first searched for authoritative guidance that directly addresses this specific issue. We conducted an exhaustive search of the authoritative accounting and auditing literature, and did not find any guidance that addresses the exact facts and circumstances of this case. However, we think that Governmental Accounting Standards Board (GASB) Interpretation No. 2, *Disclosure of Conduit Debt Obligations,* is the most closely related. Interpretation No. 2 defines conduit debt as follows:

> The term conduit debt obligations refers to 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 a part of the issuer's financial reporting entity. Although conduit debt obligations bear the name of the governmental issuer, 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. [1]

Given that this interpretation does not exactly address this specific issue, we approached the problem from a more theoretical perspective.

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[1] GASB Interpretation No. 2, *Disclosure of Conduit Debt Obligations*, paragraph 2.

What is a Liability?

In 1985 the Financial Accounting Standards Board (FASB), as part of its conceptual framework project, issued Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*. There, the FASB defined liabilities as follows:

> Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.[2]

The Board further describes a liability as possessing three essential characteristics:

> (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date…,
> (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice…, and
> (c) the transaction or other event obligating the entity has already happened.[3]

We considered whether the PHA debt in question meets the FASB's definition of a liability (on its books), and concluded that it does not. In the case of the HUD-guaranteed, third party debt, the obligation is being satisfied directly by HUD. The PHA is not currently making any payments, nor is it likely to ever make future payments under this program. With respect to the HUD-held debt, these obligations have already been forgiven. Accordingly, there is no probable future transfer or use of assets by the PHA.

We continued our deliberations by considering another important accounting concept, substance over form.

Substance Over Form

One of the essential characteristics of financial accounting has been the emphasis on measuring and reporting the substance of a transaction over merely its form. Perhaps the best example of substance over form in accounting appears in the area of accounting for leases. When a lease transaction actually transfers substantially all of the benefits and risks inherent in the ownership of property from a lessor to a lessee, GAAP requires that the transaction be treated very differently than a simple rental agreement.

The FASB, in Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, attempted to describe the characteristics that give accounting information reliability:

> Accounting information is reliable to the extent that users can depend on it to represent the economic conditions or events that it purports to represent.[4]

[2] FASB Concepts Statement No. 6, *Elements of Financial Statements*, paragraph 35.
[3] FASB Concepts Statement No. 6, *Elements of Financial Statements*, paragraph 36.
[4] FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, paragraph 62.

Accounting information that does not capture the substance of a transaction is not reliable.

The Board considered substance over form to be very important, so important that two other qualities that make accounting information useful prescribe it and even make its explicit use in Statement of Concepts No. 2 redundant:

> Substance over form is an idea that also has its proponents, but it is not included because it would be redundant. The quality of reliability and, in particular, of representational faithfulness leaves no room for accounting representations that subordinate substance to form.[5]

Auditing Literature

The auditing literature also makes frequent reference to the issue of substance over form. Generally accepted auditing standards provide:

> The auditor should view related party transactions within the framework of existing pronouncements, placing primary emphasis on the adequacy of disclosure. In addition, the auditor should be aware that the substance of a particular transaction could be significantly different from its form and that financial statements should recognize the substance of particular transactions rather than merely their legal form.[6]
>
> Some pronouncements specify criteria for determining, presenting, and accounting for the substance of certain transactions and events. Examples include: (1) presenting consolidated financial statements instead of separate statements of the component legal entities; (2) capitalizing leases; and (3) imputing an appropriate interest rate when the face amount of a note does not reasonably represent the present value of the consideration given or received in exchange for it.[7]

Generally accepted auditing standards emphasize the role of the auditor in assuring the financial reporting of substance over form:

> Generally accepted accounting principles recognize the importance of reporting transactions and events in accordance with their substance. The auditor should consider whether the substance of transactions or events differs materiality from their form.[8]

We concluded that the substance of this debt is something else, given its failure to meet the definition and characteristics of debt prescribed by the FASB.

[5] FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, paragraph 160.
[6] AICPA Professional Standards, section AU 334.02.
[7] AICPA Professional Standards, section AU 334.02.
[8] AICPA Professional Standards, section AU 411.06.

We are aware that some advisors believe that GASB Interpretation No. 2 does not apply here. What does the literature tell us to do in a situation where no promulgated GAAP exists? Answer: The auditor should search for guidance that captures the economic substance of the economic event:

> If the accounting treatment of a transaction or event is not specified by a pronouncement covered by rule 203, the auditor should consider whether the accounting treatment is specified by another source of established accounting principles. If an established accounting principle from on or more sources in category (b), (c), or (d) is relevant to the circumstances, the auditor should be prepared to justify a conclusion that another treatment is generally accepted. If there is a conflict between accounting principles relevant to the circumstances from one or more sources in category (b), (c), or (d), the auditor should follow the treatment specified by the source in the higher category – for example, follow category (b) treatment over category (c) – or be prepared to justify a concluding that a treatment specified by a source in the lower category better presents the substance of the transaction in the circumstances.[9]

What if no promulgated GAAP applies precisely?

> Because of developments such as new legislation or the evolution of a new type of business transaction, there sometimes are no established accounting principles for reporting a specific transaction or event. In those instances, it might be possible to report the event or transaction on the basis of its substance by selecting an accounting principle that appears appropriate when applied in a manner similar to the application of an established principle to an analogous transaction or event.[10]

<u>Conclusion</u>

After a detailed examination and study of the documents and a search of relevant professional guidance, we conclude that PHAs should remove these debt instruments, and the related interest expense and liability, from their financial statements. As discussed, they do not meet the definition of a liability. In addition, we find it difficult to demonstrate how debt exists in a situation where the obligor makes no payments and is not likely to ever do so in the future.

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[9] AICPA Professional Standards, section AU 411.07.

[10] AICPA Professional Standards, section AU 411.09.

We appreciate the opportunity to be of assistance in this matter. We are available to meet with you to discuss this issue further, if you desire.

Sincerely,

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Background Overview

Cornelius Tierney, a certified public accountant and for almost 25 years the chairman and national director of Ernst & Young's (and earlier Arthur Young's) governmental practice, has since August 1993 been a full-time professor of accountancy at The George Washington University. For the decade of the 1960s, Neil Tierney was a federal financial management executive (serving with the U. S. General Accounting Office, Office of Economic Opportunity, and the Civil Aeronautics Board).

For the American Institute of CPA, professor Tierney chaired the task force that the drafted the AICPA's guide to the accounting profession for implementing the Single Audit Act of 1984. He also chaired the Association of Government Accountant's and AICPA's task forces and was a principal author of reports essentially codified in 1990 by Congress as the Chief Financial Officers Act. From 1991 to 1997, professor Tierney was an original member and served the maximum 6-year term on the Federal Accounting Standards Advisory Board, having been jointly appointed by the Secretary of Treasury, Director of OMB and the Comptroller General. He is presently a member of the federal government's Government Auditing Standards Advisory Council, having been appointed by the Comptroller General to serve a 3-year term.

1999, Professor Tierney was voted as the Faculty of the Year by the Board of Visitors of The George Washington University's School of Business and Public Management. In 1992, he was the recipient of the Association of Government Accountant's highest award, the Robert W. King Award, for "distinguished service of such significance as to have importantly enhanced the Association's national prestige and stature."

Academic and Publication Background

• ***Academic*** 1980-1981, fulltime visiting professor and 1982-1986 adjunct professor at Georgetown University; 1993 to present, full-time professor of accountancy at The George Washington University. Since 1995, Director of GW's Center for Public Financial Management.

• ***Publications.*** Since 1970 have authored or co-authored eleven books and numerous articles on governmental accounting, auditing, and financial management.

• ***Degrees/Certification.*** Bachelors in accounting and finance 1958; Masters in business administration 1960; Doctorate in business administration (honoris causa) 1992; Certified public accountant (Massachusetts) 1964. Certified government financial manager 1995.

Professional Affiliations

Since 1962, an active member and chair of several task forces and national committees of the Association of Government Accountants. From 1964, an active member and chair of many task forces and national committees of the American Institute of Certified Pubic Accountants..

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July 1999

Lawrence G. Singleton, BS, MS, PhD, CPA
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Lawrence G. Singleton is an Associate Professor of Accountancy in the School of Business and Public Management at The George Washington University in Washington, D.C. He teaches financial accounting and managerial accounting courses to undergraduate and graduate students at The George Washington University, including GW's Executive Master of Business Administration and Accelerated Master of Business Administration programs. Dr. Singleton has instructed financial executives within the United States government as well as international executives. Prior to joining the faculty at The George Washington University, Professor Singleton taught at Louisiana State University.

Dr. Singleton has conducted research and published articles in various areas of accounting, including the FASB's conceptual framework project and small business uses and preparation of accounting information. During his tenure at Ernst & Young LLP, he conducted research for E&Y's Central Region Auditing and Accounting Group and National SEC Practice Group, where he co-authored sections of *The Ernst & Young Guide to Taking Your Company Public.*

Dr. Singleton writes and consults on financial and managerial accounting and auditing topics and their applications in both the private and public sectors. He frequently provides litigation support services and has testified as an expert witness. His clients have included America Online, Inc., The National Geographic Society, the United States Department of Housing and Urban Development, and The World Bank.

In 1998 he formed Singleton Associates to provide training and consulting services to professional services firms, corporations, not-for-profit organizations, and government agencies. Singleton Associates is comprised of a select group of university faculty who are widely respected for both their technical expertise and their excellent teaching and communications skills. The firm focuses on the areas of accounting, finance, real estate, human resource management, health care economics, federal taxation, and business law.

Dr. Singleton is a recipient of the George Washington Award in recognition of outstanding contributions to the University. He served as faculty advisor to Beta Alpha Psi, the national professional accounting fraternity, and received the Beta Alpha Psi Outstanding Faculty Vice President - Arthur Andersen/Richard E. Claire Faculty Development Award. He has also served as President of the Mid-Atlantic Region of the American Accounting Association. Dr. Singleton is a member of the American Institute of Certified Public Accountants, Beta Gamma Sigma, Beta Alpha Psi, and the American Accounting Association.

Dr. Singleton received Ph.D., M.S., and B.S. degrees in accounting from Louisiana State University. He is a Certified Public Accountant.

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BIOGRAPHICAL DATA

Mr. Moraglio is a consultant with over 38 years experience as an association executive, consultant, instructor, and public speaker. He is currently an Assistant Professorial Lecturer in Accountancy at George Washington University and Editor of the *Members in Government Supplement* to the American Institute of Certified Public Accountants (AICPA) publication, The CPA Letter.

Mr. Moraglio was the Vice-President of the AICPA Federal Government Division where he oversaw the activities of the division and staff. He also interacted with the legislative and executive branches of the federal government on a variety of legislative, regulatory, and accounting and auditing matters.

Before joining the AICPA, Mr. Moraglio was a consultant and has worked both for a large accounting firm and in industry. He recently wrote the AICPA Practice Aid, "Auditing Recipients of Federal Awards: Practical Guidance for Applying OMB Circular A-133, *Audits of State, Local Governments, and Non-Profit Organizations.*" He is the co-author of the book, “The Federal Budget and Financial System: A Management Perspective” and other technical articles. He has taught part-time at American University.

He is a graduate of the College of the Holy Cross and a member of the AICPA.