Conduit Debt Obligations: Is Your NFP Subject to Accelerated Effective Dates?

Not-for-profit (NFP) entities with conduit debt can be subject to the accelerated effective dates and expanded disclosure requirements required of public entities for some of the new major accounting standards. The Financial Accounting Standards Board (FASB) excludes NFPs from the definition of a public business entity (PBE) but evaluates an NFP’s likeness to a public entity on a standard-by-standard basis. For the newly effective revenue recognition guidance and the upcoming leases standard, FASB has concluded NFPs with access to public capital markets—including those acting in a conduit manner—should adhere to the same effective dates and implementation guidance applicable to PBEs.

A public entity is an entity that is any one of the following:

1. A PBE
2. An NFP entity that has issued, or is a conduit bond obligor for, securities that are traded, listed or quoted on an exchange or over-the-counter (OTC) market
3. An employee benefit plan that files or furnishes financial statements to the U.S. Securities and Exchange Commission (SEC)

Not all conduit bonds fit the characteristics that subject NFPs to accelerated effective dates.

For NFPs, this classification conclusion has a major effect on costs and compliance with generally accepted accounting principles. Detailed questions were raised as NFPs began their assessment process. The American Institute of CPAs (AICPA) issued a Technical Questions and Answers (TQA) document in October 2017 and a follow-up article in December 2017 to provide further clarification on factors NFPs should consider in making their assessments that form the basis of this alert.

Regardless of the conclusion reached, NFPs should document and support their decision-making process. An NFP’s status can change over time, e.g., issuance of new debt securities; therefore, entities also should review internal controls to ensure timely identification of any changes that may affect their status.

Each financing instrument must be assessed to determine if the security is traded in the public OTC market to conclude if an NFP is subject to the accelerated effective dates and expanded disclosures. Consultation with legal counsel or bond trustees may be necessary to evaluate trading restrictions.

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Conduit Debt

A conduit bond obligor is an entity that is obligated for the repayment of conduit debt securities. Conduit debt securities are defined as municipal securities issued by state or local governments, agencies or instrumentalities on behalf of a third party, e.g., an NFP. Municipal bonds generally are issued through negotiated sales, competitive bids or private placements. Negotiated sale and competitive bid issuances are structured through underwriters who resell the securities to the general investing public. These securities generally are deemed to be traded, listed or quoted on an OTC market.

A private placement, or unregistered offering, refers to securities released for sale only to a small number of select institutional and accredited investors. Municipal bonds issued in private placements generally are not deemed traded, listed or quoted on an exchange or OTC market because the investors typically are subject to restrictions on resale. NFPs should review their bond documents and hold discussions with their trustees or attorneys as needed to determine whether municipal bonds for which they are the obligor are restricted or unrestricted. Relief from the earlier implementation rules may be afforded if access to the public capital market is deemed restricted.

The evaluation of whether these securities are traded, listed or quoted on an OTC market is based on who has the ability to purchase the securities, not just who purchased them initially or who holds them currently. Regardless of past trading volume or frequency, if the general public has the ability to purchase the securities (even if use of a dealer is necessary), earlier implementation and expanded disclosures of the revenue recognition and leases standards apply.

Exchanges & OTC Markets

Securities traded in an OTC market are not differentiated from securities publicly traded on a formal exchange, e.g., the New York Stock Exchange, in the assessment of public entity classification. Both presume access to the public capital markets. In an OTC market, a security trades in some context other than on a formal exchange and without supervision of an exchange. OTC trades of municipal securities generally occur in a decentralized OTC dealer market, often without other security holders being aware of the affected transaction price. OTC markets also include an interdealer quotation or trading system for securities that are not listed on an exchange. Markets that are not generally accessible by the public or do not publish such data points are not OTC markets for the purpose of determining if an NFP is considered public.

AICPA’s TQA clarifies that the Municipal Securities Rulemaking Board Electronic Municipal Market Access (EMMA®) is not itself an OTC market. EMMA is the official SEC-designated repository for disclosure documents related to public offerings of municipal securities. EMMA provides historical trade prices, credit ratings and other information related to those securities, but does not allow execution of trades.

The determination of whether the conduit debt is considered to trade in public markets is not based on who purchases the debt securities initially or who holds the debt securities currently, but rather who has the ability to purchase the securities.

Conclusion

NFPs should immediately begin the assessment process of public entity status, as the revenue recognition rules are now effective. Entities that have completed this process should review whether documentation is sufficient to support its conclusion and that internal controls are in place to quickly identify any changes to public entity status.

For more information, contact your BKD advisor.
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