

Appendix L: State Auditor's Financial Reporting Guidelines for Industrial Development and Pollution Control Bonds

According to GASB criteria, industrial development corporations are component units and are included in a river authority's or water district's (hereafter referred to as "districts") financial reporting entity.

To conform with GAAP, districts should publish a "comprehensive annual financial report covering all funds and account groups of the reporting entity." (GASB Codification, Section 1100.112) The reporting entity begins with the district itself (the "oversight unit"), but also includes all component units meeting criteria stated in Section 2100 of the Codification. The purpose of these criteria is to assist in determining whether, in substance rather than form, the district has sufficient oversight, accountability, financial relationship, and/or common scope of public service regarding potential component units to justify including them in the district's financial statements.

The State Auditor's Office (SAO) has examined all known industrial development corporations (IDC) associated with Texas districts in light of these criteria and has found the IDCs very similar in the way they were structured, and their relationships to the districts very close. Typically, the IDC's Board was appointed by the district's Board and could be removed by them for cause or at will. The IDC's office address was the same as the district's. Upon full payment of expenses, bonded debt, and other obligations of the IDC, any net earnings of the IDC were transferred to the district. In several of the larger districts, the issuer fees from IDC-issued industrial development and pollution control bonds were one of the major sources of revenue for the districts' General Fund. Otherwise, these fees were a significant portion of a district's operating revenues.

In every case looked at, the SAO concluded:

- the district does have effective oversight over the IDC
- all factors considered, the district should include the IDC as part of the district's reporting entity.

In the financial statements, inclusion of the IDC should be accomplished by combining, or blending, the IDC's financial information with that of the district's similar fund types. Also, the Notes to the Financial Statements should include disclosures on the definition of the reporting entity, including a description of the structure of the IDC, its relationship to the district, and the nature of its financial activities.

Industrial development and pollution control bonds issued by the district as a conduit for other entities are not reported in the district's financial statements if the bonds are obligations of the other entities and not the district.

The industrial development and pollution control bonds issued by districts fall into the category of conduit bonds. That is, they are bonds issued by a state or local governmental unit, acting essentially as an agent or intermediary, for the purpose of obtaining tax-exempt financing, or financing on more favorable terms, for third parties.

The terms governing individual industrial development and pollution control bond issues vary, and the district's financial reporting treatment of the bonds should reflect the substance of each transaction.

In some cases, the terms may indicate that the bonds are to be treated as debt of the district. If so, the district must display in its financial statements all balances and transactions related to the bonds, including the bonded debt; an offsetting contract receivable reflecting the revenue contracts with other entities on whose behalf the bonds were issued; the interest expense; and an offsetting contract revenue.

However in most cases, the bonds are regarded as a debt and the responsibility of the third party on whose behalf they were issued. Typically:

- The bonds are supported solely by pledged contractual payments originating from the third party to fund the bonds' interest and principal.
- Such payments are made by the third party directly to the trustee bank, so that the district or the IDC which issued the bonds has no cash receipts, no cash disbursements, and no control of the debt service transactions.
- No district or IDC revenues are pledged.
- In marketing the bonds, investors look to the creditworthiness of the third party and do not consider the creditworthiness of the district or the IDC.

Where such terms and circumstances exist, reporting the bonds and related accounts in the district's financial statements could misrepresent the substance of the transactions, significantly inflating the assets, liabilities, revenues, and debt service expenses, and distorting the financial statements.

Bonds not considered to be debt of the district should not be included in the district's financial statements. The bonded debt, the offsetting contract receivable, the interest expense, and the offsetting contract revenue should not be reported on the face of the statements. Any contract payments received as issuer fees or as offset to operation and maintenance expenses would be reported as revenues.

Whether the bonds are reported on the face of the financial statements, substantive disclosures regarding industrial development and pollution control bonds are to be included in the Notes to the Financial Statements.

Disclosures on the bonds in the district's financial statements include a descriptive statement on the bond issues, a summary of changes in the bonds payable, a summary of the debt service requirements to maturity, information on advance refunding, and information on defeased bonds outstanding. When there are many bond issues, these required disclosures can be made in a summarized form in the Notes to the Financial Statements and supplemented by detailed schedules. Industrial development and pollution control bonds reported as debt of the district would be included in such disclosures.

A separate note should provide appropriate disclosures of the IDC activities. Additional disclosures should be made on the industrial development and pollution control bonds considered as debt of another entity and therefore not included in the district's financial statements. When there are many bond issues, these disclosures can be made in summarized form in the Notes to the Financial Statements and supplemented by detailed schedules. The minimum disclosure standards for each bond series is:

- The name of the receiving entity
- The issue date
- The interest rate(s)
- The maturity date(s)
- The amount issued
- The current balance

Pollution control bonds issued by the district before the establishment of an IDC is reported in the same manner as bonds issued by its IDC.

In some cases, districts issued pollution control bonds in their own name at one time, then later established an IDC. Subsequent pollution control bonds were then issued through the IDC. The bonds issued in the districts' name have remained on the districts' financial statements, but those bonds issued through the IDC were not placed on the districts' financial statements.

These guidelines place *all* industrial development and pollution control bonds on the same footing. The presumption is that the IDC is a part of the district's reporting entity. The question then becomes, are the bonds obligations of the district or the IDC, or are they an obligation of the third-party entity on whose behalf they were issued? The decision of how to report and disclose the bonds should be made solely on that basis.

This Page Intentionally Left Blank