

August 2, 2006

Code: AD 06-06

Memorandum

To: Vice Presidents for Administration

From: George V. Ashkar
Senior Director/Controller, Financial Services

Subject: Systemwide Revenue Bond Program - Auxiliary Organization Debt Refinancing and Construction Financing

Overview

During fiscal year 2002/03, the California State University (CSU) Board of Trustees (Trustees) approved its first issuance of systemwide revenue bonds (SRB) that included auxiliary organization projects. In order to finance an auxiliary project with SRB's, it was necessary to create a financing lease business relationship between the Trustees and the auxiliary organization. An auxiliary organization's decision to enter into this type of arrangement results in an auxiliary project being financed with better interest rates, increased bond ratings, reduced bond issuance costs, no debt reserve requirement, and lower debt service coverage when compared to the financing an auxiliary organization would be able to obtain on its own credit. Although the SRB covenants in the bond resolution allow for a loan of bond proceeds to an auxiliary, the CSU Bond Act of 1947 does not permit the loan of bond proceeds. Thus, the financing lease relationship was established.*

Management's Intent

The Office of the Chancellor's intent is to utilize the campus as a "pass-through" entity in order to facilitate the debt refinancing (of existing auxiliary organization debt) for the auxiliary organization or debt financing of an auxiliary organization construction project. This is accomplished through the issuance of SRB debt by the campus and the campus entering into one or both of the following two agreements with the auxiliary organization:

- Facilities purchase contract

CSU Campuses

Bakersfield
Channel Islands
Chico
Dominguez Hills
East Bay

Fresno
Fullerton
Humboldt
Long Beach
Los Angeles
Maritime Academy

Monterey Bay
Northridge
Pomona
Sacramento
San Bernardino
San Diego

San Francisco
San José
San Luis Obispo
San Marcos
Sonoma
Stanislaus

- Ground and facilities lease agreement

To facilitate the debt refinancing and secure the SRB debt issued by the campus, the campus enters into a facilities purchase contract with the auxiliary organization whereby the underlying asset (auxiliary project) is sold to the campus. The campus then simultaneously enters into a ground and facilities lease agreement with the auxiliary organization in order to lease such asset back to the auxiliary organization. In effect, this creates a “sale-leaseback” arrangement between the campus and the auxiliary organization, thus creating the “pass-through” of the new debt obligation from the campus to the auxiliary organization.

To facilitate the debt financing for an auxiliary organization construction project, the campus enters into a ground and facilities lease agreement with the auxiliary organization prior to the SRB issuance. This is necessary in order to obligate the auxiliary organization of its commitment to pay the debt. The campus uses the proceeds from the SRB issuance to construct the asset. When the constructed asset is completed, the asset is leased to the auxiliary organization.

The term and payment schedule under the ground and facilities lease agreement mirrors the term and debt service schedule of the related SRB debt issued by the campus.

Accounting Treatment

It is our opinion that the above transactions between the Trustees (campus) and an auxiliary organization meets the capital lease criteria as described in FAS 13, *Accounting for Leases*.

The campus and an auxiliary organization are considered related parties. In accordance with FAS 13, paragraph 29: “Except as noted below, leases between related parties (as defined in paragraph 5(a)) shall be classified in accordance with the criteria in paragraphs 7 and 8. Insofar as the separate financial statements of the related parties are concerned, the classification and accounting shall be the same as for similar leases between unrelated parties, except in cases where it is clear that the terms of the transaction have been significantly affected by the fact that the lessee and lessor are related. In such cases, the classification and/or accounting shall be modified as necessary to recognize economic substance rather than legal form. The nature and extent of leasing transactions with related parties shall be disclosed.” In this case, the economic substance of the transaction is that the Trustee’s SRB program is being used solely for the purpose of refinancing the auxiliary organization debt or financing an auxiliary organization construction project in order for the auxiliary organization to achieve the benefits discussed above.

Debt Refinancing

The Office of the Chancellor regards the sale-leaseback arrangement (through the facilities purchase contract and the ground and facilities lease agreement discussed above) as a financing tool that does not give the campus constructive ownership of the underlying asset. The auxiliary organization (seller) maintains continuing use of the asset after the sale. The intent of the sale-

leaseback arrangement was not to generate any profit or loss on the sale of the asset for the auxiliary organization but was merely necessary to be able to accomplish the debt refinancing.

In summary, the auxiliary organization's old debt (refunded debt - auxiliary issued debt) is replaced by new debt in the form of a capital lease obligation payable to the campus. Additionally, the underlying asset (leased asset) is recorded on the auxiliary organization's financial records. The end result for the auxiliary organization is that it now reports a capital lease obligation instead of a long-term debt (bond) obligation. Additionally, any bond premium or discount resulting from the campus' issuance of SRB debt is "passed-through" the campus (i.e. not recorded by the campus) and recorded by the auxiliary organization as an "unamortized premium/discount on capital lease obligation", which is deferred and amortized over the term of the related capital lease. Any loss on refunding resulting from a refinancing transaction is also recorded by the auxiliary organization. For GASB entities, this loss must be deferred and amortized over the life of the new or old debt, whichever is shorter, and netted with the gross capital lease obligation payable balance for reporting purposes. For FASB entities, this loss must be expensed in the current year.

On the campus' financial records, the campus records the gross outstanding balance of the SRB and the corresponding capital lease receivable due from the auxiliary organization. Note that any bond premium or discount related to the SRB debt is not recorded by the campus but is instead recorded by the auxiliary organization as discussed above.

Debt Financing For An Auxiliary Organization Construction Project

While under construction, the construction work in process (CWIP) asset is recorded on the campus' financial records. When the asset is completed, the total cost of the asset is removed from the campus' financial records and a capital lease receivable due from the auxiliary organization is recorded. The leased asset and the related capital lease obligation payable to the campus are recorded on the auxiliary organization's financial records.

Note that in certain situations, the total construction costs of the asset may ultimately be more or less than the SRB issuance amount. In these situations, the campus and the related auxiliary organization would need to come to agreement on how to handle the resulting "excess" or "shortfall". Upon agreement, the campus and the auxiliary organization must consult with the Office of the Chancellor, the independent auditors of the auxiliary organization, and the independent auditors of the campus in order to determine the proper accounting treatment for the transaction.

Other considerations include:

- Emerging Issues Task Force (EITF) 97-10 addresses circumstances when the lessee should be considered the owner of a real estate project during the construction period. In summary, the lessee should be considered the owner of a real estate project during the construction period if the lessee has substantially all of the construction period risks, as outlined in EITF 97-10. If EITF 97-10 applies, the asset would be recorded on the lessee's (auxiliary organization's) financial records from the point of time of starting the construction. The

asset (CWIP) balance would then continue to increase as the asset was constructed. Applicability of EITF 97-10 should be analyzed by the campus and the auxiliary organization in consultation with the Office of the Chancellor.

- In certain situations, such transactions may be classified as an operating lease (instead of a capital lease), depending on the facts of the circumstances of the transaction. The analysis and determination must be made by the Office of the Chancellor in consultation with the campus and the auxiliary organization.

Please contact Sedong John at 562-951-4577 or sjohn@calstate.edu, or Lily Wang at 562-951-4628 or lwang@calstate.edu, if you have any questions.

Legend:

* Legislation is currently underway that would change the Education Code to allow for the loaning of SRB proceeds to auxiliaries. If this legislation is approved, it would become effective January 1, 2007.

GVA:LW:td AD 06-06

Distribution: Auxiliary Organization Financial Officers
Campus Financial Officers
FOA
Campus and Auxiliary GAAP Coordinators
Financing and Treasury
Chancellor's Office - SFO
KPMG