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# Terminology, Theories, Philosophy and Beliefs

Dear Reader:

The following document was created from the CTAS website (ctas.tennessee.edu). This website is maintained by CTAS staff and seeks to represent the most current information regarding issues relative to Tennessee county government.

We hope this information will be useful to you; reference to it will assist you with many of the questions that will arise in your tenure with county government. However, the *Tennessee Code Annotated* and other relevant laws or regulations should always be consulted before any action is taken based upon the contents of this document.

Please feel free to contact us if you have questions or comments regarding this information or any other CTAS website material.

Sincerely,

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# Terminology, Theories, Philosophy and Beliefs

Reference Number: CTAS-1747

In understanding and developing a debt management program we must have a basic comprehension of the terminology used in the financial industry, as well as the theories, philosophies and our personal beliefs of how we view debt. You may not agree with all of the theories, philosophies, and even our assumptions and related conclusions of debt management, but you must be able to reconcile your understandings about debt management with that of your fellow policy makers.

# Terminology

Reference Number: CTAS-1748

- Backloaded, Balloon or Bullet Debt - Considered debt that a borrower would pay, predominately interest, the first number of years before any reduction in principal would be made. This type of financing would cause higher interest cost over the time of a loan as compared to straight-line amortization or advanced payment of principal.
- Balance Sheet - An accounting statement that reflects the assets, liabilities and net worth of an entity at a point in time.
- Bond Counsel - A firm or lawyer who insures that the local government complies with the legal obligation of issuing debt.
- Capital Projects Committee - An advisory committee established by the county commission to develop policies and advise the commission, county mayor/executive and finance department on the matters of long-term asset management and replacement.
- Capital Improvement Policy - A formal statement, generally an adopted county commission resolution, which states how the county government intends to identify, acquire, maintain and replace assets that have a high cost and long life expectancy.
- Capital Improvement Plan/Budget - A formal or informal written statement and/or series of spreadsheets that depict an anticipated cost in acquiring, maintaining, and replacing high cost and long life expectancy assets. The plan or budget notes specific revenue to support the anticipated cost of the new asset.
- Conflicts of Interest - Occur in situations where parties in a transaction have multiple interests or relationships that could possibly corrupt the motivation to act. The presence of a conflict of interest indicates the potential for divided loyalty and does not automatically indicate wrong doing.
- Costs - Means fees and expenses of professionals and service providers and other similar fees and expenses, whether or not payable at the time the debt is incurred. "Costs" also means recurring and nonrecurring fees and expenses during the life of the debt.
- Credit Rating - An assignment of risk or quality of a loan or security placed on certain debt by rating agencies (Moody's, Standard and Poor's and Fitch). The higher rating of the loan would indicate a lower risk, thus a lower interest rate.
- Credit Enhancements - A separate insurance or letter of credit that would be purchased to insure a higher credit rating, thus a lower interest rate.
- Credit Reviews - The process used to examine a potential debt issuance risk and then the assignment of a debt credit rating. Credit reviews generally look at two broad areas: (1) quantitative analysis (audit opinions, fund balances, debt levels and ratios) and (2) qualitative factors (management experience, political and economic climate, and policy and procedures).
- Debt - Means indebtedness lawfully issued, executed or assumed by a public entity. Debt is created when a public entity agrees to pay over time to someone else, in exchange for receiving an upfront payment or loan or for acquiring an asset. "Security" refers both to debt that can be transferred or delivered to another party, as well to property or assets pledged as collateral for a debt. Common instruments or evidence of debt are:
- Bonds - Debt instruments issued for a period of one year or longer, usually for permanent financing.
- Notes - Debt instruments issued for a short period of time, often for interim financing. Notes may be rolled to bonds. Examples are Capital Outlay Notes, Tax and Revenue Anticipation Notes, Bond

Anticipation Notes, and Grant Anticipation Notes.

- Capital leases or a lease purchase - Written agreements allowing the use of property in exchange for payment of funds.
- Loans - Debt agreements usually with a financial institution such as a local bank or an organized loan program such as the Tennessee Municipal Bond Fund or the State Revolving Loan Program. Loans are also internal loans between funds within the entity or seller financed loans.
- Debt Committee - An advisory committee established by the county commission to develop policies and advise the commission, county mayor/executive, and finance department on debt management policies and practices.
- Debt Resolution(s) - A resolution or series of resolutions that preliminarily approve the issuance of debt, or specifically and legally approve the issuance of debt.
- Debt Service - A series of payments including **interest** (the amount or fee earned or paid for use of money or credit, calculated on the amount of principal) and **principal** (the amount of money borrowed or credit provided) required on a debt over time. The rate of interest can be **variable** or **fixed**. A few terms related to debt service include:
- Schedule - The plan listing the amount and when debt service will be paid.
- Backloading **-** Refers to delaying repayment of principal until the end of the financing term. A standard or default structure for debt service is level debt service payments, similar to a standard home mortgage. Backloading should be considered only when 2 beneficial to the overall amortization of debt, upon the occurrence of natural disasters, or when project revenues are not available during the early years of a project.
- Maximum total level of debt - The maximum principal amount of debt a public entity will have outstanding at any time, usually for each type of debt issued.
- Debt Service Policy - A formal statement, generally an adopted county commission resolution, that expresses the type of indebtedness the county believes is most effective and efficient, such as, whether debt should mirror the life expectancy of the assets or be a percentage of years less than the life expectancy; whether the county debt should be a mixture of fixed and variable rates; whether the county should anticipate hiring a financial advisor; whether a multi-year debt budget will be presented before the issuance of new debt; and when an existing debt should be considered for refinancing or early payoff.
- Debt Service Payment Calendar - A calendar that a county uses to track a schedule of when its indebtedness is due, scheduled to be paid, and to whom it is to be paid.
- Federal Compliance Issues - The ongoing responsibilities of a public entity after issuing debt. If the debt is sold as being "federally tax-exempt," then the entity will have to comply with federal tax law. If the debt is a "security" for federal securities laws, then the public entity is subject to anti-fraud provisions and possibly is subject to continuing disclosure obligations.
- Finance transaction - Both debt obligations and derivatives. A derivative is a financial product deriving value from a separate security. This term refers to many different products. "Derivative" includes an Interest Rate Agreement as defined in Tennessee Code Annotated Section 9-22-103 and other transactions as identified by the State Funding Board.
- Financial Advisor - An individual or firm who assists and advises the local government of its debt financial needs, existing debt obligations, refunding debt opportunities, funding needs for new debt obligations, arrangements for bond counsel, bidding procedures, advertisement of bonds, preparation of debt resolutions and official bond or loan documents.
- Financing Structure - Deals with matters in which an entity would issue debt, taking into consideration items such as principal amortization, call provisions, coupon/yields, fixed or variable rates, credit enhancement and interest swap provisions.
- Fixed Asset Policy - A formal statement, generally an adopted county commission resolution, which identifies by type (in dollar amounts and life expectancy), assets that will be placed on or in the accounting records to be tracked and maintained over a period of time.
- Fund Balance Policy - A formal or informal statement that establishes how much excess revenue over expenditure should be accumulated and carried over from year to year. The policy should address how the county should use or accumulate funds if the fund balance is not at the optimal level. A fund balance policy would address, on a fund by fund basis, what the respective fund balance target should be. The policy would be expressed either as a percentage or dollar amount fund balance compared to the annual appropriation or revenue budget.

- Guidelines - The document adopted by the Tennessee State Funding Board providing statutorily required guidance on Interest Rate and Forward Purchase Agreements. The current version became effective November 1, 2009. The Guidelines are available on the internet at https://www.comptroller.tn.gov/sl/pdf/revguidelines.pdf.
- Professionals - Individuals or firms advising or offering to provide professional services to a public entity with respect to a finance transaction. Examples of professionals are:
- Advisor - An individual or firm with a deep knowledge in a specific area, engaged in the business of advising others. It can include a Financial, Swap, or Program Administrator.
- Counsel - A legal advisor or attorney, whether an individual or a firm, representing a client. It can include Bond, Disclosure, Issuer, Swap, Tax, or Underwriters Counsel.
- Counterparty - The other party or participant in an agreement or contract; usually it refers to the other party in an Interest Rate (or swap) Agreement.
- Lender - An individual or firm who loans a borrower money.
- Paying Agent - An individual or firm that transfers the periodic interest and principal payments from the public entity to the investors.
- Registrar - The individual or firm responsible for maintaining a record or list of owners or investors in debt (sometimes referred to as holders of the debt).
- Remarketing Agent - The firm responsible for reselling to new investors debt instruments that have been "tendered" for purchase by their holders. The remarketing 3 agent is also usually responsible for resetting the interest rate for variable rate debt instruments.
- Underwriter - The firm that buys new debt for reselling to the public for a profit. The underwriter may acquire the debt either through negotiation or by award on the basis of competitive bidding.
- Verification Agent **-** Usually a certified public accountant or other independent third party that determines that the cash flow from investments purchased with proceeds of a refunding debt issue, along with other money, will be sufficient to pay the refunded bonds.
- Project Budget Resolution - A resolution that establishes a capital budget for a particular acquisition or construction of an asset. The project budget, if in a capital project fund, will last to the duration of the project.
- Public Entity - A governmental organization or unit that has a legal existence and is authorized to borrow money or enter into debt. It includes the State, state agencies, local governments, local government instrumentalities, and any other authority, board, district, instrumentality, or entity created by the State, a state agency, local government, a local government instrumentality, or any combination of the above. It does not include legal entities without debt authority, such as a county school board; however, a special school district with debt authority is included.
- Governing Body - The group of individuals with the authority to make decisions for a public entity, often referred to as the "legislative body." Governing bodies are subject to the Tennessee Open Meetings Law (requiring public notice and recording of minutes).
- Members - The individuals serving on the governing body.
- Conduit Entity - A governmental entity or agency that borrows money to lend to another entity, and not to finance a project for itself. Examples of conduit issuers are health and education boards, economic development boards, and public building authorities
- Matching Principles - The accounting theory stating that expenses should be matched or related to the revenue produced by the expenses, or the expenses charged to the asset, over the asset's useful life. Depreciation is an example of the practice of the matching principle.
- Multi-Year Debt Budget - A planning document that estimates future revenues and estimated or known scheduled debt payments along with project fund balances over time until all debts are fully paid.
- Risk - Refers to the uncertainty (downside) involved in a debt transaction, including investment, business, credit, market, liquidity, operations, tax, and basis risks.
- Spectrums - A graphic or photographic representation of a sequence or range of related qualities, ideas or activities.
- State Agency Loan Program **-** Refers to programs offered by the state or state agencies, such as the State Revolving Loan Program offered by the Tennessee Local Development Authority or the Qualified School Construction Bond program offered by the Tennessee State School Bond Authority.

- State Funding Board - The state entity whose members are the Governor, the Commissioner of Finance and Administration, the Comptroller, the State Treasurer, and the Secretary of State. The State Funding Board is created by Tennessee Code Annotated Section 9-9-101.
- Straight-line Amortization - Is a level (same dollar amount) repayment schedule over the term on the loan that would reflect smaller principal payments increasing to larger principal payments over the life of the loan, and conversely larger interest payments reducing to smaller interest payments over the life of the loan. A typical home mortgage has a straight line amortization payment schedule.
- Tax Exempt Debt - Debt of which the holder does not have to pay income tax on the earnings.
- Underwriter - A firm or group of firms that are selected to purchase and re-market the debt to the public or investment community.
- Wrapped Debt Service - Is the practice of reviewing an entity’s existing debt payment schedule and insuring that the new debt payment schedule would reflect that the new payments of interest and principal would create a straight line or level payment structure over the life of all debt. This practice generally would create the payment of more interest over the life of a loan as compared to straight-line amortization.

# Basic Debt Practices and Beliefs

Reference Number: CTAS-1749

Here are some Basic Best Practices and Beliefs regarding county financial management:

1. You should be as efficient in use of taxpayer money as possible. There may be disagreement on how this is achieved, but there should be agreement that we want efficiency.
2. Tax rates and the related tax levy should be in most circumstances stable and not fluctuate up or down from year to year. There is little benefit in raising a tax one year, only to reduce the tax the next year, only to raise it again the third year.
3. Issuance of debt should not exceed the life expectancy of the asset being purchased or constructed.
4. Understand to the best of our ability how we perceive risk and the related cost of that risk. You should have an understanding of the risk of interest rate changes and the changes in the value of money, along with the risk of making and not making decisions or putting off a decision.
5. Decisions are made based on the facts at hand, and that better decisions are made based on the best facts. However, you should realize that you will never have all the facts, and you will not always make the best decision. This limitation should not impede you from trying to understand your current situation and facts and how that will impact the future. You should not make capital investment decisions hastily, or draw the decisions out over a number of years.
6. Money has a value, and that value changes over time. The changes in the value of money are related to a number of factors, the greatest of which are inflation and interest rate changes. This concept is known as the time value of money.
7. Capital projects can be funded out of current revenue and savings, debt obligations, or a mixture of the savings, current revenue and debt obligations. A county’s capital project plan and debt service plan should address these funding issues.
8. Excessive debt or no debt can be bad policy for your government and citizens. This is based on the theory that individuals who use an asset should assist in the payment of that asset by the payment of debt service, and also that if a county has excessive debt, generally the interest rates are higher than considered normal and their flexibility in current operations can be hindered due to a larger percentage of revenue required to pay debt interest and principal.
9. As we discuss being conservative or aggressive in our approach to debt management, we are not drawing a conclusion whether one approach is better than the other; however, we are saying that you and the county must understand the risk involved in being conservative, aggressive or moderate in your debt management approach.

# Accounting Theory/Philosophy-Matching Principle

Reference Number: CTAS-1750

We would be negligent if we did not discuss the matching principle of accounting as it relates to the annual operation of the local government. An easy way to describe this principle is the philosophy that an asset should be paid for during the time the asset is in use. This principle has some weakness, but a straight forward example of this matching is as follows: A government purchases land and constructs a library building at the cost of $1 million. The land has an infinite life expectancy, but the building, properly maintained, may be used for 30 years. Should the taxpayers who have access to the use of the building 30 years from today pay a portion of the cost?  If you answer yes, then this is a belief in the matching principle. In the new approach to making government accounting look more like commercial accounting, we now use depreciation to reflect this cost. However, depreciation is not a cash accounting entry; but if debt is issued, the payment of principal and interest is a cash payment and therefore a 30-year bond payment schedule reflects what is paid by current and future taxpayers throughout the useful life of the loan, thus the use of the building.

Now the matching principle as it relates to payment of debt is never exact with the asset's useful life, but it can fairly represent matching use of the asset with payment for the use of the asset.  Some weakness in pure matching deals with time value of money; useful life exceeding or being less than planned debt or planned life; and more or fewer taxpayers making debt payments or using the asset over time along with issues of changes in value of property. Figure 1 reflects a pure relationship with a set number of taxpayers.

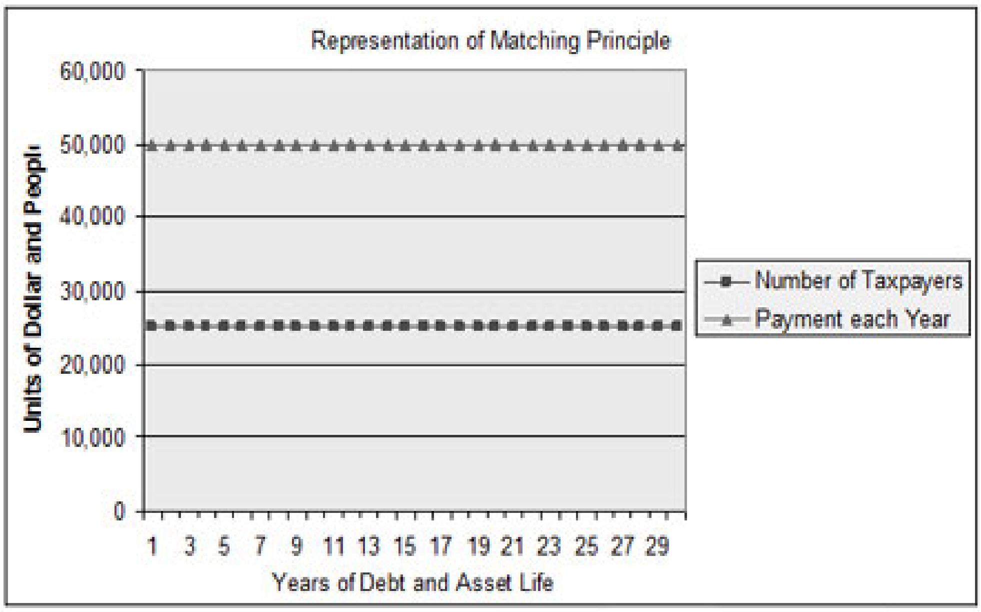


Figure 1

Figure 1 reflects that each taxpayer pays $2 per year for the assets use for 30 years.

# Debt Percentage and Interest Rate Mixture Spectrums

Reference Number: CTAS-1751

As we talk about the matching theory, we also must talk about the debt management and how this philosophy has been developed over time as we have managed our personal debt. The approach used as we manage our personal debt transfers to our beliefs, and sometimes our practices, of managing public debt. Some of us (or at least our parents) may not believe in having any debt, and if we believe in debt, have a very conservative approach to debt management. Others have a very aggressive management approach and thus one would anticipate having more debt. Consider that some of our parents, or even some of your classmates, may have paid cash for their homes. They built their houses as money was available or waited until they had accumulated enough money before they purchased their homes. Some people may have borrowed from family members (similar to an inter-fund loan). Others were willing to have a mortgage, but would never borrow money for any other items. Others would borrow for a house and an investment property, but nothing else. And still others would borrow to purchase a house, car, boat, investments, vacations, and maybe even their meals. These beliefs in debt management in our personal life impact our thoughts and decisions on how our government should borrow and pay back its debt.

What is important to know is that our approach to managing our government's capital improvement and debt has a lot to do with our personal philosophy of debt management, which varies from person to person. This philosophy carries over further as we evaluate fixed or variable interest rate debt instruments.

We must personally examine to what extent and how strong our beliefs are on answering questions such as the following:

1. Is it acceptable to have debt?
2. What are acceptable assets for which to borrow money?
3. Should our debt be fixed rate, variable rate or mixed debt?
4. How long a time frame should money be borrowed?

Even if our personal belief is that we should pay as we go and not incur any debt for all practical purposes, it is almost impossible for the local government to acquire large assets without debt. However, even if we don't like having debt and recognize the necessity for the local government in acquiring expensive assets, we can structure the debt policies and practices that only borrow for long life and high cost assets.

As we answer the questions above, we explore our risk tolerance in having debt.

We must examine our risk tolerance on whether debt should be all fixed interest, all variable interest, or a combination of both fixed and variable rates; and if so, what percentage should be fixed and variable.

The following spectrums will deal with our risk tolerance.

The concepts of our personal beliefs in debt, how much debt, and should debt be fixed or variable interest rates, can be depicted in the following low (conservative) to high (aggressive) risk tolerance spectrums. The first spectrum (figure 2) is a Debt Percentage Spectrum of total assets or an individual asset. The second spectrum (figure 3) is considered an Interest Rate Mixture spectrum.

If one were to place a home mortgage on the spectrum below, you could see this relationship of the risk as it relates to being conservative or more aggressive. Mortgage brokers generally like to loan no more than 80 percent of the value of a home, and if they loan more than 80 percent, they require the future homeowner to buy Purchase Mortgage Insurance (PMI) for the additional risk. A homeowner would like to have no mortgage debt, but may be willing to accept up to 90 percent mortgage in order to have the home asset.

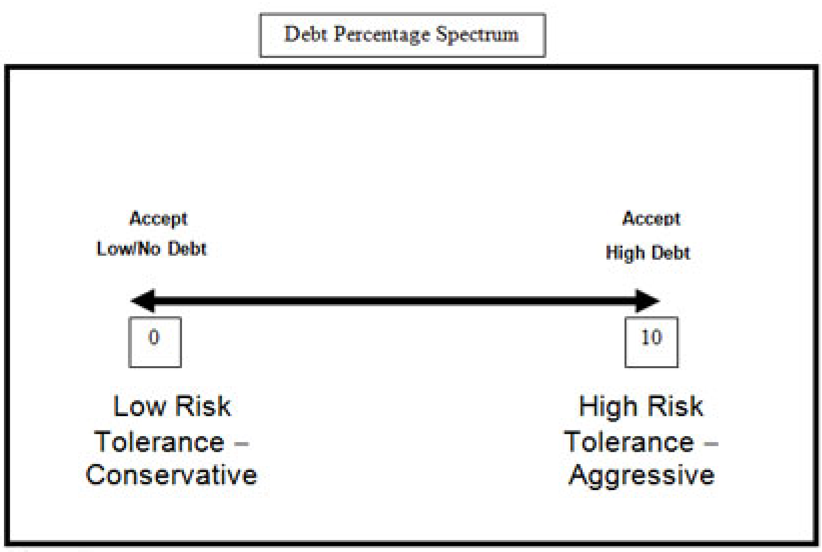


Figure 2

This spectrum reflects a debt percentage of an asset or group of assets. Zero assumes that no money was borrowed to purchase the asset, and 10 assumes that 100 percent was borrowed to purchase the asset.

Using the same home mortgage and asset, you could plot a risk tolerance of whether the interest rate is fixed or variable. An individual may have a fixed rate if he/she has a large mortgage. The same individual may be willing to have a variable rate if the mortgage is lower, all depending on the risk tolerance of the individual and his/her expectation of future interest rates.

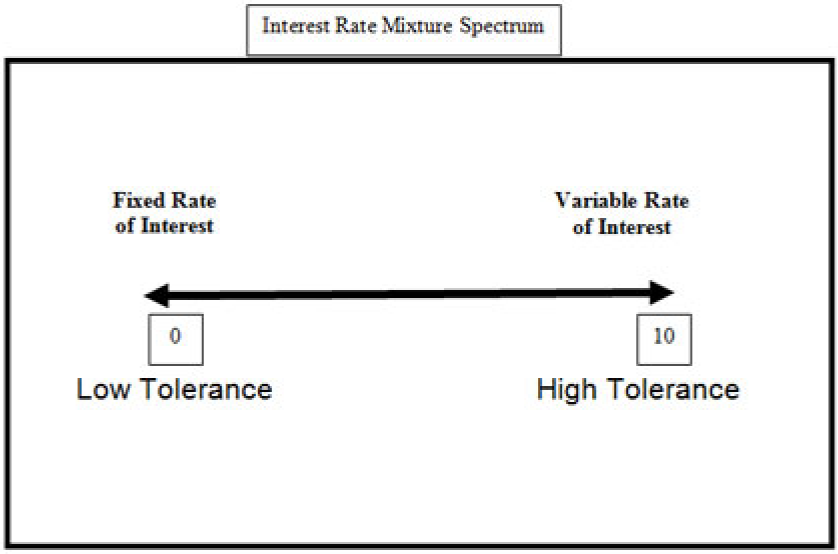


Figure 3

This spectrum reflects the extent that debt is either on a fixed rate, variable rate or mixture of rates. Zero represents that one does not like to be surprised by any change in an interest rate, and thus interest payments. Ten represents that one accepts, and will not be bothered by, a change in interest rates or interest payments. One could also speculate that a zero would be betting that interest rates are expected to go up, and a 10 would be betting that rates would go down.

Risk tolerance is not an exact measurement, but deals more with one's disposition of how he/she feels about risk.

These debt spectrums can be developed to address the following four basic questions:

1. Is debt acceptable and at what level?
2. What are acceptable assets for which to borrow money?
3. Should debt be fixed or variable?
4. How long a time frame should money be borrowed?

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