Capital Needs & Debt Management
Today’s Topics...

<table>
<thead>
<tr>
<th>Capital</th>
<th>Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Improvement Plans</td>
<td>Understanding Your Debt</td>
</tr>
<tr>
<td>Capital Budgeting</td>
<td>Debt Issuance</td>
</tr>
<tr>
<td>Funding Capital Projects</td>
<td>Managing Debt</td>
</tr>
</tbody>
</table>
Capital Improvement Plans
What is a capital asset?

• Land
• Building
• Additions/renovations to buildings
• Improvements to land, drainage, parking, landscaping, etc.
• Infrastructure - streets, roads, bridges, utilities, parks
• Landfill, convenience centers, transfer stations
• Useful life limits > 1 year
Capital Asset Policy

• Capitalization thresholds
• Depreciation methods and rates
• Procedures to identify existing capital assets and infrastructure
• Methods to determine historical costs
• Procedures to tag and track movable assets
• Procedures for recording new/transferred/disposed assets
• Identify available software
Capital Asset Policy - Depreciation

• Process of allocating cost of tangible property over a period of time
  • Useful life

• Straight-line method writes off value evenly over useful life of asset
  • To Determine Annual Depreciation
  • Total Cost – Salvage Value = Adjusted basis
  • Adjusted basis / Estimated Life
## Classification & Types of Capital Assets

### Classifications
- Land
- Land Improvements
- Buildings
- Building Improvements
- Vehicles
- Equipment

### Examples of Asset
- Courthouse
- Schools
- Right of way
- School buses
- Patrol cars
- Dump trucks
- Front-end loaders
Understanding Capital Assets and Needs

• Major assets that benefit more than a single fiscal period
• Facilities and equipment
  • Required by law
  • Necessary for public interest
• Required to have a capital asset policy per GASB 34
GASB 34

• Fundamental revision of the financial reporting model
• Presentation of government-wide financial statements
• Requires management discussion and analysis
• Implementation required of all TN governmental entities
• Failure to comply resulted in adverse audit opinion
Capital Planning Process

- Need
- CIP
- Funding
- Purchasing
- Monitoring
  - Observe
  - Inspection
- Communication
  - Recognition
- Using the Asset
Capital Improvement Plans

• What is a capital improvement plan (CIP)?
  • Multi-year documents used to identify needed additions and/or improvements

• Why implement a CIP?
  • Provide for required services mandated by state or federal law
  • Assets have life expectancy – physically or functionally obsolete
  • Identify services due to citizen pressure or population growth
  • CIP may be required legally
Capital Improvement Plans (CIP)

• Help in determining critical capital asset needs versus wants
• Should involve every level of government
• May involve public input
• Identifies available funding sources
• May rely on available debt capacity
Reasons for a CIP

• Projects are large and expensive
• Impact county financially for years
• Needs and spending will vary from year to year
• Asset service life should meet asset life expectancy
Legal authority for a CIP

• Operating departments required to prepare and submit budget annually
  • On or before April 1 unless alternately adopted budget calendar

• County Powers Relief Act of 2006 (T.C.A § 67-4-2901)
  • Requires CIP if county desires to levy privilege tax on residential developments
    • School facilities tax (T.C.A § 67-4-2904)

• Inventory of Public Infrastructure Needs (T.C.A. § 4-10-109)
  • Annual inventory purposed to assist state, counties, and cities develop goals, strategies, and programs to improve the quality of life for citizens
Steps to Create a CIP

• Establish capital improvement policies
• Perform a capital inventory
• Adopt standards to rank project requests
• Identify projects
• Assess funding sources
• Develop the capital improvement plan
• Approve the CIP and budget
Advantages of a CIP

• Creates orderly and systematic planning for acquisition, financing and use
• Provides effective evaluation of alternatives and solutions
• Allows in-depth consideration of hidden costs
• Funds projects on a priority basis
• Stabilizes payments and tax rates over time
• Better understanding of needs and alternatives
• Proactive stance instead of reactive, crisis management
Disadvantages of a CIP

• Requires time and effort
• Could create false expectations for public
• Funding source
• Implementation cost
Developing a Capital Improvements Plan

- County Legislative Body establish a committee
  - Made up of CLB members, elected officials, department heads, possibly others
  - Authorize process via resolution
- Authorized to set policies and procedures for capital improvement plan
- Committee adopts annual calendar for capital improvement requests
- Establish method for assigning priority to projects
To Ensure a Quality Project

• Complete and clear specifications
• Proper bidding and awarding of the contract
• Complete contract with surety bond requirements
• Constant monitoring of specifications via inspection of projects
• Monthly project progress and financial condition reporting
• Encumbrance accounting for contract and change orders
• Final inspection and approval by responsible parties
Definitions

• Payment in Lieu of Taxes (PILOT) – any amount that is negotiated separately from rent in lieu of applicable ad valorem (property) taxes, TCA §7-53-101

• Capital Policy – a policy that enables management to control accountability for all capital assets, over capitalization thresholds, acquired by county departments.

• Debt Policy – a policy that details the handling of county debt.

• Fund Balance Policy – a policy that sets recommended minimum fund balances for certain fund types, and how management intends to achieve and maintain these balances.
Capital Improvement Budget
Capital Budgets

• Differ from an operating budget – may extend beyond 12 months
• Include funds for education, highways, other general needs
• A finance plan and program to purchase capital improvements
Capital Budgets

• Capital budgets are approved by the CLB during the operating budget process, or at the beginning of a capital project.

• Capital budgets that span multiple years (i.e. building projects) do not have to be reallocated the subsequent years.
Capital Project Budgeting

• Project Budgets should be turn-key including:
  • Bond issuance
  • Architecture
  • Engineering
  • Land
  • Construction Management
  • Furnishings
Accounting for Capital Projects

Fund Balance Sheet, Revenues and Expenditures

177 Educational Capital Projects

Subfund ROF
- Balance Sheet
- Stat of Rev
- Stat of Exp

Subfund LND
- Balance Sheet
- Stat of Rev
- Stat of Exp

Subfund FIR
- Balance Sheet
- Stat of Rev
- Stat of Exp

Subfund 007
- Balance Sheet
- Stat of Rev
- Stat of Exp

Subfund 008
- Balance Sheet
- Stat of Rev
- Stat of Exp

You now can monitor each subfund by Cash
Funding Capital Projects
Capital Improvements Plan Funding

• CLB and/or the CIP committee determine
  • How much county can afford – relative to debt capacity and/or taxing tolerance
  • How county will pay for improvement

• Possible funding
  • Cash from within capital project fund
  • Cash from other county funds or interfund loan
  • Local banks have available funds to loan
  • Issuance of bonds or loan agreements
Debt Service Fund
• Accounts for the principal and interest payments related to financing of capital improvement projects.

Capital Projects Fund
• Accounts for the revenues and expenses of capital improvement projects.
Fund Relationship

County

Annual Revenues

Debt Service Funds
151-Gen Debt
152-Rural Debt
156-Education

Annual Revenues and/or Debt Proceeds

Capital Project Funds
171-General Proj
176-Highway
177-Education

Annual Budgets for Principal and Interest

Project Budgets may be > 1 year. For engineering, site work, building materials, GC costs.
Flow of Cash in Case of Issued Debt

**Capital Projects Fund**
- Revenue from Financing
- Expenditures on Projects
- Vendors

**Debt Service Fund**
- Taxpayers
- Revenue from taxes or other sources
- Expenditure of Annual Principal and Interest
## Paying for Capital Assets

<table>
<thead>
<tr>
<th>Pay-As-You-Go</th>
<th>Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual Revenue – Local Taxes</td>
<td>General Obligation Bonds</td>
</tr>
<tr>
<td>Reserves – one-time transfer</td>
<td>Capital Outlay Notes (CON)</td>
</tr>
<tr>
<td>Earmarked Revenue</td>
<td>Revenue Bonds</td>
</tr>
<tr>
<td>Special Assessments</td>
<td>Capital Leases</td>
</tr>
<tr>
<td>Impact Fees</td>
<td>Special Obligation Bonds</td>
</tr>
<tr>
<td>Grants/Donations</td>
<td>Loan Pools</td>
</tr>
</tbody>
</table>
Accounting for Capital Improvement Projects

• Use fund accounting system that features:
  • General accounting
  • Budgetary
  • Encumbrance

• Use of sub-funds allows tracking of multiple ongoing capital projects within a single fund
Encumbrances

• Method to identify the portion of the budget that has already been contracted but has not been expended. Purchase Orders

  • Main contract
  • Change orders as they are encountered
  • Engineering work
Year End/Beginning Records/Encumbrances

• Contract payable and retainage payable amounts may need to be established.
  • When contracted work has been performed but has not been paid at June 30, instead of accounts payable the contracts payable and any associated retainage payable accounts will need to be used.

• Encumbrances outstanding at year end will need to be deleted and reestablished when opening a new year.
Capital Project Revenues

• Capital Funding Sources
  • Annual revenue
  • Surplus
  • Earmarked specific revenues
  • Impact or user fees
  • Grants
  • Debt
Capital Project Expenditures

• Capital Funds
  • 171 – General Capital Projects
  • 177 – Education Capital Projects

• Capital Functions
  • 91120 – Administration of Justice Projects

• Capital Objects
  • 706 – Building Construction
  • 711 – Furniture and Fixtures

• Subfunds – Not uniform!
Capital Construction Management

• Role of Construction manager/Owners Representative
  • Manages change orders
  • Liaison to architects, contractors, and county
  • Works with officials from first steps of planning project
  • Becomes the county’s advocate

• Focus is on project and insuring quality control
If you only remember one thing....

• Capital improvement plans are helpful and once the initial assessment is done, they are easy to maintain

• Capital purchases are generally expensive and require the county to issue debt, this makes the timeline to purchase capital assets longer than regular purchases

• Your office will probably not have capital asset needs each year
Debt
Understanding Your Debt
What is Debt?

• Payments of an asset over its useful life

• Used in financing public works projects
  • Bonds
  • Notes
  • Loans
  • Leases
What Debt Does Your County Have?

• Find it in your county’s Annual Financial Audit

  • Long-term Obligation Section to the Notes of the Financial Statements
  • Schedule of Changes of Long-term Notes, Bonds, and Other Loans
  • Schedule of Long-Term Debt Requirements by Year
Debt Capacity

• How much can you afford with existing revenue?
• Evaluate effect of new payment on existing debt payments
• Know all the costs including interest
• Debt service obligation
• Measures of debt burden on the community
• Measures of the tax and revenue base
• Statutory or constitutional limitations affecting the amount that can be Issued
• Market factors affecting tax-exempt Interest costs
The Debt Service Fund

Per GASB 54, Debt service funds

• Are used to account for and report financial resources that are restricted, committed, or assigned to expenditure for principal and interest

• Should be used to report resources if legally mandated.

• Financial resources that are being accumulated for principal and interest maturing in future years also should be reported
Debt Service Budgets

• Details the principal and interest payments
• Debt service fund budget is approved annually by county commission
• Another resource for finding the county’s current year debt
• Funds 151 through 169 are typically used as debt service funds
• Principal and interest are two common object codes used for expenditures
  • Object codes 601-699
Multi-Year Debt Budget

• Should include:
  • Most recent prior year’s audit
  • Current year’s operation

• Budget should reflect revenues over the term of the county indebtedness

• Extend annually until the final debt payments are made
Debt Ratios

• Identify current debt capacity
  • Impact on debt ratings
  • Citizens’ ability to pay for future indebtedness
Debt Statistics & Ratios

<table>
<thead>
<tr>
<th>Debt per capita</th>
<th>Per capita income</th>
<th>Per capita debt as percentage of per capita income</th>
</tr>
</thead>
<tbody>
<tr>
<td>( \frac{\text{Total debt}}{\text{County population}} )</td>
<td>( \frac{\text{Total personal income}}{\text{County population}} )</td>
<td>( \frac{\text{Debt per capita}}{\text{Per capita income}} )</td>
</tr>
</tbody>
</table>

$1,200-$2,500 is top range of national benchmark per GFOA/rating agencies

Population and income information found at Census Bureau website

Total overall debt per capita should not exceed 15% of per capita income
Debt Statistics & Ratios

• Debt to assessed property value

\[
\frac{\text{Total debt}}{\text{Assessed property value}}
\]

• The overall net debt should not exceed 10% of assessed value
  (best practice)
# Debt Ratios

<table>
<thead>
<tr>
<th></th>
<th>County A</th>
<th>County B</th>
<th>County C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Debt</td>
<td>$185,000,000</td>
<td>$316,000</td>
<td>$46,000,000</td>
</tr>
<tr>
<td>Assessed Property Value</td>
<td>$1,900,000,000</td>
<td>$186,000,000</td>
<td>$219,000,000</td>
</tr>
<tr>
<td>Debt Ratio</td>
<td>9.70%</td>
<td>.17%</td>
<td>21.00%</td>
</tr>
<tr>
<td>County Population</td>
<td>92,000</td>
<td>12,000</td>
<td>15,000</td>
</tr>
<tr>
<td>Debt Per Capita</td>
<td>$2,000</td>
<td>$26</td>
<td>$3,200</td>
</tr>
</tbody>
</table>
Statistical Reference

• The highest debt county is Davidson County at more than $5.7 billion.

• Davidson County’s debt per capita is over $9,134.

• McMinn and Giles counties are debt free.
Debt Analysis

• Beneficial to show:
  • Current debt service and capacity
  • Current fund balance
  • Potential capacity for new debt
  • Funding needed for new debt
  • Debt ratios for your county
RECAP
Recap of Understanding Your Debt

What is debt?

T or F: The county’s annual audit has information about how much debt is owed.

How is debt capacity like your checking account or paycheck?
Recap of Understanding Your Debt

What hits your Debt Service Fund?

Can operational expenses hit this fund?

T or F? Debt per capita is the debt of the capital.
Can a county be debt free?
Debt Issuance
Debt Issuance

• Legal Authority
• Types of Debt
• Credit Rating
• Process
• Methods for Funding the Project
• How Much Should Be Borrowed?
Major Factors Determining Debt Issuance

• Amount of Issuance

• Type of asset

• Life expectancy of asset

• Impact of new debt on existing debt service
Local Government Public Obligations Act of 1986

• Consolidated statutes pertaining to debt obligations
• All interest income received by bond/note investors are exempt from income taxes and from all state, county, and municipal taxation
• Debt must be authorized by resolution and then approved by the Office of State and Local Finance
• Issued debt can be called to referendum by the public
Public Building Authorities

• Lowering issuance costs

• Financial advisor is not required

• Issue debt in large denominations

• Loan in smaller denominations to multiple entities
Credit ratings

• Counties are predominantly rated by Moody’s Investor Services and Standard and Poor’s (S&P)

• County’s last rating will be provided on the last debt instrument

• Any future rating will be provided prior to the debt being issued
<table>
<thead>
<tr>
<th>Investment Grade</th>
<th>Strongest</th>
<th>Non-Investment Grade</th>
<th>Weakest</th>
</tr>
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<tbody>
<tr>
<td>Moody’s</td>
<td>Standard &amp; Poor’s/Fitch</td>
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<td></td>
<td></td>
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<td>C</td>
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Acquiring a Credit Rating

• Counties may be required to obtain a credit rating in order to issue debt (if the county does not have one) – costs vary
• Credit agencies help the county gather information in order to issue a rating
• Once a credit rating is issued, the county can borrow money
• Remember….a county may lose their credit rating if they go years without borrowing money
Types of Debt

- Capital Outlay Notes (CON)
- Bond Anticipation Notes
- Grant Anticipation Notes
- Tax (Revenue) Anticipation Notes
- Health Care Anticipation Notes
- General Obligation (G.O.) Bonds
- School Bonds
- Loans
- Capital Leases
Notes

• Tax (Revenue) Anticipation Notes generally used when cash flow doesn’t meet current expenditures.
  • Must be approved by Office of State and Local Finance
  • Must be repaid by June 30th of FY in which issued

• Grant Anticipation Notes may be used county contracted to receive a grant and funding from grants is delayed

• Bond Anticipation Notes may be issued while awaiting favorable conditions for issuance of G.O. bonds.
Capital Outlay Notes

- Initial issue can’t exceed the end of the 3rd FY following year of issuance
- May be renewed for two more periods up to three years each
  - Requires approval from Office of State and Local Finance
- Requires minimum of 1/9 principal to be retired each year
  - Requirement may be waived by Office of State and Local Finance
- May also be issued for three years but no longer than the end of 12th FY following year of issuance (T.C.A § 9-21-608)
  - Must be sold competitively if more than $2 million
General Obligation (G.O.) Bonds

• Usually capital improvements with a longer life span

• By issuing, county pledges full faith, credit, and unlimited taxing power

• May be issued with a maturity up to 40 years

• Registered voters may petition for referendum of proposed bonds
School Bonds

• Backed by the full faith and credit of the county and its taxing authority

• May be issued up to 40 years

• No authority for public to petition for a referendum

• Counties with multiple school districts may be required to share bond or loan proceeds
Loans

- Reduces issuance cost
- May be variable rate or fixed rate
Leases

• Any lease for capital items are considered long-term debt
• Only true “rentals” can be treated differently (e.g., copy machines)
• Always get an actual purchase price and an imputed interest rate (effective APR) - can be 13% to 25% or more
• A CT-0253 form MUST be filed with the Office of State and Local Finance
• A non-appropriation clause in the lease does NOT mean the lease can be treated as a year-to-year rental
Balloon Indebtedness

• Counties may be authorized to issue balloon indebtedness

• Approval would come through the Office of State and Local Finance

• This language would have to be included in the county’s debt management policy
Process - Disclosures

• County can select to have a competitive, negotiated, or private placement of bonds

• Competitive selection would require a financial advisor

• Financial advisor, issuer, or bond counsel will develop legal notices, bid forms, and various disclosures

• EMMA reporting
Office of State & Local Finance Requirements

• Cover letter with contact info
• Original, signed, certified copy of the debt resolution
• Pro forma statement (monthly cash flow)
• Clearly define the public purpose
• Include amortization schedule
• Useful life of the asset

*CT-0253 must be completed within 45 days after issuance*
RECAP
Recap of Debt Issuance

• Public Building Authorities have higher or lower issuance costs?

• What are the four types of Debt?

• What state agency requires several documents for debt?
Additional Considerations for Issuance of Debt

• Borrow only for assets in current capital improvement plan or emergency situations
• Create a debt management committee
• Seek competitive proposals for all issuances
• Only use leases when more advantageous than purchasing the asset
• When using variable interest debt, budgeting a specified percentage above current rate
• Life of debt for a capital asset may not exceed the life of the asset
Funding Projects

• Only the CLB has funding authority for all debt issues

• Most commonly funded by local revenues – especially property or wheel tax

• Some local revenues may be subject to a referendum
How Much Money is Needed?

• Counties should determine their debt capacity

• Analyze debt service fund revenue, expenses, and fund balance

• Is fund balance growing or depleting?

• Remember…. a debt being paid off will expand debt capacity
The Debt Resolution

• Only required to be posted or published after adoption

• Cannot be vetoed by county mayor/executive

• Takes only a majority commission to approve

• May delegate to county mayor authority to sell notes or bonds
Refunding

• Restructuring of bonds to create more capacity in debt service
• Refunding bonds use the same pledge for security and replace the original issue with a lower rate of interest
• If bonds are refunded at a lower interest rate, interest costs will be less
• Process usually begins 18 months from the call date
• Refund only to achieve overall savings on debt service costs
• Don’t refund beyond original anticipated life of asset
Managing your debt
Cash Flow

• Know your payment schedule

• Typically schedule payments when cash flow is highest
  • December through February

• Allows counties to maximize investments when funds are not required for use
Fund Balance Policy

• Counties are encouraged to have fund balance policies in writing

• Debt service fund balance should be considered a restricted fund balance

• Improve financial reporting by providing fund balance categories

• Principal and interest – restricted, committed or assigned

• GASB issued Statement 54
Fund Balance Policy

• The Office of State and Local Finance recommends a fund balance of 50% to 100% at the end of the fiscal year

• Considerations should be:
  • Cash flow needs
  • Budgeting contingencies
  • Emergency contingencies
  • Variable rate volatility contingencies plus
  • Future forecasted needs
Debt Management Policy

• Legal Requirements

• Objectives

• Minimum Language Required

• Additional Considerations to the Minimum Language
Objectives of Debt Management Policy

• Make the decision process transparent

• Address hiring outside professionals

• Address any potential conflicts of interest
Debt Management Policy
Minimum Language Required – Transparency

• Comply with legal requirements for notice and public meetings
• Disclose all costs including:
  • Interest
  • Issuance
  • Continuing
  • One-time
Debt Management Policy
Minimum Language Required – Professionals

• Require disclosure of all compensation related to debt issuance
• Enter into letter of engagement with all counsel representing the entity
• Written agreement with financial advisors
• Financial advisors not allowed to bid, privately place, or underwrite for any issuance for which they provide advisory services
• Require underwriter to be clearly identified in writing
Debt Management Policy
Minimum Language Required – Conflicts of Interest

• Required all professionals involved to disclose existing client business relationships between and among the professionals to a transaction

• Requirement excludes professionals involved via electronic bidding platform
Additional Language Considerations

• Who responsible for analysis reporting?
  • Preparation of CT-0253
  • Annual debt report to CLB
  • Multi-year debt budget
  • Debt payments via debt service fund
  • Debt shall not exceed life of asset
Additional Language Considerations

• Identify individual responsible for understanding and explaining debt management policy

• Annual debt budgets shall be adopted by CLB

• New debt issuance detail all associated costs

• County will comply with current and future statutory requirements
Other Additional Conflict of Interest Considerations

• Require all professionals to enter into an engagement letter related to:
  • Proposed services
  • Cost
  • Any potential conflict of interest
Recap
Recap of Managing Your Debt

• Most debt is funded by what tax?

• Because of the deadline for this tax, when does the county have the most cash flow: winter or summer?

• T or F: a debt management policy increases transparency
Remember

• Current and future community needs is paramount

• Debt payment length of time = life of asset

• Understand debt process
Thank you!

More information:

http://eli.ctas.tennessee.edu