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July
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Accounting Newsletter for Governmental Entities

Arbitrage Rebate vs. Yield Reduction Payments

by Cherie R. Wright, CPA, CFE, CGFM, Partner

While many have heard of arbitrage rebates, yield reduction payments are lesser known. Yet, the yield reduction payments under the yield restriction rules have been in existence longer. The rebate rules were implemented with the 1986 Tax Reform Act and have been revised several times over the years, but the yield restriction rules began in 1979.

In general, arbitrage rebate rules mandate when arbitrage must be remitted to the IRS and yield restriction rules govern when arbitrage may legally be earned. The thing to keep in mind is that tax-exempt bonds are subject to both sets of rules, and both constitute different forms of taxation on arbitrage.

The dictionary definition of arbitrage is the purchase of currencies, securities, or commodities in one market for immediate resale in others in order to profit from unequal prices. In the realm of tax-exempt bonds, arbitrage occurs when entities use proceeds from tax-exempt obligations to acquire higher yielding investments. In other

(Continued on P.2)

Update to Employer Shared Responsibility Provisions of the Affordable Care Plan

On July 2, 2013, the U.S. Department of the Treasury announced that the delayed implementation of certain provisions of the Afffordable Care Plan, in particular those impacting the shared responsibility penalty for employers and the employer and plan reporting requirement. These will both be delayed for one year (until 2015). You can read the Treasury's announcement online here. The IRS has also removed their Q&A and they are expected to provided updated information soon. ■

Why Good People Do Bad Things

by Michael L. Lauzon, CPA, Audit Manager

When fraud occurs, it is often assumed that the perpetrator will be easily identifiable as an unethical person. Indeed, many organizations' fraud prevention tactics focus on interviews and background checks during the hiring process, as well as ongoing feedback and interaction from coworkers or supervisors to identify individuals who potentially may commit fraud. However, not all fraud is committed by people with a history of unethical behavior. People who consider themselves ethical (and who may be viewed as good people by their coworkers and supervisors) can commit fraud too.

Think about the examples of fraud that you have heard relayed in seminars and ethics training events. Part of the reason that the stories are so intriguing is the fraudster is often the last person you would suspect - someone's friend, parent, grandparent or trusted member of the organization. As an organization, we cannot control or necessarily identify an individual's rationalization or pressure that have motivated fraudulent activity. We can, however, implement procedures to reduce the opportunity for fraud to occur.

When designing and implementing internal controls to help prevent and detect fraud, an important (but often overlooked) element is the establishment of an organizational tone that

(Continued on P.3)

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HMU Events

Details and links to online registration can be found at www.heinfeldmeech.com/hmu. For more help, contact Susan at 520-742-2611, x107 or hmu@heinfeldmeech.com.

The Ins and Outs of the FLSA - How to Keep Your Organization Out of Trouble

Location: Mesa, AZ (Mesa Convention Center)

Date: Tuesday, August 20

Registration Ends: 8/12/13

Introducing the H&M Clinic (free webinar)

Date/Time: Wed., August 21, 10-11 am

Registration Ends: 8/19/13

Communicating Accomplishments and Annual Financial Results to the Public (free webinar)

Date/Time: Monday, August 26, 2-3 pm

Registration Ends: 8/22/13

Payroll Essentials for Governments and Non-Profits

Location: Mesa, AZ (Mesa Convention Center)

Date: Friday, December 6

2014 Local and State Government Accounting Conference

Location: Mesa, AZ (Mesa Convention Center)

Date: Thursday, January 23

Sharpening Internal Controls to Prevent Fraud

Location/Date: Vail, AZ - Wed., Jan 15th

Location/Date: Mesa, AZ - Thurs., Jan 16th

Capital Assets Accounting for Governmental Agencies

Location: Mesa, AZ (Mesa Convention Center)

Date: Tuesday, March 4

Arbitrage Rebate vs. Yield Reduction Payments

(cont'd from P.1)

words, if the interest received on the proceeds held during the project construction exceeds the interest payments ultimately made to the bondholders, arbitrage has been earned.

Of course, it's never as simple as it sounds. There are very complex rules and exceptions that go into the calculations and, of course, there are different rules and various exceptions for arbitrage rebate and yield restriction. Calculations under both sets of rules must be performed and evaluated to determine which payment should be made.

One of the areas that seems to be most misunderstood is the small issuer exception. Under the arbitrage rebate rules, there is an exception for "small issuers." For those familiar with the arbitrage rebate, this small issuer exception is often relied upon to avoid arbitrage calculations. Generally speaking, when a governmental entity issues tax-exempt debt of $5 million or less in a calendar year, it is exempt from the arbitrage rebate rules for the debt issued during that year. This threshold must be evaluated for all tax-exempt debt, which may include bonds, certificates of participation, etc.

However, just because your entity qualifies for the small issuer exception, does not mean you are off the hook. The yield restriction rules still apply, and this small issuer exception is one of the reasons that the older yield restriction rules have not gone away. The yield restriction calculations must still be performed regardless of the small issuer status under the arbitrage rebate rules, and, if an amount is owed, a yield reduction payment must be made.

Under the yield restriction rules, during "temporary periods" the yield on the investment of proceeds is unrestricted, and no yield reduction liability will be incurred. Of course, the bonds are still subject to the arbitrage rebate rules, and

(Continued on P.3)

Why Good People Do Bad Things

(cont'd from P.1)

requires that all decisions include consideration of ethical principles. Psychological studies have shown that the business mind set activates one set of goals - to be competent and successful. On the other hand, the ethical mind set activates another set of goals - to be fair and not hurt others. Therefore, if decisions are presented from a strictly business perspective, employees may not see past the impact of their decision on immediate business results or the achievement of a specific desired outcome. Therefore, individuals are more likely to follow ethical rules when they are asked to consider both business and ethical implications during the decision making process.

The importance of setting an environmental tone that considers ethics in decision making was revealed by a study by a University of Notre Dame psychological researcher, as cited in a story by National Public Radio's *Planet Money*. In this study, two groups were presented with a desired outcome (or goal). The instructions for the first group

(Continued on P.4)

H&M News

Michael A. Hoerig, CPA, was recently promoted to Partner. Michael has been with our firm since 2001 and specializes in providing auditing services to governmental and non-profit clients from our Tucson office.

We are also happy to announce the following recent staff promotions: *Eugene Park, CPA*, to Audit Manager; *Michael Paul Rohr, CPA,* to Senior Associate; & *Anthony St. George* to Staff Associate II.

Brittney Williams Spross, Audit Manager, has joined the Financial Management Standards Board of the Association of Government Accountants.

Arbitrage Rebate vs. Yield Reduction Payments

(cont'd from P.2)

barring any qualifying exceptions, an arbitrage rebate liability can still be incurred during these "temporary periods." A few of the "temporary period" exceptions include:

- Project funds – generally 3 years with certain exceptions
- Debt service funds – 13 months
- Interest earnings – 1 year
- Reserve funds – unlimited temporary period as long as certain qualifications are met
- Replacement proceeds (certain other revenues) – 30 days

After the "temporary periods" are ended, the investment yield is restricted. If the investment yield is "materially higher" than the bond yield, a yield reduction payment is owed. Depending on the circumstances, "materially higher" is defined as either 0.001% or 0.125%. In other words, if the bond yield is 4% and is subject to the 0.125% restriction, the investment yield must be less than 4.125% to avoid a liability.

The end result is that your entity may incur a rebate liability or a yield reduction liability. If both calculations indicate an amount is owed, the IRS requires payment of the larger of the two. If nothing is owed under either set of rules, there are no filing requirements with the IRS. However, your entity is still subject to a potential audit, during which the IRS will request the calculations verifying no liability was incurred.

For IRS purposes, the calculations must be performed each "installment computation date," which is typically every fifth year since the bonds

(Continued on P.4)

Why Good People Do Bad Things

(cont'd from P.3)

merely indicated that they were to achieve the end result. The second group was instructed to achieve the result but consider the ethical implications of actions taken. When presented with an opportunity to cheat, the second group (who had simply been reminded to consider ethical implications) did not take the bait, but the first group did. This group may not have intentionally intended to make unethical decisions, but nevertheless it occurred in the process of achieving the set goal.

Setting organizational policies and procedures and implementing strong internal controls are key to fraud deterrence and prevention. Internal controls help mitigate opportunities for fraud to be committed or the possibility for someone to be wrongly accused of committing fraud. Terms like micromanaging, lack of trust, red tape, and jumping through hoops are used to describe work processes or environments which seem to have an undue amount of oversight over routine activities. While these extra steps may be perceived as inconvenient to employees, they are put in place to protect the organization itself as well each individual within the organization. To help achieve these goals, your organization should also review your internal control processes with an eye to incorporating ethics as an important aspect of the decisions made by your employees every day. ■

Arbitrage Rebate vs. Yield Reduction Payments

(cont'd from P.3)

were issued, and at the "final computation date," when all the bonds have been retired whether matured or redeemed early. However, annual calculations are recommended for financial statement and other bond disclosure purposes.

To ensure compliance with these and other arbitrage requirements, the entity's debt management policy should include a section on arbitrage compliance. The arbitrage compliance policy may include a variety of topics including definition of bond years, rules for establishing appropriate accounts and the treatment of commingled accounts, frequency of calculations, record retention, etc.

Questions? Contact Cherie Wright at (602) 277-9449, ext 376 or cheriew@heinfeldmeech.com. ■

About H&M

Heinfeld, Meech & Co., P.C., CPAs are recognized leaders in the field of governmental accounting and auditing and are frequently called upon to speak at events sponsored by industry organizations such as the AICPA, AGA, and GFOA.

Our active involvement with national and state associations keep us up-to-date about emerging issues affecting the governmental industry. We offer this free newsletter as part of our commitment to providing resources and training to governmental business personnel.

For more about our firm, please visit our web site at www.heinfeldmeech.com.