3. ACCOUNTING

3.4 **Liabilities**
3.4.6 **Arbitrage Rebates**

Overview

3.4.6.10 Any local government may engage in arbitrage by borrowing funds at one interest rate and investing those same funds at a higher rate. The primary reason for arbitrage is that the rates of interest paid on tax exempt debt normally are lower than those paid on taxable securities and it is possible for local governments to profit from this disparity in interest by temporarily reinvesting the proceeds of lower interest tax exempt borrowings in higher yielding taxable securities. The proceeds from those transactions are called *arbitrage earnings*.

3.4.6.20 When governments reinvest tax-exempt proceeds at a higher, taxable yield, the *excess* earnings must be remitted to the federal government as arbitrage rebate. There are some important exceptions to this general rule. These special situations are known as *safe harbors* (e.g., small issuer safe harbor, six-month expenditure safe harbor, eighteen-month expenditure safe harbor, twenty-four month expenditure safe harbor).

3.4.6.30 If a government fails to qualify for one of the safe harbors, it must calculate and rebate arbitrage earnings to the federal government. The tax code requires that arbitrage be calculated every five years and upon maturity.

Financial accounting and reporting for arbitrage

3.4.6.40 As noted earlier, the federal government only requires that arbitrage be calculated and reported every five years and at maturity. Rebatable arbitrage should not be treated as a reduction in investment revenues in governmental funds; it should instead be treated in the same way as any other claim or judgment. That is, there should be no recognition in the governmental fund's balance sheet or operating statement until rebatable amounts are actually due and payable to the federal government. Of course, a liability and expense must be recognized in the full accrual-based government-wide financial statements as soon as arbitrage is incurred.[1]

3.4.6.50 In calculating the amount of the liability, it should be remembered that *excess* earnings of one year may be offset totally or in part by lesser earnings in a subsequent year. Therefore, the liability recognized for a year should be only that portion of the estimated future payment that is attributable to earnings of the current period.

3.4.6.60 In practice, two different acceptable approaches are taken to accounting and reporting rebatable arbitrage in the financial statements.

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[1] The rebatable arbitrage is subject to the accounting and reporting rules governing claims and judgments. See the GASB Statement 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*.

3.4.6.70 ***Revenue reduction approach***

This approach treats the rebatable arbitrage as a reduction of revenue rather than as a separate expenditure or expense.

Assume, for example, that $5,000 in interest has been earned on reinvested proceeds reported in a capital projects fund, and that $1,000 of that amount needs to be remitted to the federal government.

The journal entries would be as follow:

Year 1

<u>Construction Fund</u>

111.10	Cash		$5,000	
	3611000	Arbitrage Interest		$5,000

(To record the receipt of interest from arbitrage transaction.)

288.00	Assigned Fund Balance		$1,000	
	282.00	Restricted Fund Balance		$1,000

(To reserve fund balance.)

This entry would be reversed at the beginning of the subsequent year.

Year 5

<u>Construction Fund</u>

282.00	Restricted Fund Balance		$1,000	
	288.00	Assigned Fund Balance		$1,000

(To reclassify fund balance.)

231.20	Short-Term Arbitrage Rebate		$1,000	
	111.10	Cash		$1,000

(To record the payment of the arbitrage rebate.)

3.4.6.80 ***Tax approach***

In the second approach the rebatable arbitrage is treated essentially as a tax. This approach argues that the earning of revenue and the incurrence of a tax liability are really two separate transactions. Accordingly, the rebatable arbitrage is treated separately from investment income.

Rebatable arbitrage is reported as a long-term liability on the government-wide statement of net position until due and payable to the federal government. When payable, the liability and expenditure would be reported in the appropriate governmental fund.

Year 5

Construction Fund

592PP50	Expenditures – Arbitrage Rebate Tax		$1,000	
	263.70	Arbitrage Rebate Tax Payable		$1,000

(To report liability for rebatable arbitrage arising from the investment of debt proceeds.)

263.70	Arbitrage Rebate Tax Payable		$1,000	
	111.10	Cash		$1,000

(To record the payment of arbitrage rebate.)

Special arbitrage implications for proprietary funds

3.4.6.90 Proprietary funds often are required to capitalize interest in conformity with the GASB Statement 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*. Under the GASB Statement 62, the amount of interest to be capitalized is determined by netting interest revenue against interest expense. If interest revenue temporarily exceeds interest expense (i.e., arbitrage), the result can be *negative* interest capitalization (i.e., a reduction in the cost of the capitalized asset).

3.4.6.100 The method of accounting and financial reporting selected for arbitrage (i.e., revenue reduction approach or tax approach) can have an effect on the amount of interest capitalized in proprietary funds that follow the provisions of the GASB Statement 62. Specifically,

- If interest revenue reduces the amount of interest to be capitalized under GASB Statement 62,
- And the revenue reduction approach reduces the amount of interest revenue, then
- The revenue reduction method would increase the capitalized value of the asset (i.e., by reducing what otherwise would have been a reduction in cost).

3.4.6.110 Viewed another way, the practical effect of selecting the revenue reduction approach in a proprietary fund using the GASB Statement 62 is to *capitalize* arbitrage. In other words, under the tax approach, rebatable arbitrage is reported as an expense when it is incurred, whereas under the revenue reduction approach it is effectively included in the cost of the asset and only gradually reported in the operating statement as depreciation expense over the asset's useful life.