

**Manual of Accounting and Financial Reporting for  
Pennsylvania Public Schools**

**CHAPTER 12**  
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*Debt Management, Accounting And Reporting*

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# Chapter 12

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## Debt Management, Accounting And Reporting

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**\*\* Updated 8/1/05 \*\***

## ❖ *What Is Debt Management?*

Debt management is an integral part of a school entity's financial management. It involves planning, budgeting, accounting and financial reporting, as well as good public relations. If you incur debt for your school, you should be aware of the impact the debt will have on your overall finances. There are laws that regulate how much and when you can incur debt for certain purposes. Proper debt management will require a capital budget as well as an operating budget to avoid obligating more current and future school resources than will be available. Capital projects should be well justified, planned and conducted with every aspect of the budget. Proper debt planning helps to show the effects of incurring debt for a building project or renovation that extends well beyond the annual debt service costs. A good debt management plan also includes an LEA policy setting forth the anticipated need, timing and purpose for incurring debt. You will also want to consult a financial specialist such as a bond counselor, accountant or investment banker before incurring debt. And finally, you will want to maintain your debt obligations at a manageable limit on a day-to-day basis to protect the LEA's credit rating.

## ❖ *Is There A Statutory Debt Limit On Pennsylvania Public Schools?*

LEAs are independent local governments. An LEA's existence, form and power are derived from the Constitution of the Commonwealth, the Pennsylvania Public School Code, and Acts of the General Assembly. One of the powers granted Pennsylvania Public Schools is to borrow funds and pledge future revenues. Thus, local debt levels have been controlled by the state since 1874. The Pennsylvania Local Government Debt Act was initially passed in 1972 to control debt, and is monitored by the Pennsylvania Department of Community and Economic Development.

**NOTE:** Pennsylvania Charter Schools are limited in the type of long-term debt allowed; thus, not all guidance in this Chapter will apply to charter schools.

## ❖ *What Is The Local Government Unit Debt Act?*

The Local Government Unit Debt Act (the "Debt Act") provides the framework for the issuance of debt by Pennsylvania Local Education Agencies (LEAs). The Debt Act was re-enacted and revised by Act No. 177 of 1996. The Act contains the absolute debt limits determined by the legislature. It provides the exclusive methods of borrowing by LEAs and municipalities, and it applies to all local governmental units except for Philadelphia City and county. It grants every local governmental unit the "full power and authority" to issue bonds or notes, and make guarantees, leases, subsidy contracts or other agreements within the absolute limits. The Act provides general debt limits and special debt limits.

In addition to granting the authority and conditions required to issue debt, this Act provides various definitions pertaining to debt. Limitations on the amount of debt a school district can incur are established. Procedures to be performed in the issuance of

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debt, whether it is a bond, note, lease, or tax anticipation note, are described. Guidelines are provided for acceptable preliminary cost estimates. Remedies are provided for failure of the school district, the borrower, to comply with legal requirements. The Department of Community and Economic Development (DCED) is named as the enforcement agency within the Commonwealth of Pennsylvania for the approval of debt. The Debt Act also requires the establishment of sinking funds for the repayment of debt, and defines allowable investments for sinking funds. A copy of the DCED's Debt Management Handbook including the Pennsylvania Local Government Unit Debt Act can be found on their website at [www.newpa.com](http://www.newpa.com)

A transcript of all proceedings undertaken in the issuance of debt is required to be filed with the DCED. All debt issued by an LEA is deemed to be non-electoral debt unless it is specifically approved as electoral debt via a general election. Procedures and requirement for approval are set forth in Chapter 80, Subchapter C of the Debt Act for non-electoral debt. There are no limitations on electoral debt.

The issuance of non-electoral debt requires that the school district calculate and certify its (1) borrowing base and (2) net non-electoral debt plus net lease rental debt as part of the proceedings to be filed with the DCED. The borrowing base for a local government unit is the arithmetic average of the total revenues for the three (3) full fiscal years immediately preceding the year of borrowing non-electoral debt or lease rental debt. The borrowing base certificate submitted to DCED will list the revenues for each of the three (3) preceding years and the average revenue. It will be signed and executed by authorized officials of the school district or by an independent auditor. A detailed description of the calculation of nonelectoral debt plus net lease rental debt is provided in DCED's **Debt Management Handbook**.

The borrowing base calculation is used to determine nonelectoral borrowing limitations for a school district. A complete explanation of this calculation and the debt limitations on nonelectoral debt, lease rental debt and combined debt can be found in the DCED Debt Management Handbook, and by referencing 53 Pennsylvania C.S.A. Local Government Unit Debt Act.

The Department of Community and Economic Development (DCED) must approve the sale of bonds or notes issued by a school district. Approval of the DCED is not required for the issuance of tax and revenue anticipation notes (TRANS); however, there are certain filing requirements that must be met. The Department has the power to prescribe the form and content of the filings. Failure of a school district to meet filing and / or approval requirements will nullify the validity of the incurred debt. The DCED is also empowered with the authority to audit bond sinking funds and to enforce investment provisions of the Pennsylvania Local Government Debt Act.

### ❖ **What Debt Do Schools Incur?**

Schools borrow money on a short-term basis either to meet seasonal cash needs or in anticipation of long-term borrowing at later dates. Schools usually borrow money on a long-term basis to finance capital asset construction or infrastructure improvements.

Borrowings may also occur for other needs such as the initial funding of a risk-retention program, the payment of a claim or judgment or the financing of an accumulated operating deficit.

Local Educational Agency (LEA) debt may come in the form of bank loans, capital leases, general obligation bonds, State Public School Building Authority obligations, tax and revenue anticipation notes, bond anticipation notes, claims and judgments, employee-compensated absences, special termination benefits awarded employees, and mortgages or liens.

### ❖ *What Is Short-Term Debt?*

Short-term obligations are any loan, negotiable note, time-bearing warrant or lease whose duration is 12 months or less, regardless of whether or not it extends across more than one (1) fiscal year. The measurement focus for governmental funds is the flow of current financial resources. When a school district issues short-term debt that is to be repaid from governmental funds, the liability is recorded in the balance sheet of the fund responsible for the repayment of the debt. This liability is not recorded as current or long-term since the balance sheet of a governmental fund is unclassified. However, the mere presentation of the liability on the balance sheet of a governmental fund implies that the debt is current and will require the use of current expendable financial resources.

### ❖ *What Is Long-Term Debt?*

Long-term obligations are any loan, negotiable note, time-bearing warrant, bond or lease whose duration is more than 12 months. Non-current obligations of a school that will be repaid from revenues generated by proprietary funds should be recorded in the related proprietary fund while non-current obligations issued to be repaid from governmental funds is defined as “Non current debt” and should be recorded in the school district’s statement of net assets.

### ❖ *What Is General Long-Term Debt?*

General long-term debt is the unmatured principal debt that is secured by the general credit and full revenue powers; that is, full faith and credit, of the LEA. It is not a debt that is specific to a specific fund. Debt specific to a fund is a fund liability backed by the revenue power of the fund.

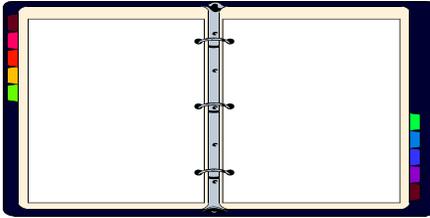
Long-term debt is not limited to liabilities from debt issuances. Long-term debt also includes the noncurrent portion of lease-purchase agreements, capital leases, operating leases with scheduled rent increases, compensated absences, claims and judgments, pensions and special termination benefits. Interfund liabilities are not general long-term liabilities.

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## ❖ How Should Debt Be Accounted For By LEAs?



The accounting treatment of debt depends on the characteristics of the specific debt. The characteristic of the specific debt will determine if it is a current liability or a long-term liability.

A current liability will require the use of current resources. Such resources are referred to in accounting literature as expendable available financial resources of the fund responsible for repayment during the fiscal period. Current liabilities are presented on the Balance Sheet as a liability of the responsible fund. The Governmental Accounting Standard's Board's (GASB) *Codification of Governmental Accounting and Financial Reporting Standards*, Section 1600, sets forth the general rule for recognizing expenditures and associated liabilities in the respective fund. The explanation here is that a fund liability should only be recognized in governmental fund types if the obligation will be satisfied with "expendable available financial resources." Unfortunately, the GASB Codification does not define "expendable available financial resources," and there have been varying interpretations of this term applied to liability classifications. If in doubt, LEA administrators are advised to consult with their independent auditors for guidance on the appropriate liability classification, and apply the classification criteria consistently from year to year. The non-current portion of a liability in governmental fund types is not reportable in the fund. Long-term liabilities of governmental funds should be reported in the governmental activities column of the government-wide statement of net assets only. This requires that you continue to account for this debt and any associated assets by type activities i.e., governmental or business type.



## ❖ Types Of Debt

### COMPENSATED ABSENCES



The GASB Codification Section C60 provides guidance for accounting and financial reporting for compensated absences. Compensated absences are absences for which employees are paid, such as vacation, sick or sabbatical leaves. All state and local governments must account for and report accumulated unpaid compensated absence balances in accordance with GASB Statement #16. The accumulated, unpaid balance is generally reported as a current liability and a long-term liability. The

balance to be paid from available expendable financial resources is reported as a current liability. The amount to be paid from future fiscal year appropriations is a long-term liability. The accumulated, unpaid compensated absence balance should be calculated using the current salary rates for each employee and all direct and incremental salary-related expenses; i.e., social security and medicare taxes,

retirement contributions, all probable leave payouts, and leave that is likely to vest. The amount calculated should not include leave likely to lapse, the cost of life insurance, health care premiums, or sabbaticals granted for current service.

Expenditures are recorded as operating salary expenditures when benefits for sick time or vacation time are used. However, a payout at termination requires an expenditure entry and a reduction of the same amount in “general long-term liabilities – compensated absences.”

#### Reporting In Government-Wide Financial Statements

Report compensated absences expenses and liabilities in the government-wide financial statements. Compensated absences that are general long-term liabilities should be reported in the governmental activities column in the Statement of Net Assets. Liabilities greater than one (1) year should be segregated between those due within one (1) year and those due in more than one (1) year.

#### Reporting In Fund Financial Statements – Proprietary And Fiduciary Funds

Report compensated absences of proprietary and fiduciary funds (and similar component units) as a fund liability.

#### Reporting In Fund Financial Statements – Governmental Funds

The amount of compensated absences recognized as expenditures in governmental funds should be the net amount accrued during the year that normally would be liquidated with expendable available financial resources. These expenditures should be calculated each period using the modified accrual basis of accounting.

### ❖ Accounting For Debt Issues

Proceeds from the issuance of debt are recorded in the fund that is authorized to receive the cash. Debt proceeds are recognized as an "Other Financing Source," not as revenue. If the debt is classified as current, the fund receiving the money will also record the liability. A proprietary fund type or a trust fund presents long-term debt as a liability of the specific fund.

Bond issuance costs are those costs related to the issuance of general obligation bonds. They can include items such as bond insurance, rating fees, financial advisory / underwriting fees, solicitor and bond counsel fees, printing costs and paying agent fees. Generally, issuance costs are paid from bond proceeds. Generally Accepted Accounting Principles permit bond proceeds to be reported “net” of issuance costs in governmental funds; however, the LECS Comptroller’s Office requires LEAs to record the proceeds gross and record the issuance costs in service area account 2390. This is necessary to get credit for these expenditures when your tuition rate calculation is computed electronically from your school’s annual financial report. Issuance costs for proprietary and trust funds are recorded as a pre-paid expense in the Asset Section of the fund’s balance sheet and are amortized over the life of the issue.

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Normally, interest is not accrued and expenditures are recognized when payment is made by the LEA. It is recommended that a Debt Service Fund be used to record the payments of principal and interest on debt. If the resources being provided for the principal and interest are coming from the General Fund, the General Fund will record a transfer of resources to the Debt Service Fund in service area account #5240-Transfer to Debt Service. In turn, the Debt Service Fund will report an incoming transfer of resources in revenue account #9310-Transfer from General Fund, and principal and interest expenditures in sub-function #5100-Debt Service. Establishing a Debt Service Fund will also satisfy the requirements of the Pennsylvania Local Government Debt Act. Debt service expenditures are recognized when payments are due, not when the liability occurs, at the fund level. However, LEAs may recognize a July obligation at June 30<sup>th</sup> if the previous fiscal year's budget provided for the expenditure.

Long-term liabilities of a Proprietary Fund are reported on the fund's Balance Sheet at the principal balance, net of any unamortized premium or discount. Unamortized premiums or discounts are amortized over the life of the issue using the effective interest method and are reported as an asset / liability on the fund's balance sheet. Principal payments on a Proprietary Fund's debt obligation are recorded as a debit to the liability account, while interest payments are charged as an expenditure of the fund.

The above material provided a general overview of the treatment of debt. The following sections will discuss more specific types of debt commonly issued by an LEA, and accounting requirements.

## **BANK LOANS**

An LEA can obtain financing for a project through traditional bank financing. In this method of financing, issuance costs are minimal to the LEA. However, banks may be less flexible in terms of the maturity of a loan, prepayments and other terms. In the process of asset and liability management, a bank will attempt to match the loan maturity against certificates of deposit to ensure an interest rate spread or to otherwise hedge its position. Most banks will not fix loan rates beyond seven (7) years. Banks are also limited in the amount they can lend to any one (1) customer. This limit is determined by the individual bank's financial condition. Small borrowings, generally under \$1,000,000.00, are the most viable candidates for bank loan financing.

## **BOND FINANCING**

Bond financing can take the form of a general obligation issue, an authority revenue bond, State Public School Building Authority issue, or a bond loan pool. These forms of financing allow the LEA greater flexibility in terms of lower borrowing costs (interest rate) than a bank loan, fixed interest rates, term of issue (up to thirty years in some cases) and repayment conditions. The various forms of bond financing are discussed below. The Commonwealth of Pennsylvania will reimburse the LEA for a portion of its bond debt service payments on approved Plancon projects. Chapter 17

of this Manual explains further the debt service / rental reimbursement subsidy available to most LEAs from the Commonwealth of Pennsylvania.

## **GENERAL OBLIGATION BOND ISSUE**

General obligation bonds are direct debt instruments issued by a school district that are secured by the LEA's taxing power.

## **AUTHORITY REVENUE BONDS**

In this type of financing, a local authority is used as a financing conduit. The authority obtains the bond financing. The project is leased to the issuing authority in exchange for the bond proceeds and then sub-leased back to the LEA for a rental equal to the semi-annual debt service payments on the bonds. The LEA may also be required to pay the authority an administrative fee. Authority revenue bond covenants may be more restrictive than that of a general obligation bond.

## **PENNSYLVANIA STATE PUBLIC SCHOOL BUILDING AUTHORITY ISSUE (SPSBA)**

The SPSBA was created to construct, improve, maintain, equip and lease public school building projects. It gives LEA's the option of combining borrowed funds with one (1) or more other LEA borrowings or individual debt issuance utilizing the LEA's own credit strength. Under either option, a district leases the project to the SPSBA, and the SPSBA sub-leases the project back to the LEA. In exchange for the bond proceeds, the district makes lease rental payments that consist of the debt service payments and an administrative fee.

## **BOND POOL LOAN**

A bond pool is a pool of funds that is created from the issuance of tax-exempt revenue bonds by an authority empowered to issue the bonds for the purpose of lending these funds to eligible LEAs for the funding of capital projects. These pools are usually utilized for short-term borrowings. Benefits of this type of financing include standard loan documents, lower financing costs than that of a general obligation bond, and perhaps the option of fixed or variable interest rates.

### **❖ Steps In Bond Financing**

Depending on the method of sale, the actual issuance process may take up to eight (8) weeks. This timetable takes into consideration the investor requirements and the procedures involved in adhering to the requirements of the Pennsylvania Local Government Debt Act. It is assumed that the financing team has already been selected by the LEA. The following steps are performed in the issuance of bonds, regardless of the method of sale.

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- ◆ Adopt the resolution expressing intent to issue debt.
- ◆ Prepare the Preliminary Official Statement (POS). The POS contains material information about the LEA as a borrower. This document is distributed to potential investors. It is similar to a prospectus, which is used in private sector debt issuance.
- ◆ Prepare legal documents.
- ◆ Submit application for rating and / or bond insurance.
- ◆ Send bid invitations to underwriting firms (competitive sale).
- ◆ Print and mail Preliminary Official Statement.
- ◆ Pre-market and price bond issue (negotiated sale).
- ◆ Advertise LEA's intent to adopt bond resolution (at least three (3) days before board meeting).
- ◆ Adopt bond resolution accepting purchase contract from the investment banker (negotiated sale) or lowest underwriter's bid (competitive sale).
- ◆ Advertise the adopted bond resolution.
- ◆ File debt proceedings with the Department of Community and Economic Development.
- ◆ Print Official Statement.
- ◆ Finalize legal and financial documents.
- ◆ Receive approval from the DCED (20 days after filing).
- ◆ Settlement, which consists of the signing of legal documents, delivery of bonds, receipt and investment of bond proceeds.

### ❖ *Sale of Bonds*

The two predominant methods for selling bonds are the competitive sale and the negotiated sale. The method of sale affects the overall cost of financing. It impacts both the costs of issuance and the debt service costs over the life of the bonds. The method of sale must be carefully evaluated to determine which type of sale will result in the lowest, total financing cost for the LEA, while maintaining public trust.

### **COMPETITIVE SALE**

In a competitive method of sale, the issuer solicits bids from underwriting firms to purchase its bonds, and sells bonds to the firm or bond syndicate offering the lowest interest rate bid. The issuer determines the size and other essential characteristics of the issue, prepares bond documents, obtains a rating, and completes all other

necessary tasks for the issuance of the bonds prior to soliciting bids. A financial advisor and bond counsel are usually employed to assist in these tasks.

Advantages of a competitive sale include: assurance that bonds are sold at the lowest available interest cost to the district, lower compensation costs paid to the bond syndicates in the form of spread, and the removal of the appearance of impropriety in the sales process that can exist in a negotiated sale. Competitive sales have certain disadvantages. They are more driven by market conditions at the time of sale, which may offer fewer options to the issuer in terms of structure and market conditions. In a period of rising interest rates, the cost to the issuer may increase to compensate the underwriting syndicate for the risk of rate changes. There are certain advertising requirements for a competitive sale that increase the time frame for the sale and issuance of bonds. This can adversely affect the sale in a period of rising interest rates. If a school district has weak or unknown credit (infrequent issuer), there may be reduced market interest in the bonds. Finally, the issuer has little control in selecting the underwriting syndicate buying the bonds.

## **NEGOTIATED SALE**

In a negotiated sale, an underwriting firm is selected in advance of the proposed sale date before the issuer has full knowledge of the terms of the purchase. The issuer and the underwriter negotiate the amount of compensation, which the issuer will pay for the sale of the bonds. The underwriter advises the issuer on the characteristics of the offering and other costs. The final purchase price negotiated with the underwriter reflects the amount of compensation for the underwriter and the coupon interest rates at which the bonds will be sold. The underwriter takes an active role in structuring the issue, including the size, as well as preparing bond documents. The underwriter is also responsible for managing the activities of the bond syndicate. At the time bonds are to be sold, the underwriting syndicate meets to determine the interest rates at which various maturities will be offered. With issuer approval, the syndicate will approach investors to determine whether the bonds can be sold at the specified rates. Adjustments will be made as necessary until a final set of maturities and interest rates are reached, reflecting the supply of and demand for the bonds. The underwriter's discount, or gross spread, represents compensation for structuring and selling the bonds and includes a risk component for members of the bond syndicate for taking the risk that the bonds may not be sold to investors at the stated coupon rate.

Advantages of negotiated sales are flexibility, greater pre-sale marketing activities, and control over the buyers of the bonds. The approval and advertising time frame for negotiated sales is shorter than that for competitive sales. The timing of the sale can be adjusted as necessary to respond to changing market conditions. The structure of the issue can also more easily be adjusted to the needs of the issuer through this type of sale. The underwriter has a greater incentive to engage in pre-sale marketing activities in a negotiated sale. This greatly aids an LEA experiencing financial difficulties or one that is an infrequent issuer, thus having an unproven credit history.

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Disadvantages of negotiated sales include less certainty in verifying the lowest cost of debt issued to the LEA and the appearance of favoritism, reducing public confidence in the bond issuance process. An issuer must make a greater effort to remain informed of developments in the municipal market to ensure that bonds are priced at a favorable rate and that underwriting spreads are reasonable. Employment of a financial advisor to oversee the underwriter may mitigate these disadvantages.

Selection of the method of sale depends on the individual LEA's circumstances based on the structure of the debt, credit quality of the issuer and other characteristics, and market conditions. Generally, if a bond issue is easily understood by the market (for example, the issuance of general obligation bonds), if the issuer can obtain a rating of "A" or better on its bonds, and if the market for interest rates is stable, it is more advantageous for an issue to be sold on a competitive basis. If these conditions cannot be met, the more advantageous form of sale may be the negotiated sale.

### ❖ Debt Structure

Issues in structuring the financing of the bond issue revolve around the annual amount of debt service, the length of the final maturity, call provisions and repayment dates.

#### **LEVEL DEBT SERVICE**

The annual debt service payments over the life of the issue are equal in amount. In the early years of the financing, interest payments are at their highest and will decrease over the life of the issue, while the principal payments increase. If a school district has several bond issues outstanding, the resulting overall debt service payments will not be level, with larger debt service payments in the earlier years until the earlier bond issues are paid. Current outstanding debt, along with expectations of future borrowings must be considered.

#### **WRAP-AROUND DEBT SERVICE**

This debt service structure wraps the amortized principal and interest payments around the district's current outstanding debt service so that overall debt service remains level. Principal payments in the wrap-around structure are normally increased in the later maturities of the issue, increasing the total debt service over the life of the issue. Benefits of this financing structure are more apparent in the early years of the financing. Debt service payments in the years immediately following the issuance of new debt are minimized, eliminating the problems with the level debt service structure.

## **CAPITAL APPRECIATION BONDS (CABS) / ZERO-COUPON BONDS**

Unlike current interest bonds, interest is not paid semi-annually. CABs are issued at a discount from the face value such that interest is payable at maturity. With this method, the district can defer all debt service payments until maturity. CABs are used in wrap-around financing when the traditional current interest bond structure cannot accommodate a wrap-around debt structure. CABs generally carry higher interest rates than current interest bonds. They can also be non-callable, eliminating the opportunity to refinance them at a later date.

## **CAPITALIZED INTEREST**

This is a structuring technique where the interest due on the bonds is paid from bond proceeds and/or interest earnings on the proceeds in order to mitigate the impact of the debt payments in the early years of an issue. This technique enables the school district to phase in the millage impact of the debt over a longer time frame. The Local Government Unit Debt Act restricts the use of capitalized interest for no more than one (1) year after the completion of the construction of the project being financed.

## **LENGTH OF MATURITIES**

The final maturity of a bond issue cannot exceed forty (40) years, depending on the useful life of the asset being financed. The longer the final maturity, the lower the annual debt service payments; however, total debt service over the life of the issue will be higher. There are also market considerations in determining the life of the issue. Principal repayment dates can be determined after considering the LEA's annual cash flow and the requirements of other outstanding debt by the LEA.

## **CALL PROVISIONS**

The call provision is the earliest date at which the LEA can repay an outstanding bond. Shorter call dates are more difficult to market since they benefit the issuer in terms of refunding opportunities. Other factors such as current market conditions, and the size of the financing also affect the call provision.

### ***❖ Approaches To Bond Financing***

An LEA's primary objective in selecting a financing approach is the financing of the project at the lowest possible cost. Three (3) considerations in achieving this objective are (1) issuing the bonds at the lowest possible interest rate; (2) limiting the bond issuance costs; and (3) maximizing the rate of investment interest on the bonds without incurring an obligation to rebate that interest to the federal government. The principal approaches are discussed below.

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## **CURRENT FUNDING**

The school district issues all debt for a capital project after the receipt of construction bids. This method enables the district to borrow the exact amount required, avoiding the risk of over- or under- borrowing. Current funding of a project will also make the district more likely to qualify for one of the spending exceptions to the arbitrage rebate requirements. Arbitrage is explained later in this Chapter. A disadvantage of current funding is that the school district cannot control the interest rate environment in which the bonds are issued.

## **ADVANCE FUNDING**

The financing for capital projects is totally funded prior to the receipt of construction bids. Advance funding is generally done to take advantage of favorable interest rate conditions or to take advantage of positive arbitrage to the extent allowable by the Internal Revenue Service. The LEA should be very confident in the construction cost estimates provided by the architect in order to correctly size the borrowing as this method of financing risks over- or under-borrowing.

## **MULTIPLE FUNDING**

This approach utilizes multiple bond issues to fund a capital project. Some bonds can be issued before construction bids are received for a portion of the funds that will be needed. These bonds can be issued to take advantage of favorable interest rate conditions existing at the time or for allowable arbitrage benefits. Partial advance funding allows the district financing to begin the project and allows the district the time to further monitor the market to complete financing under favorable market conditions. Multiple fundings also permit the school district to phase-in the financial impact of the project to the district's taxpayers as opposed to a one-time tax increase. Disadvantages to this funding approach include additional bond issuance costs (which may be offset by interest cost savings and/or investment earnings) and the risk that interest rates may rise.

## **INTERIM FINANCING**

The LEA issues general obligation notes on a short-term basis in anticipation of obtaining more permanent financing on a capital project at a later date. Advantages of interim financing include positive arbitrage earnings used to reduce the amount of permanent financing required; lower issuance costs associated with the issuance of notes; possibly no impact on budget; allows phase-in of millage impact; avoids the possibility of over- or under-issuance; provides funds to initiate the project; and the lack of arbitrage restrictions.

## ❖ Roles Of Participants

The primary participants in the issuance of bonds are the school district administration, the investment banker (negotiated sale) or the financial advisor (competitive sale), the bond counsel, solicitor, and the paying agent. These parties are also known as the financing team or working group. The roles and responsibilities of each party are discussed further below:



### **ADMINISTRATION**

The administration identifies the school district's capital projects and financing needs. It advises the Board on such matters and provides the Board with advice and recommendations regarding other professional advisors (architect, financial advisor, bond counsel, paying agent) involved with the project and its financing. The administration provides current financial information and consults with and assists the financial advisor / underwriter on estimated project and financing cost. The administration also assists the financial advisor / underwriter with various financial calculations (borrowing base) and information for the Official Statement, confirms outstanding debt, assesses financing alternatives proposed by the financial advisor / underwriter including budgetary impact, and prepares recommendations for the School Board's approval. The Administration reads and comments on the Preliminary Official Statement, participates in the "due diligence" conference with the working group, reviews final debt service schedules and bond issue terms to be presented to the Board for approval, and cooperates with the working group to complete and execute the required forms related the bond issue (IRS Form 8038-G, closing documents, Plancon filings, etc.). They also establish procedures with the advice of the financial advisor and bond counsel for post-issuance compliance. These issues include arbitrage requirements, SEC requirements, distribution of financial statements, annual debt service payment requirements in the annual operating budget, coordinating debt service payments with the paying agent, preparing and filing requests for state reimbursements of debt service payments, and maintaining records of bond proceed expenditures and investments.

### **FINANCIAL ADVISOR (COMPETITIVE SALE) / UNDERWRITER (NEGOTIATED SALE)**

The financial advisor assists the issuer by identifying financing needs, obtaining and reviewing current financial information (financial statements, debt service requirements, tax collection data) to develop appropriate financing alternatives, and evaluating the issuer's creditworthiness. The advisor also provides proposed financing structures and debt service schedules to other participants for analysis and review, and identifies novel aspects of the proposed structures. In addition, the financial advisor may provide analysis concerning the budgetary impact of the financing issue. Issues of concern here include gross debt service, millage requirements, estimated state aid, arbitrage rebate requirements and restrictions, and restrictions on future refunding options. Further duties of the advisor include attending meetings to present financing alternatives and making recommendations

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concerning those alternatives; monitoring current interest rates and market conditions; timing the bond issue; and completing applications for bond rating and insurance. The advisor coordinates the filing and application process, assembles the Preliminary Official Statement, circulates the statement to the working group for comment, conducts the “due diligence” conference, prepare the final text of the Preliminary Offering Statement, arranges for its printing and distribution, consults with other participants to determine the bond sale date, and coordinates legal advertising.

The underwriter in a negotiated sale will prepare the bond purchase proposal, assemble the underwriting syndicate, price and market the bonds, and determine the final offering terms. The financial advisor in a competitive sale prepares and distributes the Invitation to Bid and Bid Form to underwriters invited to bid, and receives, tabulates, and determines the best bid.

The underwriter / financial advisor prepares and circulates to the working group the final maturity and debt service schedules, attends Board meetings to present the final bond commitment for Board approval, notifies the bidder of acceptance of proposal, provides notification of bond sale to bond insurance / rating agencies, and prepares the final Official Statement for printing and distribution to all participants. They coordinate arrangements for settlement, provide financial information and calculations to complete IRS Form 8038-G and other closing documents, attend settlement; deliver closing certificates and receipts required by the terms of bond purchase, bond insurer or bond counsel, and assist the LEA with Plancon filings regarding the bond issue.

## **SOLICITOR**

The solicitor represents the LEA in the financing and delivers a legal opinion on various matters at closing; advises the Board as to the structure of the financing; reads and comments upon legal portions of the draft Preliminary Official Statement and matters regarding the business and financial affairs of the district and other local matters; assists with the identification of matters requiring disclosure; renders an opinion regarding pending litigation or certifies absence of relevant litigation; prepares, reviews and coordinates publications of "Sunshine Law" notices of Board meeting related to the issue; participates in the due diligence conference for the Preliminary Official Statement, and reviews the draft Official Statement. They review closing documentation prepared by bond counsel; render additional closing opinions as required by the terms of the bond purchase commitment, bond insurance or bond counsel; and attend closing.

## **BOND COUNSEL**

The bond counsel assists with the structuring of the bond transaction to ensure compliance with state and federal tax laws; prepares the legal documentation required on a bond financing; provides legal advice to the issuer; renders an opinion as to the validity and tax-exempt status in the financing (with emphasis on state and federal compliance); and coordinates the settlement.

In conjunction with the issuance, bond counsel provides advice on arbitrage yield restrictions, arbitrage rebate requirements and future refunding eligibility consequences. The Bond Counsel reviews and comments on legal portions of the draft Preliminary Official Statement; participates in the due diligence conference; reviews bid and sale documents and public notices in accordance with the Debt Act; reviews the terms of the final bond purchase contract; schedules and coordinates settlement; and renders an opinion regarding the validity of the bond issue and its tax-exempt status.

## PAYING AGENT

The paying agent, normally a bank, is primarily responsible for maintaining a current record of bondholders and making principal and interest payments to the bond holders. Other duties performed by the paying agent during the issuance process include review of bond proofs, inspection of completed bonds for accuracy, and authentication of completed bond certificates. At settlement, the paying agent will provide required closing certificates and receipts, receive and confirm the wire transfer on bond purchase price, wire transfer bond proceeds authorized by the issuer, and issue checks for payment of authorized bond issue closing costs.

The paying agent will establish and maintain a bond sinking fund for the duration of the bond issue. Procedures will be established with the issuer for debt service payments. The paying agent is also required to issue notices of mandatory / optional redemption of bonds, and provide the LEA with proper receipts for payments made for state reimbursement application purposes.

In refunding transactions, the paying agent will establish and administer the escrow account and purchase investments as required by the escrow deposit agreement and mail notices of redemption of prior bonds as per terms of the escrow agreement (advance refunding) or issuer instructions (current refunding).

## ❖ Accounting Entries And Disclosure Requirements

### GENERAL OBLIGATION BONDS / GOVERNMENTAL FUNDS

#### Issuance Of Bond

The proceeds are recorded in the fund authorized to receive and expend the funds, that is, Capital Projects Fund.

30-0100 Cash	\$	XXX	
30-2390 Bond Issue Expenses			\$ XXX
30-9100 Bond Issue Proceeds			XXX

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## Payments Of Principal And Interest

From the fund responsible for repayment:

30-5110-832 Debt Service, Interest	\$	XXX	
30-5110-912 Debt Service – serial Bonds Principal Payments		XXX	
30-0100 Cash	\$		XXX

### Footnote Disclosures

1. A summary of each issue outstanding which includes the following: Name of issue, original amount, date, type of bond, purpose of issue, interest rate range, maturity range including final maturity date, payment dates, and principal amount due at financial statement date.
2. Listing of all outstanding bonds and principal amounts due.
3. Annual debt service requirements to maturity.
4. Beginning balances, along with additions, reductions and ending balances are included in the Statement of Indebtedness.

## **REPAYMENT OF AUTHORITY BONDS**

The principal and interest are recorded as an Other Financing Use.

30-5110-920 Debt Service, Authority Obligations	\$	XXX	
30-0100 Cash			\$ XXX

### Footnote Disclosures

1. A description of the Authority financing the obligation, including its date of inception.
2. A description of each financing, including the principal amount, issue date, purpose of the issue, interest rate range, and payment dates.
3. Total annual debt service requirements, principal, interest and administrative cost, in future years.
4. Beginning and end of year balances;
5. Increases and decreases (separately);
6. The portions of each item that are due within one (1) year of the statement date; and
7. Which governmental funds typically have been used to liquidate non-debt long-term liabilities in prior years.

## ❖ Bond Refinancing

Bond refinancing, also known as refunding, or defeasance, is a procedure whereby the issuer refinances an outstanding bond issue by issuing a new bond issue. Two (2) primary reasons for refunding are (1) to reduce interest costs over the life of the bond issue, and (2) to remove restrictive covenants imposed by the current bond issue. In addition to the reasons cited, the Debt Act allows other reasons for refunding of debt. If the issue being refunded is eligible for state reimbursement, PlanCon Part K must be submitted to the Pennsylvania Department of Education, Division of School Facilities after settlement of the refunding issue.

### **CURRENT REFUNDING**

In this type of refunding, the LEA will borrow funds sufficient to pay off the existing bonds and to pay the costs of issuing the refunding bonds. A current refunding can only occur if the call date for the bond issue has already passed or if it will occur within 90 days of the issuance of the refunding bonds. All legal requirements for defeasance of debt are met. There are no tax law restrictions on the number of times an issue can be currently refunded.

### **ADVANCE REFUNDING**

In advance refunding, new debt is issued to provide money to pay principal and interest on old, outstanding debt as it comes due, or prior to the call date. Sufficient funds are borrowed to cover the costs of new bond issuance along with an amount to be deposited to an escrow fund which, when combined with interest income from the account, will pay the semi-annual interest and principal due on the refunded bonds through the call date, and repay principal on the remaining bonds outstanding on their call date. In order to satisfy the requirements of defeasance, the following conditions must exist:

1. The escrow must be an irrevocable trust, used exclusively to service the principal and interest payment requirements.
2. The likelihood of the LEA being required to make any additional future payments on this issue is remote.
3. The assets in the escrow account must be risk-free as to the amount, timing and collection of interest and principal. Examples of such assets are: U.S. government securities, and U.S. government- backed securities.
4. The timing of collections of principal and interest on investments in the escrow account must coincide in timing and amount with the scheduled principal and interest payments on the refunded debt.

When the above requirements are met, the outstanding principal balances associated with the refunded bonds are removed from the LEA's Debt Account, borrowing base, and debt limit calculation. The new debt is recorded in the

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statement of net assets and the proceeds from the new borrowing are recorded as an other financing source, in account #9120-Proceeds from Refunded Bonds. The subsequent payment to the escrow agent is then recorded as another financing use in account #5120-Debt Service-Refunded Bonds.

Debt may be advanced refunded to take advantage of lower interest rates, extend maturity dates, revise payment schedules or remove / modify restrictions contained in the old debt agreements.

The Tax Reform Act of 1986 limits to one (1) the number of times a bond issue can be advance refunded. The steps performed for the issuance of the refunding debt are the same as those for the issuance of new debt.

**NOTE:** A legal defeasance occurs when debt is legally satisfied based on provisions in the debt instrument even though the debt is not actually paid. In-substance defeasance occurs when the debt is considered defeased for accounting and financial reporting purposes even though a legal defeasance has not occurred. When debt is defeased, it is no longer reported on the balance sheet. The LEA irrevocably places cash or other assets in trust with an escrow agent solely to satisfy the debt service payments on the defeased debt. Then, only the new debt is reported as a liability on the balance sheet, if proprietary debt.<sup>1</sup> The outstanding balance of defeased debt must also be removed from the statement of net assets and the new debt is added, if it is general long-term debt.

Regardless of the type of debt being refunded, all governmental entities that defease debt through advance refunding should provide a general description of the transaction in the notes to the financial statements in the year the refunding takes place.

When debt is defeased, it is no longer reported as a liability on the face of the financial statements, only the new debt is reported as a liability. The proceeds of the new debt should be reported as an “other financing source – proceeds of refunding bonds” in the governmental fund receiving the proceeds.

## ❖ Accounting Entries And Disclosure Requirements

### ISSUANCE OF REFUNDING DEBT

Proceeds are recorded, along with an offset reflecting payment to escrow agent in the Debt Service Fund:

5120 Debt Service, Refunded Bonds	\$	XXX	
2390 Bond Issue Expenses		XXX	
9120 Proceeds Of Refunding Bonds			\$ XXX

<sup>1</sup> GASBS 7, Paragraph 3; GASBS 23, fn1.

## **Footnote Disclosures**

1. The new debt must disclose the same information as described for bond issues.
2. A general description of the refunding transaction which includes:
  - a) The difference between the cash flow requirements necessary to service the old debt over its life and the cash flow requirements necessary to service the new debt and other payments necessary to complete the advance refunding.
  - b) The economic gain or loss that arises because of the advance refunding, based on the present value of the old and new debt.
3. Balance remaining on all defeased debt.

## **IN-SUBSTANCE DEFEASANCE**

An in-substance defeasance occurs when debt is considered defeased for accounting and financial reporting purposes, even though a legal defeasance has not occurred. When debt is defeased, it is no longer reported as a liability on the face of the balance sheet. Only the new debt is reported as a liability. In-substance transactions place assets in trust and restrict their use to only pay off specific debt. Funding for an in-substance defeasance can come from available resources or an advance refunding. The notes to the financial statements should disclose the amount of the debt defeased and should include a description of the defeasance transaction, as well as the sources of financing. The circumstances for in-substance defeasance are detailed in *Codification* Section D20.102 – 103 and GASB Statement #7. Refer to these references to see the nature of this process and specific standards that must be used for in-substance defeasance.

## **REPORTING DEFEASED DEBT WITHIN THE NOTES**

If you defease debt by using advance refundings, you must provide a general description of the transactions in the notes to the financial statements. The disclosure must include:

1. The difference between the cash flows required to pay the old debt and the cash flows required to pay the new debt and complete the refunding.
2. The economic gain or loss resulting from the transaction.

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## ❖ *Demand Bonds, Bond Anticipation Notes (BANs)*

### **BOND ANTICIPATION NOTES (BANS)**

Bond Anticipation Notes (BANs) are notes with various maturities, which are issued with the anticipation of future bond sales. These are usually issued when the school is waiting for better interest rates or when it has additional projects, which would require financing through bond issuance. The LEA must intend to refinance the BANs with long-term bonds, and the intent to refinance must be substantiated by either post-balance sheet issuance of long-term bonds or an execution of an acceptable financing agreement. The following items concerning **bond, tax and revenue anticipation notes** must be included in the notes to the financial statements:

- Bond, tax or revenue anticipation notes excluded from fund liabilities.
- General description of the financing agreement.
- Terms of new obligations incurred or expected to be incurred under the agreement.

### **DEMAND BONDS**

Demand Bonds are bonds, which are due on demand. The demand provision is referred to as a “put.” The demand provisions require the issuer to repurchase the bonds upon notice from the bondholder. The repurchase price would be equal to the principal plus any accrued interest. The following items concerning **demand bonds** must be included in the notes to the financial statements:

- Description of the demand bond.
- Terms of any letters of credit or other standby liquidity agreements outstanding, commitments fees to obtain the letters of credit, and any amounts drawn down as of the balance sheet date.
- Description of the financing agreement converting demand bonds to long-term obligations, including expiration date, commitment fees, and terms of any new obligations under the agreement.
- Debt service requirements if the financing agreement is exercised.

## ❖ *Tax and Revenue Anticipation Notes (TRANS)*

Due to the timing of the collection of taxes as compared to the required cash outlays of an LEA, it is possible to experience temporary cash flow deficits during the fiscal year. The Local Government Unit Debt Act authorizes LEA's to issue Tax and Revenue Anticipation Notes (TRANS) to meet its immediate cash needs in anticipation of the receipt of current taxes and revenues. TRANS are one (1) year general obligation notes, exempt from federal income taxes. Questions regarding TRANS may be addressed to the Department of Community and Economic Development at [www.newpa.com](http://www.newpa.com). Use the search feature for Local Government Unit Debt Act for contact information.

The Debt Act limits the size of the tax and revenue anticipation notes to a percentage of taxes and revenues anticipated during the current fiscal year and sets forth the procedures and documents required in the issuance of TRANs. The Internal Revenue Code of 1986 sets further limits on the size of the TRAN and the yield of the invested proceeds. Compliance with arbitrage rebate requirements under the Internal Revenue Code of 1986 is essential to maintaining the tax-exempt status of the borrowing. Questions regarding IRS regulations should be addressed to your solicitor or local IRS office.

The interest earned on the investment of TRAN proceeds in excess of the cost of borrowing must be rebated to the federal government if the TRAN is not properly sized. The sizing of the issue is related to the individual circumstance of the LEA in order for it to retain arbitrage earnings. Generally, an issuer is considered to be a "small issuer" if its total borrowing for the calendar year (including general obligation bond and note issues) is \$5 million or less. For small issuers, the TRAN size is limited to the maximum cash flow deficit plus five (5) percent of the total expenditures paid out of current revenues during the prior fiscal year.

There is a requirement that the maximum cumulative deficit must occur within six (6) months of the issuance of the TRAN. For example, if the anticipated maximum deficit occurs in February of the fiscal year, the TRAN cannot be issued until September.

The maximum cash flow deficit for the fiscal year is calculated as follows:

***Opening balance plus (+) Estimated Receipts minus (-) Estimated Expenditures***

Bond Counsel should be consulted regarding the arbitrage rebate eligibility requirements, especially in circumstances where total debt issued will exceed \$5 million in a calendar year.

If it is the intent of the LEA to issue total tax-exempt debt in amounts over \$10 million for the calendar year, then the TRAN may not be considered a "qualified tax-exempt obligation" or "bank eligible." Generally, banks are only interested in purchasing "bank eligible" TRANs.

The Debt Act governs the advertising and legal procedural requirements in issuing TRANs. Requests for Proposals (RFPs), along with a completed cumulative cash flow, are normally sent to various banks and financial institutions. Items that should be addressed in the RFP include fees, date of basis for calculations, pre-payment penalties, settlement date and net interest cost quotation. The proposal with the lowest net interest cost is usually awarded the TRAN. The school board must pass a resolution at a board meeting to award the TRAN.

Standard Tax and Revenue Anticipation Note documents include Note Purchase Proposal, Resolution; Certification as to Taxes and Revenues to be Collected; Legal Opinion by the school district solicitor; Exhibit A which details the terms and conditions of the TRAN; Certificate of Cumulative Cash Flow Deficit and Non-arbitrage; Commonwealth of Pennsylvania Certificate; General Certificate; 7 Filing to the

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Pennsylvania Department of Community and Economic Development (DCED); Certificate of Incumbency and Signature; a Receipt; a No Litigation Affidavit; UCC-1 Forms; and the IRS Form 8038-G.

The Pennsylvania DCED will require the following be filed with their Department: the signed Note Purchase Proposal; the Resolution and Exhibit A; the Certificate as to Taxes and Revenues to be collected; and the Cumulative Cash Flow Statement. The UCC forms are filed with the Department of State and the local county prothonotary office. Form 8038-G is filed with the Internal Revenue Service.

Although the Debt Act requires filing the above documents with the DCED, no DCED approval is required to complete the transaction as in the case of general obligation bonds. The signed DCED receipt is sufficient evidence for the financial institution awarded the TRAN to release the funds to the LEA.

### **ACCOUNTING TIP**

Tax and revenue anticipation note proceeds are recorded in the fund that will expend them. The liability is one that will be extinguished through the use of expendable available resources; therefore, it is a current liability.

The Securities and Exchange Commission (SEC) now regulates municipal bond offerings indirectly by requiring the underwriters of these issues to obtain certain representations and agreements from the issuers before the actual bond sale can occur. Rule 15c2-12 and its subsequent amendments is the regulation that determines school district requirements.

Effective January 1, 1990, Rule 15c2-12 requires a broker, dealer, or municipal securities dealer ("Participating Underwriter") in a primary offering of municipal securities of \$1,000,000.00 or more, to obtain and review an official statement that an issuer of the bonds deems final as of the statement date. This must be done before making a bid for offering or selling the bonds. The intent of the rule is to require underwriters to insist that the issuers have prepared certain disclosure documents. It is also the intent that the final, official statement is made by any person substantially responsible for the repayment of the issue. This rule also requires the underwriter to supply copies of preliminary and final, official statements promptly to any potential customer who requests it. The underwriter must obtain a commitment from the issuer to supply adequate copies of the final official statement within seven (7) working days of the sale of the bonds. Finally, there are certain exemptions from this rule for bonds issued in \$100,000.00 minimum denominations if the bonds are sold to 35 or fewer sophisticated investors, or the bonds have a maturity, or periodic tender rights, of nine months or less.

The primary focus of the initial action was on the disclosures required at the initial sale of the bonds. Little information was available about an issuer to guide investors involving secondary market trades, leading to an inefficient municipal secondary market. In late 1994, the SEC amended Rule 5c2-15c2-12 to require issuers to provide information to the marketplace during the life of a bond issue. This rule is effective for fiscal years

ending after January 1, 1996. Again, the municipal issuer is indirectly regulated by "prohibiting a 'Participating Underwriter' from purchasing or selling municipal securities unless the Participating Underwriter has reasonably determined that an issuer of municipal security or an obligated person has undertaken in a written agreement for the benefit of all security holders to provide certain annual financial information and event notices to various information repositories."

The effective date of this ruling applies to all bonds issued after July 3, 1995. It applies to issuers who have \$10,000,000.00 or more in bonds outstanding. In the written agreement, the issuer agrees to file an annual report to all Nationally Recognized Municipal Securities Information Repositories (NRMSIR) and a state information depository (SID), if available.

You may reference the SEC Website at [www.sec.gov](http://www.sec.gov) for the most current listing of NRMSIRs and related state repository information.

The written undertaking or Continuing Disclosure Agreement between the issuer and the participating underwriter will identify the relevant obligated persons who will provide the annual report. It will also specify the type of financial information and operating data that will be provided in the annual report. Although the information required is negotiable, it must also be included in the final Official Statement. Annually updated information is financial information and operating data of the school district. The accounting principles used in the preparation of the financial statements, and the need for audited financial statements are also set forth in this agreement. Finally, the written undertaking must specify when the annual financial report will be filed with each NRMSIR. No specific format is described by Rule 15c2-12 for the reporting of financial information; however, the CUSIP numbers of the bonds to which the reporting requirements apply must be identified on the cover of the report.

In addition to filing annual information with NRMSIRs, Rule 15c2-12 requires timely notice of the occurrence of eleven (11) material events, as listed below:

1. Principal and interest payment delinquencies.
2. Non-payment related defaults.
3. Unscheduled draws on debt service reserves reflecting financial difficulties.
4. Unscheduled draws on credit enhancements reflecting financial difficulties.
5. Substitution of credit or liquidity providers, or their failure to perform.
6. Adverse tax opinions or events affecting the tax-exempt status of the security.
7. Modifications to rights of bondholders.
8. Bond calls.
9. Defeasances of bonds.
10. Release, substitution, or sale of property securing repayment of any bonds.
11. Rating changes.

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Failure to file an annual report also requires notice. Material events notices can be filed with all NRMSIRs or the obligated person has the option of filing the notice with the Municipal Securities Rulemaking Board (MSRB) in Washington, D.C. The MSRB will then distribute these notices.

Enforcement of this rule is by the individual bondholder, not the SEC. Failure to timely file annual reports requires the obligated person to describe in subsequent Official Statements instances during the previous five (5) years in which the LEA failed to comply with any previous written undertaking.

Bond documents addressing the continuing disclosure requirements of Rule 15c2-12 include the Official Statement, bond purchase agreement, trust indenture, disclosure agreement, and annual report or notice of material events.

Exceptions to this rule are as follows:

- Any single issue under \$1,000,000.
- A private placement of bonds sold to not more than 35 sophisticated investors in \$100,000 minimum denominations.

There are also two (2) partial exceptions:

- Obligated Persons with less than \$10,000,000 in total debt outstanding are not required to file their annual reports with NRMSIRS, rather they are required to provide the annual report upon request.
- Bonds with terms of less than 18 months are not required to file any annual reports.

### ❖ Arbitrage

Debt issued for public purposes by LEAs is not subject to Federal taxation. Arbitrage earnings exist when an LEA invests tax-exempt bond proceeds in higher-yielding taxable securities than that which is being paid on the debt service of the tax-exempt bond. The Internal Revenue Code restricts both the circumstances in which an LEA can invest bond proceeds above the bond yield to earn arbitrage and its right to retain the arbitrage earnings. The penalty for non-compliance with the Internal Revenue regulations is loss of the tax-exempt status of the bonds issued. There are also certain financial penalties to the LEA, depending on the nature of the violation. The IRS regulations concerning arbitrage have been in a continual state of change since 1986. The purpose of this section is to introduce the concept of arbitrage and its requirements. There are exceptions to many of the rules summarized in this section. Bond Counsel advice is strongly recommended on this subject before any action is taken. You may also want to reference the SEC web site for more information regarding financing and arbitrage at [www.sec.gov](http://www.sec.gov).

Generally, the yield on the investment of bond proceeds is limited to the yield of the bond issue subject to certain exceptions and exemptions. The proceeds of a new money issue can be invested at the highest obtainable yield for a temporary period with specific conditions. Unless the issue is exempt from rebate, earnings above the bond yield will have to be rebated to the federal government. The details of federal arbitrage taxation are outside the scope of this Manual. Please consult your bond counselor or certified public accountant for current tax language.

## **EXEMPTIONS FROM ARBITRAGE REBATE (as of the publication date)**

### **Small Issuers**

School districts issuing less than a stated dollar amount of tax-exempt obligations in the calendar year are exempt from federal arbitrage requirements.

### **Six-Month Proceeds Expenditure**

At the time of this writing, an issue is exempt from arbitrage rebate if a percent of the proceeds are expended for the governmental purpose within a stated period of time after the date of issuance.

### **Two-Year Proceeds Expenditure**

At the time of this writing, this exemption applies only to construction issues. A specified percent of the proceeds must be expended for "construction expenditures." Construction expenditures is very narrowly defined as amounts expended for items that are integral to the structure of the building. It excludes land acquisition or equipment acquisition. The expenditure tests are based on available construction proceeds, which includes net bond proceeds plus (+) any interest earnings less (-) expenditures. There are four (4) expenditure tests to be met with respect to available construction proceeds.

Failure to comply with any the above expenditure tests will make the bond proceeds subject to arbitrage rebate.

### **18-Month Proceeds Expenditure**

At the time of this writing, this exemption is not limited to construction issues. The issuer must meet the tests for the three (3) year temporary period, binding obligation within 6 months, due diligence to project completion. The expenditure tests to be met are based on periods of 12 months or 18 months.

As mentioned above, failure to meet the expenditure tests results in the rebate of earnings to the federal government.

### **Penalty In Lieu of Rebate**

At the time of this writing, this election is available only for "construction issues." This election must be made on or before issuance date. It must be written, and

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indicated by checking the designated block on IRS Form 8038-G, which is filed after issuance of the bonds.

The penalty is a percent of the amount of "available construction proceeds" that should have been spent by the end of a six-month period. The penalty is due and payable within 90 days after the end of the related six-month period. The penalty will continue to be due for each six-month period until all proceeds are spent, unless the election is terminated. The relevant six-month spend-down periods are: 6 months, 12 months, 18 months and 24 months.

The issuer can elect to terminate the penalty in lieu of rebate either within 90 days of the close of the initial temporary period (3 years), or before the close of the initial temporary period if the construction is substantially completed. The election to terminate the penalty in lieu of rebate before the initial temporary period must be made within 90 days of substantial completion of the construction. There will be a penalty for terminating the penalty in lieu of rebate at a specified percent of the unexpended available construction proceeds multiplied (X) by the number of years in the initial temporary period.

### ❖ **Rebate Calculation And Payment**

- Determine the Rebate Interest Factor:
  - Calculation: *Investment Yield minus (-) Arbitrage Yield.*
  - Investment yield is the semi-annual discount rate, which equates the principal and interest payment of an investment back to the original invested proceeds.
  - Arbitrage yield is the semi-annual discount rate, which equates the principal and interest payments of a bond issue back to the original issue proceeds.
- Determine the number of semi-annual investment periods.
- Find the future value of the invested proceeds by using rebate interest factor and number of semi-annual investment periods.

Arbitrage earnings on bond proceeds must be paid to the Internal Revenue Service within 60 days after the 5<sup>th</sup> anniversary of the settlement date of the bond issue. Subsequent payments are due five (5) years after the first payment date.

### ❖ **Accounting For Arbitrage Rebate**

The liability on bond issues subject to arbitrage should be calculated annually. Liabilities incurred due to arbitrage rebates will be accounted for in the governmental activities column of the government-wide statement of net assets. The fund balance of the fund responsible for payment of the rebate will be reserved by this amount. Current year arbitrage rebate expenditures should be recorded as a refund of prior year receipts.

## ❖ Debt Accounting & Reporting Guidance

**Authoritative Accounting and Reporting Literature for Long-term Debt can be found in the following publications.**

- Governmental Accounting Standards Board's (GASB), Codification of Governmental Accounting and Reporting Standards.
- Specific GASB Statements Dealing with Long-term Debt:
  - GASB Statement #7-Advanced Refundings Resulting in Defeasement of Debt.
  - GASB Statement #20-Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting.
  - GASB Statement #23-Accounting and Financial Reporting for Refunding of Debt Reported by Proprietary Activities.
  - FASB Statement #13-Accounting for Leases (capital leases).
  - GFOA's Governmental Accounting, Auditing and Financial Reporting, better known as the GAAFR Blue Book.
  - The Pennsylvania Municipal Authorities Act of 1945, as amended (for authorities only), and
  - Pennsylvania Department of Community and Economic Development (DCED), Center for Local Government Services' Debt Management Handbook.
  - GASB Statement #34, The New Financial Reporting Model of Governmental Entities.

## ❖ Disclosure Requirements For Debt Issues

Generally accepted accounting and reporting standards set forth by the GASB require the following disclosures for debt.

- Categories of Debt Issues
  - General obligation & capital appreciation bonds
  - Revenue bonds
  - Notes payable-bank
- Principal and proceeds, interest rates, maturity dates, subordinate features, pledged assets and restrictive covenants.
- Sources and Uses of Funds
- Changes in Long-term debt-beginning to end of fiscal year. General long-term debt and Proprietary debt must be disclosed separately.

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- Discount or Premium, amortized or not, and method used to amortize over life of issue.
- Combined aggregate amount of maturities and sinking fund requirements (principal and interest) for all long-term borrowings for each of five (5) years subsequent to the balance sheet date.
- Capital Leases should be disclosed in accordance with FASB Statement #13.
- Advance Refunding Information, such as: difference between cash flows required to service old debt and new debt, economic gain or loss, and balance of in-substance defeased debt.

## ❖ **Incurring And Repaying General Long-Term Debt**

### **ZERO-COUPON AND DEEP DISCOUNT DEBT**

Bonds are usually recorded at face value. However, some problems arise with the issuance of deep-discount debt. An example of deep-discount debt is a zero-coupon bond. Deep-discount debt is issued at a stated interest rate, which is greatly below the effective interest rates. This results in a large (e.g., deep) discount. Zero-coupon bonds are deep-discount bonds issued with a stated interest rate of zero percent. The GAAFR states that an interest rate of less than 75 percent of the effective interest rate generally is a benchmark for classifying debt in the deep-discount category. Proceeds received at issuance are far less than the face amount of the bonds. The difference represents the “interest” the investor will receive at maturity.

There is no regular interest payments associated with zero-coupon bonds. Instead, interest on the debt is incorporated into the bond’s inflated face value (such as U.S. Savings Bonds). Although debt is usually reported at face value, deep-discount debt should be reported instead at the amount of the proceeds initially received by the government.

At this time, there is no authoritative literature dealing with the treatment of bond discounts relating to deep-discount debt. To ensure full disclosure, the debt should be reported at the face value minus the discount reflected as a direct deduction. In most instances, the discount is not paid until the bond has matured. For this reason, the net value of the bond must be amortized over the life of the bond. The GAAFR states that the interest method, as set forth in Accounting Principles Board Opinion No. 12, Omnibus Opinion – 1967, provides an acceptable means of amortizing the discount.

Good financial management requires a rational, systematic accumulation of resources in a debt service fund to enable the LEA to repay the debt. If resources are not accumulated throughout the period the bonds are outstanding, the burden of debt repayment will be more difficult for taxpayers and could place a severe strain on the school’s resources.

Accumulated resources are invested and the earnings are recorded as income in the debt service fund. You may reserve or designate the fund balance to show that the resources are being accumulated to pay the bonds.

At maturity, sufficient resources should have been accumulated to pay the debt. The debt service expenditure is recorded in the debt service fund and the debt is removed. In the year of repayment, the operating statement for the debt service fund reports a large operating deficit, which is offset by previously accumulated resources presented in the fund balance. The debt service fund should be closed out upon repayment of the debt. Any remaining resources should be transferred to another fund in accordance with legal requirements.

## **SUPER-PREMIUM DEBT**

Some entities issue “super-premium” debt. In such cases, the entity receives proceeds from a debt issuance far in excess of the face value of the debt (for example, \$10,000.00 in proceeds on debt with a face value of \$6,000.00). Super-premium debt should be reported at the amount of the proceeds received (i.e. \$10,000.00), rather than at the debt’s face value (i.e. \$6,000.00). The division of debt service payments between principal and interest should be based on the proceeds received, rather than on the amounts listed on principal and interest in the legal documentation of the debt issue.

## **CAPITAL LEASES**

Authoritative guidance on leases is found in the GASB’s *Codification*, Section L20. Leases are classified as either operating or capital. A capital lease is one (1) that transfers the benefits and risks of ownership of the leased asset to the lessee. This happens if **any one** of the following conditions is met:\*

- The lease transfers ownership of the property to the lessee by the end of the lease term.
- The lease contains a bargain purchase option.
- The lease term is equal to seven (7) percent or more of the estimated life of the leased property.
- The present value of the minimum lease payments exceeds 90 percent of the fair value of the leased asset at the start of the lease.

With capital leases, periodic payments (usually monthly) are made for principal and interest. The present value of the minimum lease payments should be reported as both an “other financing source” and an “expenditure” in the governmental fund’s operating statement, even though no financial resources were actually received or disbursed by the fund. The lease downpayment and subsequent principal and interest payments are reported as expenditures.

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\* See the *Codification* reference listed above for more detail concerning these points.

## CLAIMS AND JUDGMENTS

Claims against an LEA may be from a variety of sources. Some claims are for such items as personal injury, property damage, contractual disputes and accidents. Other claims involve workers' compensation and unemployment insurance payments. Claims and judgments associated with an LEA are defined as contingent liabilities. GASB's *Codification* C50.110 requires a loss liability to be estimated and recognized on your financial statements for contingent liabilities when **both** of the following conditions are met:

1. It is probable that a loss occurred; and
2. The amount of the loss can be reasonably estimated.

You should estimate liabilities for claims filed and for loss contingencies occurring before the balance sheet date when it is probable that a claim will be filed and when the loss can be reasonably estimated. *Codification* Sections C50.112 – 113 require that claims be recorded as expenditures and liabilities in governmental funds to the extent that “they would normally be liquidated with expendable available financial resources.” The remainder is recorded in the statement of net assets. If one (1) of the criteria listed above is not met, you should not record a liability. However, you must disclose the contingency in the notes to the financial statements.

## PREMIUMS AND DISCOUNTS

Premiums and discounts associated with debt are not shown separately or capitalized over the life of the loan. Discounts are shown as reduction of proceeds, which is recorded as an “other financing source.” Premiums may be recorded as an addition to bond proceeds, or they may be recorded to in the fund in which the debt service payments will be recorded.

## POST EMPLOYMENT BENEFITS OTHER THAN PENSIONS

GASB Statement #45, *Accounting and Financial Reporting by Employers Postemployment Benefits Other Than Pension Benefits*, provides guidance on reporting this issue. OPEB are pension related benefits provided through a benefit plan that is separate from a retirement income plan and also postemployment health care benefits provided through either a separate benefits plan or a retirement income plan. Please refer to this Statement for details concerning the minimum note disclosure requirements for OPEB. *Codification* Section T25.102 and GASB Statement #4 require that the amount of special termination benefits recorded as expenditures in governmental funds be the amount accrued during the year that would normally be liquidated with expendable available financial resources.

## FINANCIAL REPORTING OF GENERAL LONG-TERM DEBT

You are required to report general long-term debt as part of the noncurrent liabilities on the Statement of Net Assets. The notes to the Basic Financial statements should include:

- Description Of The Debt;

- Nature Of Outstanding Debt;
- Material Violations Of Debt Agreements;
- Debt Service Requirements Until Maturity;
- Changes In Long-Term Debt, Including General Long-Term Obligations;
- Details Of Capital Lease Obligations;
- Claims And Judgments Data;
- Special Termination Benefits Obligation And Description;
- Amount Of Debt That Has Been Defeased;
- Bond, Tax, Or Revenue Anticipation Notes Excluded From Fund Liabilities;
- Contingent Obligations;
- Debt Incurred Subsequent To The Balance Sheet Date But Before The Financial Statements Are Issued; And
- Any Defaults, Anticipated Defaults, Or Expected Inability To Pay Debt When Due.

## **Chapter 12**

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