



State of North Carolina

Department of State Treasurer

RICHARD H. MOORE
TREASURER

*State and Local Government Finance Division
and the Local Government Commission*

JANICE T. BURKE
DEPUTY TREASURER

Memo #1011

February 24, 2004

To: Finance Officers of Local Governments, Public Authorities and Certified Public Accountants

From: T. Vance Holloman, Director
Fiscal Management Section

Subject: Governmental Accounting Standards Board Statement (GASB) 7 Restricts Allowable Investments to Qualify for In-Substance Defeasance

We have received questions over the last few weeks from local governments that have sold refunding bonds with the intent to defease the existing debt as an “in-substance defeasance.” An “in-substance defeasance” allows removal of the old debt and its debt service from the financial statements and the budgetary reporting similar to the accounting treatment for a current refunding. In each case, local governments were considering making investments of bond proceeds that could have jeopardized the unit’s ability to report the old debt as defeased. In these cases, the bonds would not have been reported as defeased because a risk existed that the timing of principal and interest payments on the escrowed investments might not coincide with the debt service requirements of the old debt. In order to clarify these issues and prevent this from occurring, we would like to present a short discussion of the investment criteria prescribed by GASB Statement 7.

GASB Statement 7 allows for in-substance defeasance “if the debtor irrevocably places cash or other assets with an escrow agent in trust to be used solely for satisfying scheduled payments of both interest and principal of the defeased debt...”¹. The requirement in GASB 7 is that the investments held in trust should be “essentially risk-free as to the amount, timing and collection of interest and principal” and as such, Statement 7 limits the investments to direct obligations of the U.S. government [*paragraph 4(a)*] or obligations guaranteed by the U.S. government [*4(b)*]¹. This is more conservative than G.S. 159-30 and G.S. 159-72 in that Agencies and other instruments permitted under North Carolina law for investment are not allowed under GASB 7. We have conferred with the staff of the GASB on this matter and they have reiterated the position that assets must be “essentially risk-free” and agreed that Agencies are not allowed. There may be other investments in addition to Agencies that are questionable.

Comparison of Investing Requirements			
Securities Allowed for Refunding Bonds:	G.S. 159-30	G.S. 159-72	GASB 7
Direct obligations of U.S. Government	✓	✓	✓
Obligations guaranteed by U.S. Government as to both principal and interest	✓	✓	✓
Agency or instrumentality of the U.S. Government as permitted by law (G.S. 159-30(c)(2))	✓	✓	Not allowed
CDs issued by NC bank properly secured by the obligations listed above (<i>Must be collateralized with the Dedicated method</i>)	✓	✓	✓

In determining whether the debt can be classified as defeased under the intent of Statement 7, there are also timing considerations and assurances that investments will meet debt service requirements. Units must be assured that the securities selected “provide cash flows (from interest and maturity of those assets) that approximately coincide, as to timing and amount with the scheduled interest and principal payments on the defeased debt.” The concern is that there may be investments that meet the criteria of paragraphs 4(a) and (b) as described in the table above but are not “essentially risk free” because of timing difficulties. For example, callable securities or investments with prepayment options (e.g. GNMA’s) cannot guarantee adequate cash flows to meet the future debt service and as such will not “qualify for defeasance purposes.”

The requirements of GASB 7 will be reviewed in the unit’s annual audit. If it is determined after the fact that the investments held by the escrow agent violate the criteria of GASB 7, paragraph 4, then the debt will not be considered defeased. In this case, both the old debt and the refunding debt must be included in the financial statements. Investments held by the escrow agent would be recorded on the government-wide statements and the fund statements skewing the fund balance available for appropriation. Debt service for both debt issues must be budgeted. More importantly, the unit has invested the bond proceeds in securities that run the risk of principal and interest payments not being made, or the timing of those payments not coinciding with the debt service requirements of the defeased debt. If this were to occur, the unit would have to honor the payments on the defeased debt from other funds.

Finance officers should review proposals carefully and consult with their auditors and the verification agent handling the refunding before investing the proceeds of refunding bonds. If there are questions on this memo, please contact Sara Shippee at 919-807-2356 or Ken Durham at 919-807-2363.

ⁱ *Governmental Accounting Standards Board (GASB) Statement 7, 1987, paragraph 4.*

ⁱⁱ *GASB Statement 7, paragraph 4* presents an option (c) for allowable investments. Our understanding is that these investments are no longer issued.