

Chapter 1

The Government and Not-For-Profit Environment

TRUE/FALSE (CHAPTER 1)

1. **F** The main objective of a typical governmental or not-for-profit entity is to earn a profit.
2. **T** A government's budget may be backed by the force of law.
3. **F** Governmental entities have no need for an accounting system.
4. **T** A government's internal managers rely on general purpose financial statements for a considerable amount of information about their government.
5. **F** Governments and not-for-profits may never engage in business-type activities.
6. **T** Lenders use the financial statements of governments and not-for profits just as they would those of businesses, that is, to help assess the borrower's credit-worthiness.
7. **T** Financial statements, no matter how prepared, do not directly affect the economic worth of an entity.
8. **F** The Financial Accounting Standards Advisory Board's standards do not apply to the federal Department of Treasury.
9. **T** Governments may be subject to the same pressures that led to accounting scandals like Enron.
10. **F** The Governmental Accounting Standards Board establishes generally accepted accounting principles for all state and local government entities, as well as all not-for-profit entities.

MULTIPLE CHOICE (CHAPTER 1)

1. A primary characteristic that distinguishes governmental entities from business entities is
 - a) The need to generate revenues equal to or in excess of expenditures/expenses.
 - b) **The importance of the budget in the governing process.**
 - c) The need to provide goods or services.
 - d) The correlation between revenues generated and demand for goods or services.

2. A primary characteristic that distinguishes not-for-profit entities from business entities is
 - a) The need to generate revenues equal to or in excess of expenditures/expenses.
 - b) **The importance of the budget in the governing process.**
 - c) The need to provide goods or services.
 - d) The correlation between revenues generated and demand for goods or services.

3. Which of the following characteristics distinguishes a governmental or not-for-profit entity from a business entity?
 - a) There is always a direct link between revenues generated and expenditures/expenses incurred.
 - b) Capital assets are used to produce revenues and save costs.
 - c) Revenues are always indicative of demand for goods and services.
 - d) **The mission of the entity will determine the goods or services provided.**

4. The most significant financial document provided by a governmental entity is the
 - a) The balance sheet.
 - b) The operating statement.
 - c) **The operating budget.**
 - d) The cash flow statement.

5. Which of the following statements is true?
 - a) **Governments may engage in activities similar to activities engaged in by for-profit entities.**
 - b) There are a limited number of different types of governments.
 - c) All governmental entities engage in the same activities.
 - d) Managers may have a long-term focus and thereby sacrifice the short-term liquidity of the entity.

6. Which of the following activities is NOT an activity in which a governmental entity might engage?
 - a) Selling electric power.
 - b) Operating a golf course.
 - c) Operating a bookstore.
 - d) **All of the above are activities that might be carried out by a government.**

7. In which of the following activities is a not-for-profit entity least likely to engage?
 - a) Providing educational services.
 - b) Providing health-care services.
 - c) **Providing for terrorism defense.**
 - d) Retail sales of cookies.

8. Which of the following can be affected by GAAP?
- a) Legal ability to issue bonds.
 - b) Ability to balance the budget.
 - c) Amount reported as employee pension plan contributions.
 - d) Claims and judgments settled.
9. Which of the following characteristics is unique to a governmental entity?
- a) The ability to have activities financed with tax-exempt debt.
 - b) The power to impose fees.
 - c) The ability to issue tax-exempt debt.
 - d) The ability to have activities financed by Federal grants.
10. To obtain a comprehensive understanding of a government's fiscal health, a financial analyst should obtain an understanding of which of the following?
- a) All of the resources owned by the governmental entity.
 - b) All of the resources which may be summoned by a governmental entity.
 - c) Demographic data about the residents served by the governmental entity.
 - d) All of the above.
11. Which of the following is common to both governments and not-for-profit entities but distinguishes these entities from for-profit entities?
- a) The budget is a legal, financial document.
 - b) Revenues are usually indicative of demand for goods or services.
 - c) There is direct matching of revenues and expenses.
 - d) There are no defined ownership interests.
12. Which of the following is NOT a purpose of external financial reporting by governments? External financial reports should allow users to
- a) Assess financial condition.
 - b) Compare actual results with the budget.
 - c) Assess the ability of elected officials to effectively manage people.
 - d) Evaluate efficiency and effectiveness.
13. Which of the following is NOT a reason why users need governmental and not-for-profit external financial statements?
- a) To determine the ability of the entity to meet its obligations.
 - b) To determine the ability of the entity to continue to provide services.
 - c) To predict future fiscal solvency.
 - d) To evaluate the overall profitability of the entity.
14. Users of government financial statements should be interested in information about compliance with laws and regulations for which of the following reasons?
- a) To determine if the entity has complied with bond covenants.
 - b) To determine if the entity has complied with taxing limitations.
 - c) To determine if the entity has complied with donor restrictions on the use of funds.
 - d) To determine all of the above.

15. Which of the following is NOT generally considered a main user of government and not-for-profit entity external financial statements?
- a) Investors and creditors.
 - b) Taxpayers.
 - c) Donors.
 - d) **Internal managers.**
16. Which of the following is a probable use a donor would make of the external financial statements of a not-for-profit entity?
- a) **To determine the proportion of entity resources directed to programs as opposed to fund-raising.**
 - b) To determine the creditworthiness of the entity for investment purposes.
 - c) To determine the salaries paid to all employees of the entity.
 - d) To determine the budget of the entity.
17. A regulatory agency would use the external financial statements of a local government for which of the following purposes?
- a) To assure that the entity is spending and receiving resources in accordance with laws, regulations or policies.
 - b) To determine how resources should be allocated.
 - c) To exercise general oversight responsibility.
 - d) **To do all of the above.**
18. Which of the following constituency groups would be most likely to evaluate government financial statements to determine likely areas in which to achieve cost-savings?
- a) Creditors.
 - b) **Union officials representing the government's employees.**
 - c) Federal agencies that provide purpose-restricted grants.
 - d) Students of governmental accounting.
19. Which of the following objectives is considered to be the cornerstone of financial reporting by a governmental entity?
- a) **Accountability.**
 - b) Budgetary compliance.
 - c) Interperiod equity.
 - d) Service efforts and accomplishments.
20. Which of the following is an objective of financial reporting by governmental entities as established by GASB?
- a) Financial reporting should assist users in assessing the management skills of top management.
 - b) **Financial reporting should assist users in determining if current-period revenues were sufficient to pay for current-period services.**
 - c) Financial reporting should assist users in evaluating the cash management operations of the governmental entity for the year.
 - d) Financial reporting should assist users in assessing whether the government provided appropriate services to its constituents in the current year.

21. Which of the following is an objective of financial reporting for not-for-profit entities as established by FASB? Financial reporting should provide information that is useful to present and potential resource providers and other users in:
- Assessing the types of services provided and the need for those services.
 - Assessing the services provided and the entity's ability to earn a profit.
 - Making rational decisions about the allocation of resources to those organizations.**
 - Assessing how managers have managed personnel.
22. As used by GASB, interperiod equity refers to which of the following? Financial reporting should:
- Demonstrate compliance with finance-related contractual requirements.
 - Provide information to determine whether current-year revenues were sufficient to pay for current-year services.**
 - Demonstrate whether resources were obtained and used in accordance with the entity's legally adopted budget.
 - Provide information to assist users in assessing the government's economy, efficiency, and effectiveness.
23. Given a specific set of data, the basis of accounting selected by or imposed on a governmental entity will least affect which of the following?
- Determining whether or not the governmental entity has a balanced budget.
 - Determining whether or not the governmental entity has the ability to issue debt.
 - Determining whether or not certain economic events occurred.**
 - Determining the annual payments to a government-sponsored pension plan.
24. The basis of accounting selected by or imposed on a governmental entity can influence which of the following?
- A decision to contract-out a specific service rather than provide that service itself.
 - The amount of salary increases proposed by union negotiators.
 - The amount that is available to spend on a donor-specified project or service.
 - All of the above.**
25. The Governmental Accounting Standards Board is the primary standard-setting body for:
- All governments.
 - All state and local governments.**
 - All governments and all not-for-profit entities.
 - All state and local governments and all not-for-profit entities.
26. Under certain circumstances a governmental entity might use standards established by which of the following standard-setting bodies?
- GASB.
 - FASB.
 - AICPA.
 - All of the above.**

27. The primary standard-setting body for accounting and financial reporting by a state-supported college or university is:
- a) **GASB.**
 - b) FASB.
 - c) AICPA.
 - d) All of the above.
28. In descending order, the hierarchy of GAAP applicable to a church-owned college may be:
- a) **FASB Statements and Interpretations, FASB Technical Bulletins, AICPA Industry Audit Guides, FASB Implementation Guides, other accounting literature—including GASB Standards.**
 - b) FASB Statements and Interpretations, FASB Technical Bulletins, FASB Implementation Guides, AICPA Practice Bulletins (if cleared by FASB).
 - c) GASB Statements and Interpretations, AICPA Industry Audit Guides, GASB Implementation Guides, other accounting literature—including FASB Standards.
 - d) GASB Statements and Interpretations, GASB Technical Bulletins, AICPA Industry Audit Guides, AICPA Practice Bulletins (if cleared by GASB), GASB Implementation Guides, other accounting literature—including FASB standards.
29. Which of the following entities was a principal in creating the FASAB?
- a) U.S. Congress.
 - b) **Office of Management and Budget.**
 - c) Governmental Accounting Standards Board.
 - d) Securities and Exchange Commission.
30. The purpose of the FASAB is to:
- a) Establish accounting standards for not-for-profit entities.
 - b) Establish accounting standards for federal entities.
 - c) Establish accounting standards for all governmental entities.
 - d) **Establish accounting standards for non-federal governmental entities.**

PROBLEMS (CHAPTER 1)

1. Thorn County adopted a cash budget for FY2007 as follows. The City budget laws prohibit budgeting or operating at a deficit. During the year the County collected or spent the following amounts. Was the County in compliance with budget laws? Did the County accomplish the goal of interperiod equity? Explain your answers in detail.

| | <u>Budgeted</u> | <u>Collected/Spent</u> |
|--|-----------------|------------------------|
| Receipts from Property tax collections | | |
| From the 2006 levy | \$ 100,000 | \$ -0- |
| From the 2007 levy | \$1,000,000 | \$ 900,000 |
| In advance for 2008 | \$ 50,000 | \$ -0- |
| Receipts from Bonds Issued | \$ 500,000 | \$ 500,000 |
| Borrowed from Bank (due in 5 years) | \$ -0- | \$ 75,000 |
| Disbursements | | |
| Salaries and Wages | \$ 500,000 | \$ 500,000 |
| Operating Expenses | \$ 200,000 | \$ 275,000 |
| City Hall Annex purchased | \$ 500,000 | \$ 500,000 |
| Payments on Debt-Principal | \$ 150,000 | \$ 150,000 |
| Payments on Interest | \$ 50,000 | \$ 50,000 |
| Pension Contribution | \$ 80,000 | \$ -0- |

Explanations provided by the City for the differences between budget and actual are as follows. Property tax collections are down because the major industry in the community closed and many citizens are currently unemployed. Operating expenses are up because the only bridge over a river bisecting the City sustained damages by an uninsured motorist and had to be repaired immediately. The repair was not budgeted.

- Save-the-Birds (STB), a not-for-profit entity dedicated to acquiring and preserving habitat for upland birds, prepares financial statements in accordance with generally accepted accounting principles. Currently, standards require that a not-for-profit entity report virtually all contributions as revenue in the year received. During the current year STB received a donation of several hundred acres of prime habitat for upland birds. STB will require several hundred thousand dollars in additional donations in order to make the land completely suitable for the birds. Before embarking on its fund-raising campaign STB prepares financial statements which are summarized as follows.

Statement of Financial Position (Balance Sheet)

| | |
|---------------------------------|--------------------|
| Cash | \$ 8,000 |
| Supplies | \$ 2,000 |
| Equipment (net of depreciation) | \$ 5,000 |
| Land | <u>\$1,000,000</u> |
| Total Assets | <u>\$1,015,000</u> |

| | |
|----------------------------------|--------------------|
| Liabilities | \$ 1,000 |
| Net Assets—Unrestricted | \$ 14,000 |
| Net Assets—Restricted | <u>\$1,000,000</u> |
| Total Liabilities and Net Assets | <u>\$1,015,000</u> |

Statement of Activities (Income Statement)

| | |
|----------------------|--------------------|
| Revenues | \$1,030,000 |
| Expenses: | |
| Salaries | <u>\$ 30,000</u> |
| Change in Net Assets | <u>\$1,000,000</u> |

What difficulties, if any, will Save-the-Birds encounter in its new fund-raising drive? Knowing that the donation of the land accounted for \$1,000,000 of the revenue reported by Save-the-Birds, do you think the financial statements present fairly the financial position and results of operations of this not-for-profit entity?

- Johnson City prepares its budget on the cash basis and prepares its external financial statements on the accrual basis. From the following data prepare statements of activity (income statements) on both the cash basis and the accrual basis. Which statement best represents the results of operations of the City? Which statement best demonstrates compliance with laws and regulations? Which statement would you rather see? Which conveys the best information to the citizens of Johnson City?

The City levies taxes in the current year of \$1 million. Of this amount \$.9 million is collected during the current year, \$.05 will be collected next year, and \$.04 will be collected in the future. \$.01 will never be collected. During the current year the City pays bills from prior periods \$.06 million, bills of the current period \$.8 million, and defers payment until future periods on bills that were received for services consumed during the current period \$.1 million.

4. Certain fiscal practices of governments promote interperiod equity while others do not. For the situations listed below, indicate whether interperiod equity is promoted or undermined. Why?
- a. Issuing 30-year serial bonds to finance the construction of capital assets with estimated 30 year lives.
 - b. Paying for the pensions of retired employees out of resources provided by current-period taxpayers.
 - c. Charging the cost of supplies as expenditures in the year in which they were used rather than when they were purchased.
 - d. Issuing 30-year bonds to finance a portion of the current period operating costs of a city's school system
 - e. Charging payments of wages and salaries made in the first week of a new year to the previous fiscal year, the year in which the wages and salaries were earned.

ESSAY (CHAPTER 1)

1. In the United States, educational services can be provided by federal governmental entities, by non-federal governmental entities, by not-for-profit entities, and by for-profit entities. Are the accounting and financial reporting standards the same for each of these entities? Should they be the same?
2. The Governmental Accounting Standards Board (GASB) stated that an objective of financial reporting is to measure interperiod equity, that is—“Financial reporting should provide information to determine whether current-year revenues were sufficient to pay for current-year services.” What is your understanding of interperiod equity? What costs incurred in the current year should be paid for by the taxpayers of the current period? What costs incurred in the current year should be paid for by future taxpayers?
3. A not-for-profit entity raises funds to support specific programs, services, and activities. The recipients of the programs, services, and activities are frequently not the providers of the resources to deliver the programs, services, and activities. What information would donors to these not-for-profit entities be interested in seeing? What information would program beneficiaries be interested in seeing? Identify other users of the financial statements of a not-for-profit and the types of information in which they would be interested.
4. What is the significance—for financial reporting purposes—of the fact that neither not-for-profits nor governments have owners (stockholders)?
5. What are some of the definitional criteria that distinguish a governmental entity from a not-for-profit entity?
6. How does the FASB influence generally accepted accounting principles for state and local governments?

ANSWERS TO TRUE/FALSE QUESTIONS (CHAPTER 1)

1. F
2. T
3. F
4. T
5. F
6. T
7. T
8. F
9. T
10. F

ANSWERS TO MULTIPLE CHOICE (CHAPTER 1)

1. B
2. B
3. D
4. C
5. A
6. D
7. C
8. C
9. C
10. D
11. D
12. C
13. D
14. D
15. D
16. A
17. D
18. B
19. A
20. B
21. C
22. B
23. C
24. D
25. B
26. D
27. A
28. A
29. B
30. B

ANSWERS TO PROBLEMS (CHAPTER 1)

1. The City adopted a cash budget that projected an operating surplus of \$170,000; therefore, it was in compliance with the “budgeting” portion of budget laws. In addition, the City “balanced” its current period operations. Total inflows are \$1,475,000 and total outflows are \$1,475,000. The City was seriously affected by the closure of the major employer in town. The City compensated for the shortfall in property tax revenues by failing to make the pension contribution in the current period and by borrowing on a long-term note at the bank. Although one expenditure category exceeded the budgeted amount (operating expenses was \$75,000 more than budgeted), another was short by \$80,000 (pension contributions). The City has probably complied with the budget laws that prohibit operating at a deficit (if deficit is defined as a cash deficit). It has probably not complied with the budget laws if the laws state that current revenues (not including borrowing) must be equal to or exceed current period costs.

Interperiod equity is another issue. By failing to make the required contribution the City has passed on to future taxpayers costs that were associated with operations of the current period. Also, by borrowing at the bank the City has incurred obligations that must be borne by future taxpayers.

2. Save-the-Birds will be launching a major fund-raising drive with a financial statement that shows \$1,030,000 in donations and only \$30,000 in expenses. It may be difficult to explain to potential donors why the entity is conducting a fund-raising drive at the present time. The balance sheet should help Save-the-Birds explain why they need the additional monies. However, many people familiar with financial statements of for-profit entities may have difficulty understanding how an entity can generate a \$1,000,000 ‘profit’ and still need to be soliciting funds. The equity section shows Net Assets of \$1,000,000. It may be difficult for readers to understand that this is not similar to Retained Earnings in for-profit entities. The distinction between unrestricted and restricted may be meaningless to the average reader. **[Note:** Students may react as readers—why do they need another fund-raising drive now? If so, they have failed to grasp an important issue for many not-for-profit entities.]

The financial statements of Save-the-Birds present fairly the financial position and results of operations of the entity. The financial statements do not tell the whole story. It will be necessary for Save-the-Birds to explain why they need the funds.

3. Johnson City financial statements would be as follows:

| <i>Cash Basis</i> | | <i>Accrual Basis</i> |
|---------------------|-----------------------|----------------------|
| \$.9 million | Property tax receipts | |
| | Property tax revenues | \$.99 million |
| (.06) million | Prior period expenses | |
| | Accrued expenses | (.1) million |
| <u>(.8) million</u> | Current expenses | <u>(.8) million</u> |
| \$.04 million | “Net Income” | \$.09 million |

The cash basis financial statement would best demonstrate compliance with the budget but the non-cash basis financial statement would best convey results of operations. As a citizen, I would like to see both because legal compliance is important to me but so are results of operations. It may take both statements to fully inform the public about operations. [Note: At this point students have not been exposed to 'modified accrual' accounting so they will not struggle with revenue recognition issues imbedded in this problem.]

- 4.
- Promotes interperiod equity. Because the bonds are required to be repaid over the life of the capital assets, the cost of those assets is allocated to the periods over which taxpayers benefit from the use of the assets.
 - Undermines interperiod equity. The employee benefits costs—pension benefits—are paid by an entirely different generation of taxpayers—long after the employees earned the benefits by providing services.
 - Promotes interperiod equity. Although not particularly material, supplies do not benefit taxpayers until they are used to provide services. Reporting these as expenditures when purchased reports the cost in a different period from when the benefit is provided.
 - Undermines interperiod equity. Using debt to finance operating costs spreads the cost of providing services provided *in a single period* over the entire term of the long-term debt. Interest costs on the debt amplify the problem.
 - Promotes interperiod equity. Again, while possibly immaterial, reporting the cost of providing services—in the form of wages and salaries—in the period in which services were provided promotes interperiod equity.

ANSWERS TO ESSAY QUESTIONS (CHAPTER 1)

1. Accounting standards for educational institutions differ by the nature of the ownership. Public schools (K-12) are accounted for in the same way as state and local governments, as are public colleges and universities, theoretically. Private schools, colleges, and universities are accounted for using not-for-profit standards established by FASB. For-profit educational institutions would use the FASB rules for other for-profit entities.

Because these entities are all involved in delivering the same basic service—education—it would appear that they should have the same standards. However, public schools are subject to the same openness as other government activities. The citizens should have a voice in determining what services are offered through the schools and how those services are delivered. The budget process is the opportunity for the public to be heard and the adopted budget is a plan of action to which citizens can, and should, hold officials accountable. For-profit schools are organized to generate profits and should measure net income using full accrual accounting. Not-for-profit entities generate revenues from tuition and solicit contributions from the public, or a select group of the public. Donors to not-for-profit entities may be interested in different information than taxpayers are interested in.

[**Note:** Students will have differing opinions about the appropriateness of different accounting standards for educational institutions determined by ownership rather than by activity. The question is designed to solicit their thoughts.]

2. Interperiod equity means that the citizens of one time period should pay the costs of the goods and services consumed during that time period. Interperiod equity as an accounting concept means that the financial statements should measure the success of a governmental entity in accomplishing the goal of raising sufficient revenues to pay for the cost of services consumed during a period. However, interperiod equity is a policy decision, not an accounting decision.

To achieve interperiod equity, current-year taxpayers should cover the cost of current-year services. Everyone would agree that current period operating costs should be covered, including supplies and payroll costs. In addition, a portion of the cost of capital assets or other improvements, which benefit more than one period, should be considered in the equation. Finally, certain costs may not be paid until well into the future but arise from current operations. The government's employees *earn* many of these in the current period, including accumulating vacation benefits, pension benefits, and other postemployment benefits.

Costs that should not be included in the current year measure of interperiod equity are costs that will benefit future periods—for example, the portion of the historical cost of capital assets that will be allocated over future periods.

3. Donors to not-for-profit (NFP) entities are probably interested in information about the costs incurred by the not-for-profit. Donors would be interested in comparing the cost incurred in delivering services by one entity compared to the cost incurred by another entity for delivering the same type of service. The amount spent on programs compared to the amount spent on fund-raising and general and administrative costs would be of interest to donors. Major donors should be very interested in the amounts spent on salaries to top NFP officials because major donors are, in effect, paying those salaries. Beneficiaries would be interested in the costs of delivering the goods and services and the success of the NFP in securing the funds necessary to continue to deliver those goods and services.

Regulatory agencies, such as the IRS, would be very interested in the financial information of NFP entities to assess whether they should continue to be considered a NFP entity.

Governments would be interested in the financial information of NFP entities. Many governments are considering outsourcing or privatizing the delivery of goods and services. If other entities can, indeed, perform those services more efficiently than government, perhaps the services should be privatized or outsourced.

4. The obvious significance of the fact that neither not-for-profits nor governments have owners is that neither governments nor not-for-profits report owner's equity. More important however, is the fact that financial reports of governments cannot focus on owners. They must be prepared from the perspective of parties other than stockholders. Generally this focus is on resource providers and the restrictions they place on the assets they contribute.

In addition, this distinction often means that there is less interest in the fair market values of assets and liabilities and other accounting measures that rely on fair values, such as pension expense. No stockholders exist to consider the price/earnings ratios of these entities or a potential buyout/takeover.

Finally, both the FASB and GASB have called for information on service efforts and accomplishments. These measures would be used to assess, among other things, how effectively and efficiently the entities provide services. This information, however, is not easily expressed in monetary measures and has not yet been included in financial statements.

5. First, and foremost, a governmental entity usually has the power to assess taxes. Not-for-profit entities do not. In addition, governments may issue tax-exempt debt and their governing bodies are either elected by taxpayers or appointed by another government. Less common is the fact that a governmental entity can usually be unilaterally dissolved by another governmental entity (usually the one that created it) and its assets assumed without compensation. None of these things are true about not-for-profit entities.
6. The FASB influences generally accepted accounting principles of governments in two key ways. First, FASB pronouncements are included in the GASB "hierarchy" of GAAP. FASB pronouncements that the GASB has specifically made applicable to governments are included in the highest category; those that the GASB has not specifically adopted are included in the lowest category. Second, the business-type activities of governments are required (with a few exceptions) to follow the business accounting principles as set forth by the FASB.

Chapter 2

Fund Accounting

TRUE/FALSE (CHAPTER 2)

1. TFund accounting promotes control and accountability over restricted resources.
2. TThe basis of accounting determines when transactions and events are recognized.
3. TIf an entity adopts a full accrual basis of accounting, its measurement focus will automatically be on all economic resources.
4. TA government may report some of its funds on a full accrual basis.
5. FFunds divide a government into functional departments.
6. FGeneral funds are established to account for resources legally restricted for specified purposes.
7. FFiduciary activities only benefit parties other than the government itself.
8. TThe Financial Accounting Standards Board requires all nongovernmental not-for-profit entities to use fund accounting.
9. TIn addition to preparing fund financial statements, governments should also prepare consolidated financial statements to provide information on the financial position and operating results of the government as a single economic entity.
10. TFiduciary activities should be reported in fund statements, but should be excluded from the government-wide statements.
11. TAt first glance, the government-wide statement of activities bears little resemblance to the income statement of a business.
12. TIn accounting for costs incurred on a major construction project in a capital projects fund, the construction outlays are reported as expenditures, not capital assets.

MULTIPLE CHOICE (CHAPTER 2)

1. What is the primary reason that governmental entities use fund accounting?
 - a) Fund accounting is required by law.
 - b) Fund accounting is required by GAAP.
 - c) **Fund accounting promotes control and accountability over restricted resources.**
 - d) Fund accounting promotes better control over operating activities.

2. Basis of accounting determines which of the following?
 - a) **When transactions and events are recognized.**
 - b) What transactions and events will be reported.
 - c) Where transactions and events will be reported.
 - d) Why transactions and events will be reported.

3. A fund is
 - a) A separate legal entity.
 - b) **A separate fiscal and accounting entity.**
 - c) A separate self-balancing set of accounts for inventory purposes.
 - d) None of the above.

4. Which of the following funds is a fiduciary fund?
 - a) Permanent fund.
 - b) **Agency fund.**
 - c) Capital project fund.
 - d) Debt service fund.

5. When a governmental entity adopts a basis of accounting other than full accrual and a measurement focus that excludes long-lived assets and liabilities in its governmental fund types:
 - a) It is in violation of the law.
 - b) It is in violation of GAAP.
 - c) **It has reported in accordance with GAAP standards for the governmental fund financial statements required by the new GASB reporting model.**
 - d) It has the ability to better measure the results of operations.

6. A city receives a donation from a citizen who specifies that the principal must be invested and the earnings must be used to support operations of a city-owned recreational facility. The principal of this gift should be accounted for in which of the following funds?
 - a) Trust fund.
 - b) Special revenue fund.
 - c) **Permanent fund.**
 - d) Internal service fund.

7. Which of the following is NOT a governmental fund?
- a) City Hall Debt Service Fund.
 - b) City Utilities Enterprise Fund.**
 - c) Gasoline Tax Special Revenue Fund.
 - d) City Hall Capital Project Fund.
8. Which of the following accounts would you least expect to see in a debt service fund?
- a) Principal payments.
 - b) Interest charges.
 - c) Interest earned.
 - d) Outstanding balance of the debt being serviced.**
9. Which of the following funds is a proprietary fund?
- a) Internal service fund.**
 - b) Special revenue fund.
 - c) Capital project fund.
 - d) Permanent fund.
10. Which of the following funds is a governmental fund?
- a) Enterprise fund.
 - b) Debt service fund.**
 - c) Internal service fund.
 - d) Agency fund.
11. Which of the following activities conducted by a city-owned junior college should be accounted for in an agency fund?
- a) Receipt of tuition payments.
 - b) Receipt of revenues belonging to the student accounting club.**
 - c) Receipt of state monies appropriated for general operations.
 - d) Receipt of donations in support of the university's athletic program.
12. Which of the following transactions should the City of Highland account for in a trust fund?
- a) General fund contributions received by the City pension plan.**
 - b) Greens fees received from golfers at the City-owned golf course.
 - c) Grants received from the Federal government to purchase buses to be used for public transit.
 - d) Proceeds of bonds issued to construct a new city hall building.
13. The state collects a gasoline tax that must be used to support highway construction and maintenance. The gasoline tax revenue should be accounted for in which of the following funds?
- a) General fund.
 - b) Special revenue fund.**
 - c) Debt service fund.
 - d) Internal service fund.

14. The City of San Jose built a new city hall and financed construction by issuing bonds due in installments over the next 30 years. The bond principal and interest will be paid by a special tax levied on property in the City. The revenue received from this special tax should be accounted for in which of the following funds?
- a) General fund.
 - b) Internal service fund.
 - c) Capital project fund.
 - d) **Debt service fund.**
15. Riverside Golf Course is a City-owned golf course that collects greens fees in amounts sufficient to cover its expenses. Riverside Golf Course should be accounted for in which of the following funds?
- a) Internal service fund.
 - b) **Enterprise fund.**
 - c) General fund.
 - d) Special revenue fund.
16. To fulfill the printing needs of its various departments and agencies, the City has established a Central Print Shop, which bills the various departments and agencies of the city for printing services rendered. The Central Print Shop should be accounted for in which of the following funds.
- a) **Internal service fund.**
 - b) Enterprise fund.
 - c) General fund.
 - d) Special revenue fund.
17. Which of the following sections is NOT required in the Comprehensive Annual Financial Report of a City?
- a) Financial section.
 - b) Introductory section.
 - c) Statistical section.
 - d) **Historical section.**
18. The Basic Financial Statements of a city do not include which of the following?
- a) Government-wide Statement of Net Assets.
 - b) Government-wide Statement of Activities.
 - c) **Government-wide Statement of Cash Flows.**
 - d) Separate balance sheets for governmental and proprietary funds.
19. Which of the following funds is accounted for on the modified accrual basis of accounting?
- a) **General fund.**
 - b) Internal service fund.
 - c) Proprietary fund.
 - d) Pension trust fund.
20. Which of the following assets would NOT be found in the fund balance sheet of the General Fund of the City of Harrison?
- a) Cash.
 - b) **Capital assets.**
 - c) Due from Special Revenue Fund.
 - d) Due from State.

21. Which of the following liabilities would NOT be found in the fund balance sheet of the General Fund of the City of Marmaduke?
- a) Accounts payable.
 - b) Due to Special Revenue Fund.
 - c) Deferred revenue.
 - d) **Bonds payable, due in 5 years.**
22. For which of the following entities is fund accounting mandated?
- a) American Hospital Association.
 - b) **City of New York.**
 - c) Grace Lutheran Church.
 - d) United Way.
23. The focus of the Statement of Activities of the City of West Hills is on which of the following?
- a) Determining the total expenses by natural classification.
 - b) Determining the total expenses by function.
 - c) Determining the total revenues by function.
 - d) **Determining the net cost of functions.**
24. Which of the following statements is NOT required in the financial reports of a not-for-profit entity?
- a) Statement of Position.
 - b) **Statement of Restricted Funds.**
 - c) Statement of Activities.
 - d) Statement of Cash Flows.
25. The primary focus of the Statement of Activities of a not-for-profit organization is on determining the net increase/decrease in which of the following?
- a) Unrestricted Net Assets.
 - b) Temporarily Restricted Net Assets.
 - c) Permanent Net Assets.
 - d) **Net Assets of the entity taken as a whole.**
26. Under the GASB Statement No. 34 reporting model for governmental entities, which of the following is required?
- a) Only one set of financial statements, prepared on the full accrual basis of accounting.
 - b) Only one set of financial statements, prepared on the modified accrual basis of accounting.
 - c) **Two sets of financial statements, one that views the government as a collection of separate funds and reports using the current financial resources measurement focus and modified accrual basis of accounting for governmental funds and one that views the government as a whole by combining all governmental activities in one column and all business-type activities in another column using the full accrual basis of accounting for both columns.**
 - d) Two sets of financial statements, one that views the government as a whole using the current financial resources measurement focus and modified accrual basis of accounting and one that views the government by function and combines all

governmental activities in one column and all business-type activities in another column using the full accrual basis of accounting for both columns.

27. Under the GASB Statement No. 34 reporting model for governmental entities, the government-wide Statement of Net Assets will display which of the following?
- a) **Assets, Liabilities, and Net Assets.**
 - b) Assets, Liabilities, and Fund Balances.
 - c) Assets, Liabilities, and Fund Equity.
 - d) Assets, Liabilities, and Owner's Equity.
28. Under the GASB Statement No. 34 reporting model for governmental entities, the focus of the government-wide Statement of Activities is on which of the following?
- a) Program revenues and general revenues.
 - b) Program revenues and expenses.
 - c) Net income.
 - d) **The net cost of each of the government's main functions and programs.**
29. A not-for-profit entity Statement of Net Assets will NOT report which of the following?
- a) **Net assets invested in capital assets net of related debt.**
 - b) Capital assets.
 - c) Temporarily restricted net assets.
 - d) Permanently restricted net assets.
30. Which of the following funds of Chessie City would be consolidated to form the governmental activities column in the City's government-wide financial statements?
- a) Its general fund, special revenue fund, and agency fund.
 - b) **Its general fund, debt service fund, and capital projects fund.**
 - c) Its general fund, enterprise fund, and fiduciary fund.
 - d) Its enterprise fund and internal service fund.
31. Which fund type would all governments normally include in their fund financial statements?
- a) Capital projects funds
 - b) Special revenue funds
 - c) **General fund**
 - d) Fiduciary funds
32. Under the GASB Statement No. 34 reporting model for governmental entities, fund financial statements include separate sets of financial statements for:
- a) Each major function of the government.
 - b) **Governmental funds, proprietary funds, and fiduciary funds.**
 - c) Governmental funds, enterprise funds, and internal service funds.
 - d) Governmental funds, special revenue funds, and debt service funds.

33. When a fax machine purchased by a governmental unit is received, it should be recorded in the general fund as a(n)
- a) Expense
 - b) Encumbrance
 - c) Expenditure
 - d) General Capital Asset
34. Which of the following is not included in the financial section of the Comprehensive Annual Financial Report?
- a) Required supplementary information
 - b) Letter of transmittal
 - c) Financial Statements
 - d) Notes to the statements
35. During the current fiscal year, Mountain View City's water utility, an enterprise fund, rendered billings for water supplied to the general fund. Which of the following accounts should be debited by the general fund?
- a) Transfer-out to enterprise fund
 - b) Due to water utility enterprise fund
 - c) Appropriations
 - d) Expenditures

PROBLEMS (CHAPTER 2)

1. Assume that the City of Ft. Smith maintains its books and records in a manner that facilitates the preparation of the fund financial statements. For each of the following events indicate in which fund(s) of the City of Ft. Smith the event would be recorded and justify your fund selection.
 - a. The City collected property taxes levied for the general operations of the City.
 - b. The City collected property taxes levied to pay principal and interest on bonds issued several years in the past to construct a new fire station.
 - c. The City collected property taxes levied on a specific area of the City for the purposes of providing more frequent snow removal than is enjoyed by the rest of the City.
 - d. The City sold bonds to finance the construction of a new City Hall.
 - e. The City sold bonds to finance major renovations at the city-owned electric utility.
 - f. The City purchased a street sweeping machine.

2. Assume that the City of Amber maintains its books and records in a manner that facilitates the preparation of the fund financial statements. Amber City maintains a general fund, a capital projects fund, and a special revenue fund. During the current fiscal year, the City engaged in the following transactions. Record all transactions. Be sure to clearly indicate the fund in which the entry is made.
 - a. The City sold bonds, face value \$26 million, at par to finance the construction of a new City Hall.
 - b. The City purchased two new police cars at a total cost of \$50,000.
 - c. The City collected \$8,000 in taxes dedicated for the eradication of noxious weeds.
 - d. The City spent \$6,000 on pesticides for noxious weeds.
 - e. The City acquired a new tractor for \$75,000. The City paid \$20,000 in cash and signed a note that is due in three years.

3. Assume that Blackfoot County maintains its books and records in a manner that facilitates the preparation of the fund financial statements. Blackfoot County engaged in the following transactions during the current month. Prepare journal entries in the general fund to record these events.
 - a. Paid salaries to County employees, \$100,000.
 - b. Borrowed \$35,000 on a three-year note from a local bank to use to buy a County car.
 - c. Purchased the County car for \$35,000.
 - d. Made a \$7,000 payment on outstanding accounts payable.
 - e. Collected \$3,500,000 of the current property tax levy.
 - f. Received a \$50,000 grant from the State to support general government activities.

4. Kayla Township issued the following bonds during the year:
- | | |
|--|-------------|
| • Ten-year bonds to acquire equipment for a data processing service reported in an internal service fund | \$1,000,000 |
| • Bonds to construct a new police station | \$4,500,000 |
| • Bonds to increase the capacity of the water treatment plant reported in an enterprise fund | \$2,400,000 |
- a. The amount of debt reported in the Township's general fund is:
1. \$0
 2. \$4,500,000
 3. \$5,500,000
 4. \$7,900,000
- b. The Township should report depreciation expense related to the new capital assets in these funds:
1. The general fund
 2. The enterprise fund
 3. The enterprise and internal service funds
 4. The capital projects fund
- c. The bonds issued to construct the new police stations should be reported as:
1. Debt proceeds in the general fund
 2. Long-term debt in the debt service fund
 3. Debt proceeds in the capital projects fund
 4. None of the above
- d. In accordance with bond covenants, the Township sets aside \$500,000 to help assure that it is able to meet its first payment of principal and interest on the police station debt due one year from the date the bonds were issued. The amount of liability that the Township should report in its debt service fund is:
1. \$0
 2. \$500,000
 3. \$4,500,000
 4. \$4,000,000

5. A newly established Chessie Foundation engaged in the following transactions:
1. A donor made a \$1,000,000 pledge, giving the organization a legally enforceable 90-day note for the full amount.
 2. The same donor paid \$500,000 of the amount pledged.
 3. The Foundation purchased a building for \$750,000, paying \$100,000 in cash and giving a ten-year mortgage for the balance. The building has a 25-year useful life. The organization charges a half-year's depreciation for all assets in the year they are acquired.
 4. The organization hired five employees. At year-end, these employees had earned \$10,000 in salaries and wages for which they had not been paid.
- The Foundation accounts for its activities in a single fund.

a. Prepare journal entries to record the transactions, making the following alternative assumptions as to the organization's measurement focus:

- Cash only
- Cash plus other current financial resources (cash plus short-term receivables less short-term payables)
- All economic resources

- b. Based on your entries, prepare appropriate operating statements and balance sheets for the organization.

6. Katerah City maintains the following funds:

1. General
2. Special revenue
3. Capital projects
4. Debt service
5. Enterprise
6. Investment trust
7. Permanent
8. Agency

For each of the following transactions, indicate which fund would most likely be used to report the transaction:

- a. The City collects \$1 million of taxes for an independent fire district located within the City.
- b. The City spends \$1.2 million on street maintenance using the proceeds of a city gas tax dedicated for road and highway maintenance and improvements.
- c. The City receives a bequest of \$1.5 million. The donor's Will, requires that the principal amount be invested in perpetuity and that the earnings on the investment be used to maintain a city park to be renamed for the donor.
- d. The City collects water and sewer fees of \$4.2 million.
- e. The City pays \$4 million to a contractor for work on the new bridge.
- f. The City receives \$1.3 million to invest on behalf of the County.
- g. The City pays its police officers wages of \$325,000.
- h. The City pays \$2.2 million in Bond Interest on its general obligation debt.

7. The Geneva Housing Authority, a governmental entity, accounts for its activities on a modified accrual basis of accounting. In the current period, it reports the following transactions:

- The Authority issues \$1.5 million in long-term bonds.
- The Authority purchases 4 acres of land for \$300,000 in cash.
- It sells one of these acres of land for \$75,000 in cash.
- It made a \$195,000 payment on the debt, consisting of \$45,000 of interest and \$150,000 in principal.
- It lost a lawsuit filed by one of its renters and was ordered to pay \$1 million in damages over 5 years. It made its first cash payment of \$200,000.

1. Prepare journal entries to record each of these transactions in the general fund.
2. Based on your entries, prepare a balance sheet and statement of revenues, expenditures, and changes in fund balance for the general fund.
3. Comment on how these statements capture the Authority's economic resources and obligations.
4. Comment on the extent to which the statement of revenues, expenditures, and changes in fund balances captures the Authority's costs of services.
5. When the Authority prepares GAAP financial statements based on GASB Statement No. 34, what assets and liabilities would be added in the Authority's government-wide Statement of Net Assets? What gains and losses would be added in its government-wide Statement of Activities?

8. The newly established Environmental Council (a not-for-profit organization) uses two funds for internal reporting purposes. The general fund is used to record day-to-day operating transactions. A building fund is used to accumulate resources for a new building to house the Council's operations. Both funds are reported using the accrual basis of accounting. In its first year, the Council engaged in the following transactions:

1. It received cash contributions of \$500,000, \$100,000 of which donors stipulate must be used for the new building.
2. It incurred operating payroll costs of \$200,000, of which \$180,000 is paid in cash.
3. It earned \$1,000 in interest (paid in cash) on investments restricted to the acquisition of the new building.
4. It transferred \$25,000 from its general fund to the building fund.
5. It paid \$15,000 in fees (accounted for as expenses) for architectural drawings for the proposed building.

- a. Prepare journal entries to record the transactions. Be sure to indicate the fund in which the entry would be made.
- b. Prepare a statement of revenues, expenses and other changes in fund balances and a balance sheet. Use a two-column format, one column for each of the Council's two funds.

ESSAYS (CHAPTER 2)

1. Why do governments and not-for-profit entities use fund accounting?
2. Governments use the modified accrual basis of accounting and a current financial resources measurement focus when presenting the governmental fund financial statements but they use the accrual basis of accounting and the flow of economic resources for the government-wide financial statements. What is a basis of accounting? What is measurement focus? How does the selection of one affect the selection of the other?
3. For what purposes do governmental entities use agency funds? What are the distinguishing characteristics of agency funds?
4. The Basic Financial Statements for Ammon City contains the following statements. For each statement identify the appropriate measurement focus and basis of accounting.
 - a.) Government-wide Statement of Net Assets
 - b.) Government-wide Statement of Activities
 - c.) Balance Sheet—Governmental Funds
 - d.) Statement of Revenues, Expenditures, and Changes in Fund Balance—Governmental Funds
 - e.) Statement of Net Assets—Proprietary Funds
 - f.) Statement of Revenues, Expenses, and Changes in Fund Net Assets—Proprietary Funds
5. The activities of an internal service fund are presented on the Statement of Revenues, Expenses, and Changes in Fund Net Assets in the fund financial statements. Why?
6. What are the three categories of restrictions that must be used to report the resources of not-for-profit organizations? Who must impose the restrictions in order for them to be reported?
7. Why are long-term debts generally **not** reported in a government's debt service funds?
8. What are fiduciary funds? Why don't governments incorporate (consolidate) these funds into their government-wide financial statements?
9. The City of Orlando maintains funds for debt service, capital projects and special revenues. It does not, however, maintain funds for police, recreation, and general administration. Why do you suppose it does not maintain a separate fund for each of its functional areas?
10. GASB 34 mandates that the government reconcile total governmental fund balances per the fund balance sheet with net assets of governmental activities per the government-wide statements. What are likely to be the two largest reconciling items for most major cities? Why?

ANSWERS TO TRUE/FALSE (CHAPTER 2)

1. True
2. True
3. True
4. True
5. False
6. False
7. True
8. False
9. True
10. True
11. True
12. True

ANSWERS TO MULTIPLE CHOICE (CHAPTER 2)

1. C
2. A
3. B
4. B
5. C
6. C
7. B
8. D
9. A
10. B
11. B
12. A
13. B
14. D
15. B
16. A
17. D
18. C
19. A
20. B
21. D
22. B
23. D
24. B
25. D
26. C
27. A
28. D
29. A
30. B
31. C
32. B
33. C
34. B
35. D

ANSWERS TO PROBLEMS (CHAPTER 2)

Problem 1

- a. General Fund. The general fund is used to account for the general activities of a governmental entity.
- b. Debt Service Fund. The debt service fund is used to account for payments of principal and interest on debt incurred to finance general government activities.
- c. Special Revenue Fund. The proceeds may only be used for snow removal. By accounting for these proceeds in a special revenue fund and accounting for the expenditures of the proceeds the entity can demonstrate that it used these resources for the purpose required.
- d. Capital Project Fund. A new City Hall is a general government asset. The Capital Project Fund is used to account for the resources held for the purpose of construction and/or acquisition of major capital facilities. It is also used to account for the construction and/or acquisition of those assets.
- e. Enterprise Fund. Normally, governments use enterprise funds to account for activities for which there comparable activities in the private sector. If the electric utility is accounted for in an enterprise fund, all fixed assets and all long-term debt associated with those activities will be accounted for in the enterprise fund.
- f. General Fund. The general fund is used to account for the general activities of a government. However, only the cost (expenditure) of the machine would be reported in this fund. The machine (a capital asset) is reported only in the government-wide financial statements.

Problem 2

| | | |
|--------------------------|--------------|--------------|
| a. CAPITAL PROJECTS FUND | | |
| Cash | \$26 million | |
| Bond proceeds | | \$26 million |
| b. GENERAL FUND | | |
| Vehicle expenditure | \$ 50,000 | |
| Cash | | \$ 50,000 |
| c. SPECIAL REVENUE FUND | | |
| Cash | \$ 8,000 | |
| Tax revenue | | \$ 8,000 |
| d. SPECIAL REVENUE FUND | | |
| Expenditures for weeds | \$ 6,000 | |
| Cash | | \$ 6,000 |
| e. GENERAL FUND | | |
| Tractor expenditure | \$75,000 | |
| Proceeds of note | | \$ 55,000 |
| Cash | | 20,000 |

Problem 3

| | | | |
|----|-------------------------|-------------|-------------|
| a. | Expenditures-salaries | \$100,000 | |
| | Cash | | \$100,000 |
| b. | Cash | \$ 35,000 | |
| | Proceeds of notes | | \$ 35,000 |
| c. | Automobile expenditure | \$ 35,000 | |
| | Cash | | \$ 35,000 |
| d. | Accounts Payable | \$ 7,000 | |
| | Cash | | \$ 7,000 |
| e. | Cash | \$3,500,000 | |
| | Tax Revenue or | | |
| | Property Tax Receivable | | \$3,500,000 |
| f. | Cash | \$ 50,000 | |
| | Grant Revenue | | \$ 50,000 |

Problem 4

- a. 1
- b. 3
- c. 3
- d. 1

Problem 5

a. Focus on cash

(1)

No entry necessary — no cash involved.

(2)

| | | |
|-----------------------|------------|------------|
| Cash | \$ 500,000 | |
| Contribution revenues | | \$ 500,000 |

To record the partial collection of the note

(3)

| | | |
|----------------------------------|------------|------------|
| Building acquisition expenditure | \$ 100,000 | |
| Cash | | \$ 100,000 |

To record the cash paid to acquire the building

(4)

No entry necessary — no cash involved

Focus on cash plus current financial resources

(1)

| | | |
|----------------------|-------------|-------------|
| Note receivable | \$1,000,000 | |
| Contribution revenue | | \$1,000,000 |

To record the note received

(2)

| | | |
|-----------------|------------|------------|
| Cash | \$ 500,000 | |
| Note receivable | | \$ 500,000 |

To record the partial collection of the note

(3)

| | | |
|----------------------------------|------------|------------|
| Building acquisition expenditure | \$ 100,000 | |
| Cash | | \$ 100,000 |

To record the cash paid to acquire the building (No recognition is given to the long-term note or to the building, a long-term asset.)

(4)

| | | |
|------------------|-----------|-----------|
| Wage expenditure | \$ 10,000 | |
| Wages payable | | \$ 10,000 |

To record the wages earned by employees, but not yet paid.

Focus on all economic resources

| | | | |
|--|-----|-------------|-------------|
| | (1) | | |
| Note receivable | | \$1,000,000 | |
| Contribution revenue | | | \$1,000,000 |
| <i>To record the note received</i> | | | |
| | (2) | | |
| Cash | | \$ 500,000 | |
| Note receivable | | | \$ 500,000 |
| <i>To record the partial collection of the note</i> | | | |
| | (3) | | |
| Building | | \$ 750,000 | |
| Cash | | | \$ 100,000 |
| Mortgage note payable | | | 650,000 |
| <i>To record the acquisition of the building</i> | | | |
| Depreciation expense | | \$ 15,000 | |
| Accumulated depreciation | | | \$ 15,000 |
| <i>To record depreciation on the building</i> | | | |
| | (4) | | |
| Wage expense | | \$ 10,000 | |
| Wages payable | | | \$ 10,000 |
| <i>To record the wages earned by employees, but not yet paid</i> | | | |

b.

Statements of Revenues and Expenditures

| | <u>Cash</u> | <u>Current Financial Resources</u> | <u>All Economic Resources</u> |
|---|------------------|--|---------------------------------------|
| Contribution revenue | <u>\$500,000</u> | <u>\$1,000,000</u> | <u>\$1,000,000</u> |
| Building acquisition expenditure (or depreciation expense) | 100,000 | 100,000 | \$ 15,000 |
| Wage expenditure/expense | <u>0</u> | <u>10,000</u> | <u>10,000</u> |
| Total expenditures/expenses | <u>100,000</u> | <u>110,000</u> | <u>25,000</u> |
| Excess of revenues over expenditures/expenses | <u>\$400,000</u> | <u>\$ 890,000</u> | <u>\$ 975,000</u> |

Balance Sheets

| | <u>Cash</u> | <u>Current Financial Resources</u> | <u>All Economic Resources</u> |
|--|------------------|--|---------------------------------------|
| <u>Assets</u> | | | |
| Cash | \$400,000 | \$ 400,000 | \$ 400,000 |
| Note receivable | | 500,000 | 500,000 |
| Building (less accumulated depreciation) | | | <u>735,000</u> |
| Total assets | <u>\$400,000</u> | <u>\$ 900,000</u> | <u>\$1,635,000</u> |
| <u>Liabilities and Fund Balances</u> | | | |
| Wages payable | | \$ 10,000 | \$ 10,000 |
| Mortgage note payable | | | 650,000 |
| Fund balance | <u>\$400,000</u> | <u>\$ 890,000</u> | <u>975,000</u> |
| Total liabilities and fund balance | <u>\$400,000</u> | <u>\$ 900,000</u> | <u>\$1,635,000</u> |

Problem 6

- a. 8
- b. 2
- c. 7
- d. 5
- e. 3
- f. 6
- g. 1
- h. 4

Problem 7

1. Journal entries in Authority's general fund

| | | | |
|--|-----|-------------|-------------|
| | (1) | | |
| Cash | | \$1,500,000 | |
| Proceeds from borrowing | | | \$1,500,000 |
| <i>To record the issuance of bonds</i> | | | |
| | (2) | | |
| Expenditure for land | | \$ 300,000 | |
| Cash | | | \$ 300,000 |
| <i>To record the purchase of land</i> | | | |
| | (3) | | |
| Cash | | \$ 75,000 | |
| Proceeds from sale of land | | | \$ 75,000 |
| <i>To record sale of land</i> | | | |
| | (4) | | |
| Repayment of bonds (expenditure) | | \$ 195,000 | |
| Cash | | | \$ 195,000 |
| <i>To record repayment of bonds</i> | | | |
| | (5) | | |
| Legal claims (expenditure) | | \$ 200,000 | |
| Cash | | | \$ 200,000 |
| <i>To record payment of judgment</i> | | | |

2. Modified accrual statements

Geneva Housing Authority
Balance Sheet

| | |
|--------------|------------------|
| Cash | <u>\$880,000</u> |
| Fund Balance | <u>\$880,000</u> |

Geneva Housing Authority
Statement of Revenues, Expenditures and Changes in Fund Balance

Revenues and other financing sources

| | |
|--|------------------|
| Bond proceeds | \$1,500,000 |
| Proceeds from sales of land | <u>75,000</u> |
| Total revenues and other financing sources | <u>1,575,000</u> |

Expenditures and other financing uses

| | |
|---|----------------|
| Repayment of bonds | 195,000 |
| Acquisition of land | 300,000 |
| Legal claims | <u>200,000</u> |
| Total expenditures and other financing uses | <u>695,000</u> |

Excess of revenues and other financing sources
over expenditures and other financing uses \$880,000

3. The governmental fund balance is not intended to report economic resources. Rather it reports current financial resources—current financial resources available to meet current obligations. Only the government-wide statements measure all economic resources—including capital assets and long-term obligations.
4. The governmental fund statement of revenues, expenditures and other financing sources does not measure the cost of services (e.g., it recognizes borrowings as an increase in fund balance and the full cost of acquiring capital assets as a decrease). It is not designed to do so. Instead it is designed to report on flows of current financial resources.
5. In its GAAP government-wide Statement of Net Assets, the Authority would report its capital assets (land) and long-term liabilities (long-term debt and claims and judgments). In the Statement of Activities, the Authority would report a gain on the sale of land and a loss related to the renter's lawsuit. The government-wide statements are prepared using the accrual basis of accounting and therefore measure all economic resources, not just current financial resources.

Problem 8

a. Journal entries

| | | | |
|--|-----------|--|-----------|
| | (1) | | |
| Cash | \$400,000 | | |
| Contribution revenues | | | \$400,000 |
| <i>To record contribution revenue (general fund)</i> | | | |
| Cash | \$100,000 | | |
| Contribution revenues | | | \$100,000 |
| <i>To record contribution revenue (building fund)</i> | | | |
| | (2) | | |
| Operating expenditures | \$200,000 | | |
| Cash | | | \$180,000 |
| Salaries payable | | | 20,000 |
| <i>To record payroll expenditures (general fund)</i> | | | |
| | (3) | | |
| Cash | \$ 1,000 | | |
| Interest revenue | | | \$ 1,000 |
| <i>To record interest revenue (building fund)</i> | | | |
| | (4) | | |
| Transfer to building fund | \$ 25,000 | | |
| Cash | | | \$ 25,000 |
| <i>To record transfer-out to building fund (general fund)</i> | | | |
| Cash | \$ 25,000 | | |
| Transfer-in from general fund | | | \$ 25,000 |
| <i>To record transfer-in from general fund (building fund)</i> | | | |
| | (5) | | |
| Expenditures for architectural services | \$ 15,000 | | |
| Cash | | | \$ 15,000 |
| <i>To record fees paid to architect (building fund)</i> | | | |

b. Financial Statements

Environmental Council
Statement of Revenues, Expenses and Other Changes in Fund Balance

| | <u>General Fund</u> | <u>Building Fund</u> |
|--------------------------------------|-------------------------|--------------------------|
| <u>Revenues</u> | | |
| Contribution revenue | \$400,000 | \$100,000 |
| Interest | | <u>1,000</u> |
| Total revenues | <u>400,000</u> | <u>101,000</u> |
| <u>Expenditures</u> | | |
| Operating expenditures | 200,000 | |
| Architecture services | | <u>15,000</u> |
| Excess of revenues over expenditures | 200,000 | 86,000 |
| Transfers from (to) other funds | <u>(25,000)</u> | <u>25,000</u> |
| Increase in fund balance | <u>\$175,000</u> | <u>\$ 111,000</u> |

Environmental Council
Balance Sheet

| | <u>General Fund</u> | <u>Building Fund</u> |
|-------------------------------------|-------------------------|--------------------------|
| <u>Assets</u> | | |
| Cash | <u>\$ 195,000</u> | <u>\$111,000</u> |
| <u>Liabilities and fund balance</u> | | |
| Salaries payable | \$ 20,000 | |
| Fund balance | <u>175,000</u> | <u>\$111,000</u> |
| Total liabilities and fund balance | <u>\$195,000</u> | <u>\$111,000</u> |

ANSWERS TO ESSAYS (CHAPTER 2)

1. Governmental and not-for-profit entities use fund accounting to demonstrate accountability. By segregating the assets, entities are able to demonstrate clearly that the assets were used for the intended purposes. By segregating certain activities, governments can better control the revenues and expenditures/expenses of these activities. It would not be uncommon for governments and not-for-profit entities to segregate assets whose use is restricted by outside donors, nor would it be uncommon for these entities to segregate the revenues and expenses of activities that are supposed to be self-supporting.
2. Basis of accounting determines WHEN transactions and events are recognized. Measurement focus determines WHAT is being reported upon. If an entity selects the cash basis of accounting, its measurement focus will necessarily be upon the flow of cash. If an entity selects full accrual accounting its measurement focus will, of course, be upon flow of economic resources. An entity must first decide WHAT assets and liabilities it wants to display and choose a basis of accounting that will then enable the entity to display those assets and liabilities.
3. Agency funds are used to account for assets that the governmental entity holds temporarily on behalf of other governments, private organizations, or individuals. Agency funds are mechanisms for segregating, on financial reports, assets held for others to demonstrate accountability and stewardship. Because agency funds are merely lists of assets held for others, with a corresponding obligation to those parties, agency funds have no operating accounts and no equity accounts. Assets = liabilities is the accounting equation.
4.
 - a.) Economic Resources; Accrual
 - b.) Economic Resources; Accrual
 - c.) Current Financial Resources; Modified Accrual
 - d.) Current Financial Resources; Modified Accrual
 - e.) Economic Resources; Accrual
 - f.) Economic Resources; Accrual
5. The activities of an internal service fund are presented on the Statement of Revenues, Expenses, and Changes in Fund Net Assets because they are part of the proprietary fund category. Proprietary funds are reported using the economic resources measurement focus and the accrual basis of accounting to provide information about the full cost of the activities reported in those funds.
6. Temporarily restricted, permanently restricted, and unrestricted resources. Temporarily restricted resources are those that must be used for a specific purpose (for example, to support donor-designated programs or activities) or cannot be spent until some time in the future (for example, when a donor makes good on a pledge). Permanently restricted resources are typically endowments, only the income from which can be spent. Unrestricted funds, of course, are not subject to restrictions. The restrictions are based only on donor mandates. Restrictions imposed by other parties (for example, creditors) are not taken into account for purposes of resource classification.

7. There are generally no long-term debts reported in the debt service fund because these funds are maintained on the modified accrual basis of accounting to account only for the current financial resources that will be used to pay the interest and principal on long-term debts. These resources are set apart from other resources because they can only be used for their specified purposes. The principal and interest payments on the long-term debt that are currently due and payable are reported in the debt service fund that will service the long-term debt.
8. Fiduciary funds are used to account for resources held by the government as either a trustee (a party that administers property for a beneficiary) or an agent (one who acts on behalf of another). Governments do not incorporate (consolidate) fiduciary funds into their government-wide financial statements because they benefit only outsiders and a government cannot expect to have use of their resources.
9. Funds are not maintained for organizational units. They are established only for resources that are restricted. Typically the resources for the key functional areas are provided by unrestricted tax revenues.
10. Long-lived assets and long-term liabilities. These are recorded on the government-wide statements but not the fund statements as the former are on a full accrual basis but the latter are on a modified accrual basis.

Chapter 3

Issues of Budgeting and Control

TRUE/FALSE (CHAPTER 3)

1. TCapital budgets focus on plans for the acquisition and construction of fixed assets.
2. FThe accounting cycle for most governments is two to three years, consistent with the terms of elected officials.
3. TMost budgets are prepared on a cash or modified cash basis.
4. TNeither the GASB nor the FASB set standards for budgetary accounting.
5. FState and local governments must prepare their GAAP budgetary comparisons on the modified accrual basis of accounting.
6. TWhen budgets are integrated into a government's accounting system, estimated revenues are debited.
7. FEncumbrances and expenditures both reduce total fund balances of state and local governments.
8. TNot-for-profit budgets focus first on revenues and secondarily on expenditures.

9. TState and local government's budget to actual comparisons present both original and final budget amounts.
10. FCash-basis budgets help governments focus on interperiod equity.

MULTIPLE CHOICE (CHAPTER 3)

1. Which of the following is NOT a function of a budget in the governmental environment?
 - a) Planning.
 - b) **Organizing.**
 - c) Controlling.
 - d) Evaluating.

2. For which of the following funds would flexible budgeting be most valuable?
 - a) Special revenue fund.
 - b) Capital project fund.
 - c) Agency fund.
 - d) **Enterprise fund.**

3. Property taxes levied on the citizens of the Hill County would most appropriately be budgeted in which of the following budgets?
 - a) **Operating budget.**
 - b) Capital budget.
 - c) Flexible budget.
 - d) All of the above.

4. Expenditures should be budgeted by “character.” An example of a character classification would be
 - a) **Current expenditures.**
 - b) Salaries.
 - c) Public Safety.
 - d) Police Department.

5. Which of the following is a primary benefit of a performance budget?
 - a) It facilitates control by establishing rigid spending mandates.
 - b) **It encourages accomplishment of objectives by associating expenditures with outcomes.**
 - c) It encourages planning by requiring management to anticipate every type of expenditure.
 - d) It provides decision-makers with detailed information.

6. Which branch of local (city and county) government most commonly prepares the budget?
 - a) **Executive branch.**
 - b) Legislative branch.
 - c) Judicial branch.
 - d) None of the above.

7. An officially adopted budget is generally called
 - a) **An appropriation bill.**
 - b) An operating budget.
 - c) A capital budget.
 - d) None of the above.

8. Periodic allocations of funds to departments or agencies are generally called
 - a) Appropriations.
 - b) **Allotments.**

- c) Allocations.
- d) None of the above.

9. Which of the following bases of accounting has been established by GASB for use in the preparation of the general fund budget?
- Cash basis.
 - Modified accrual basis.
 - Accrual basis.
 - None of the above.**
10. Which of the following is the best reason for preparing budgets for governmental entities on the cash basis?
- Cash basis budgeting helps to achieve interperiod equity.
 - Cash basis budgeting helps to ensure that the government will receive no more in revenues than it is required to disburse.
 - Cash basis budgeting helps a government plan to have cash on hand to pay bills**
 - Cash basis budgeting more accurately reflects the economic impact of fiscal activities.
11. Which of the following is NOT true about cash basis budgeting?
- Cash basis budgeting permits a government to balance its budget by delaying cash disbursements.
 - Cash basis budgeting permits a government to balance its budget by advancing the recognition of revenue.
 - Cash basis budgeting encourages interperiod equity.**
 - Cash basis budgeting complicates financial accounting and reporting.
12. GASB requires that governmental entities present their budgeted-to-actual comparison data on which of the following bases of accounting?
- Budgetary basis.**
 - Cash basis.
 - Modified accrual basis.
 - Accrual basis.
13. Which of the following is NOT a reason that legally adopted budgets may not be readily comparable to amounts reported in the GAAP-based financial statements?
- Differences in Basis of Accounting.
 - Differences in Timing.
 - Differences in Reporting Entity.
 - Differences in Recognition.**
14. The City of Lakeview adopts its budget on a basis of accounting that permits outstanding purchase commitments to be charged against the budget in the year that the goods are ordered instead of in the year they are received. During the year the City ordered and received \$4,000 of supplies (of which \$3,000 had been paid and \$1,000 was unpaid) and had \$500 of outstanding purchase commitments for supplies at year-end. In the Statement of Budget to Actual, the expenditures for supplies would be:
- \$3,000.
 - \$3,500.
 - \$4,000.
 - \$4,500.**

15. A governmental entity has formally integrated the budget into its accounting records. At year-end the ledger account "Revenues from Property Taxes" has a debit balance. Which of the following is the best explanation for the debit balance?
- The entity overestimated property tax revenue when preparing its budget.
 - The entity underestimated property tax revenue when preparing its budget.
 - The entity collected more in property taxes than it anticipated.
 - There is no logical explanation; revenue accounts usually do not have debit balances.**
16. A governmental entity has formally integrated the budget into its accounting records and uses encumbrance accounting. During the year the government ordered but had not yet received a new police car. What effect will this event have on the unencumbered balance in the account "Expenditures—Capital Outlay, Police Department"?
- The balance in the account will not be affected until the police car is received.**
 - The balance in the account will be increased.
 - The balance in the account will be decreased.
 - Purchase orders never affect any budgetary account balances.
17. A governmental entity has formally integrated the budget into its accounting records. At the end of the third quarter the ledger account "Expenditures--Salaries" has a \$100,000 debit balance. Which of the following is a true statement?
- The entity has \$100,000 available to spend on salaries.
 - The entity has incurred salaries in the amount of \$100,000.**
 - The entity had paid salaries in the amount of \$100,000.
 - The entity has overspent its budget for salaries by \$100,000.
18. A public school district formally adopted a budget with estimated revenues of \$500 and approved expenditures of \$490. Which of the following is the appropriate entry to record the budget?
- Debit Estimated Revenues \$500; Credit Appropriations \$490; Credit Fund Balance \$10.**
 - Debit Appropriations \$490; Debit Fund Balance \$10; Credit Estimated Revenues \$500.
 - Debit Encumbrances \$490; Debit Fund Balance \$10; Credit Estimated Revenues \$500.
 - Memorandum entry only.
19. A city formally adopted a budget at the beginning of the current year. Budgeted revenues were \$500 and budgeted expenditures were \$490. During the year actual revenues were \$520 and actual expenditures were \$480. Which of the following statements is true with regard to Fund Balance at the end of the current year. Fund balance at the end of the current year in comparison to fund balance at the end of the preceding year will be
- \$10 greater.
 - \$30 greater.
 - \$40 greater.**
 - \$50 greater.
20. A county general fund budget includes budgeted revenues of \$600 and budgeted expenditures of \$595. Actual revenues for the year were \$610. To close the Estimated Revenues account at the end of the year
- Debit Estimated Revenues \$10

- b) Credit Estimated Revenue \$10
- c) Debit Estimated Revenues \$600
- d) Credit Estimated Revenues \$600

21. A university that formally integrates the budget in the accounting system and uses encumbrance accounting orders some new computers that will cost approximately \$20,000. To recognize this event the university should make which of the following entries?
- Debit Expenditures \$20,000; Credit Encumbrances \$20,000
 - Debit Encumbrances \$20,000; Credit Reserve for Encumbrances \$20,000**
 - Debit Encumbrances \$20,000; Credit Vouchers Payable \$20,000
 - No entry required when the order is placed.
22. A county previously encumbered \$10,000 for the acquisition of supplies. The supplies were received at a total cost of \$9,800. To recognize this event the county should make which of the following entries?
- Debit Reserve for Encumbrances \$10,000; Credit Encumbrances \$10,000.**
 - Debit Reserve for Encumbrances \$9,800; Credit Encumbrances \$9,800.
 - Debit Encumbrances \$10,000; Credit Reserve for Encumbrances \$10,000.
 - Debit Encumbrances \$9,800; Credit Reserve for Encumbrances \$9,800.
23. A city received supplies that had been previously encumbered. The supplies were encumbered for \$5,000 and had an actual cost of \$4,900. To recognize this event the county should make which of the following entries?
- Debit Reserve for Encumbrances \$5,000 and Supplies \$4,900; Credit Encumbrances \$5,000 and Vouchers Payable \$4,900.**
 - Debit Encumbrances \$5,000 and Supplies \$4,900; Credit Reserve for Encumbrances \$5,000 and Vouchers Payable \$4,900.
 - Debit Reserve for Encumbrances \$4,900 and Supplies \$4,900; Credit Encumbrances \$4,900 and Vouchers Payable \$4,900.
 - Debit Encumbrances \$4,900 and Supplies \$4,900; Credit Reserve for Encumbrances \$4,900 and Vouchers Payable \$4,900.
24. To close Encumbrances at the end of the year which of the following entries should be made?
- Debit Encumbrances; Credit Fund Balance.
 - Debit Reserve for Encumbrances; Credit Encumbrances.
 - Debit Fund Balance; Credit Encumbrances.**
 - No closing entry needed.
25. To close Reserve for Encumbrances at the end of the year which of the following entries should be made?
- Debit Reserve for Encumbrances; Credit Fund Balance.
 - Debit Reserve for Encumbrances; Credit Encumbrances.
 - Debit Fund Balance; Credit Reserve for Encumbrances.
 - No closing entry needed.**
26. During the previous year, Bane County closed its Encumbrance account. At the end of the previous year there were \$5,000 in outstanding purchase commitments. To restore these commitments to the accounts, which of the following entries would be required?
- Debit Reserve for Encumbrances \$5,000; Credit Encumbrances \$5,000.
 - Debit Encumbrances \$5,000; Credit Reserve for Encumbrances \$5,000.
 - Debit Encumbrances \$5,000; Credit Fund Balance \$5,000**
 - Debit Fund Balance \$5,000; Credit Reserve for Encumbrances \$5,000.

27. When Spruce City receives goods at a cost of \$9,700 that were encumbered in the prior year for \$10,000, which of the following entries are required (assume that encumbrances lapse at year end)?
- a) Debit Expenditures \$9,700; Credit Vouchers Payable \$9,700; no entry for Encumbrances.
 - b) Debit Expenditures \$9,700 and Reserve for Encumbrances \$10,000; Credit Vouchers Payable \$9,700 and Encumbrances \$10,000.
 - c) Debit Expenditures \$10,000 and Reserve for Encumbrances \$10,000; Credit Vouchers Payable \$10,000 and Encumbrances \$10,000.
 - d) Debit Reserve for Encumbrances \$10,000; Credit Encumbrances \$10,000; no entry for Expenditures.
28. At year-end Oakland County had \$3,000 in outstanding purchase commitments on the books. After the appropriate closing entries were made, what is the effect on the *total* Fund Balance of Oakland County?
- a) It is \$3,000 greater than it would have been if the purchase commitments had been fulfilled by year-end.
 - b) It is \$3,000 less than it would have been if the purchase commitments had been fulfilled by year-end.
 - c) It is the same as it would have been if the purchase commitments had been fulfilled by year-end; it will be reduced by \$3,000 next year.
 - d) It is the same as it would have been if the purchase commitments had been fulfilled by year-end; it will not change next year.
29. Hill City uses encumbrance accounting to control expenditures. However, it charges the cost of outstanding purchase commitments to expenditures in the year they are received, not in the year they are ordered. If Hill City had \$5,000 of purchase commitments outstanding at the end of Year 1 and received those goods during Year 2 at a cost of \$4,900, what would be the impact on *total* Fund Balance for Year 2?
- a) Total Fund Balance at the end of Year 2 would be \$4,900 less than at the end of Year 1.
 - b) Total Fund Balance at the end of Year 2 would be \$100 less than at the end of Year 1.
 - c) Total Fund Balance at the end of Year 2 would be \$100 greater than at the end of Year 1.
 - d) Total Fund Balance at the end of Year 2 would be same as it was at the end of Year 1.
30. The City of Denton uses encumbrance accounting to control expenditures. It charges the cost of outstanding purchase commitments to expenditures in the year they are received, not in the year they are ordered. If the City had \$7,000 of purchase commitments outstanding at the end of Year 1 and received those goods during Year 2 at a cost of \$7,800, what would be the impact on *total* Fund Balance for Year 2?
- a) Total Fund Balance at the end of Year 2 would be \$7,800 less than at the end of Year 1.
 - b) Total Fund Balance at the end of Year 2 would be \$800 less than at the end of Year 1.

- c) Total Fund Balance at the end of Year 2 would be \$800 greater than at the end of Year 1.
- d) Total Fund Balance at the end of Year 2 would be same as it was at the end of Year 1.

31. Lincoln County uses encumbrance accounting to control expenditures. It charges the cost of outstanding purchase commitments to expenditures in the year they are ordered, not in the year they are received. If the County had \$7,000 of purchase commitments outstanding at the end of Year 1 and received those goods during Year 2 at a cost of \$7,800, what would be the impact on *total* Fund Balance for Year 2?
- Total Fund Balance at the end of Year 2 would be \$7,800 less than at the end of Year 1.
 - Total Fund Balance at the end of Year 2 would be \$800 less than at the end of Year 1.
 - Total Fund Balance at the end of Year 2 would be \$800 greater than at the end of Year 1.
 - Total Fund Balance at the end of Year 2 would be same as it was at the end of Year 1
32. Why would a government be more likely than a not-for-profit organization to integrate its budget into its accounting system?
- Because the amount of expenditures are likely to be greater.
 - Because the penalties for exceeding budgeted expenditures are more severe.
 - Because governments have more sophisticated accounting systems than not-for-profit organizations.
 - Governments are NOT more likely than not-for-profits to formally integrate their budget into their accounting system.
33. Which of the following is the primary reason why governments formally integrate their legally adopted budget into their accounting systems?
- It is required by GASB.
 - It enables the government to better control its expenditures.
 - It keeps the government from overspending its budget.
 - It helps a government by letting it know when it is in danger of overspending its budget.
34. Washington County received goods that had been approved for purchase but for which payment had not yet been made. Should the following accounts be increased?
- | | <u>Expenditures</u> | <u>Encumbrances</u> |
|--------|---------------------|---------------------|
| a) No | | No |
| b) Yes | | Yes |
| c) Yes | | No |
| d) No | | Yes |
35. In which of the following cases would the reserve for encumbrances account be decreased?
- Budget revisions are made, decreasing Appropriations
 - Payment is made for goods received
 - Goods, related to purchase orders, are received
 - Purchase orders are issued
36. A review of Park City's books shows the following information:
- \$2,500 of outstanding vouchers payable
 - \$3,000 of outstanding purchase order amounts
- Which of these amounts would you expect to see in the general fund's encumbrances account?

- a) \$2,500
- b) \$3,000**
- c) \$5,500
- d) \$500

PROBLEMS (CHAPTER 3)

1. Assume that the City of Pasco maintains its books and records in a manner that facilitates preparation of the fund financial statements. The City engaged in the following transactions related to its general fund during the current fiscal year. The City formally integrates the budget into the accounting records. The City does not maintain an inventory of supplies. All amounts are in thousands.

REQUIRED: Prepare, in summary form, the appropriate journal entries.

- (a) The City Council approved a budget with revenues estimated to be \$600 and expenditures of \$590.
 - (b) The City ordered supplies at an estimated cost of \$25 and equipment at an estimated cost of \$20.
 - (c) The City incurred salaries and other operating expenses during the year totaling \$550. The City paid for these items in cash.
 - (d) The City received the supplies at an actual cost of \$23.
 - (e) The City collected revenues of \$595.
2. School District #25 formally integrates the budget into the accounting system and uses the encumbrance system. All appropriations lapse at year-end. At year-end, before closing entries, the District had the following balances in its accounts. All accounts had normal balances.

REQUIRED: (a) Prepare the necessary closing entries.
(b) Prepare a balance sheet after closing.

| | |
|--------------------------|-------|
| Accounts Payable | \$ 50 |
| Appropriations | 590 |
| Cash | 172 |
| Encumbrances | 20 |
| Estimated Revenues | 600 |
| Expenditures | 573 |
| Fund Balance | 110 |
| Reserve for Encumbrances | 20 |
| Revenues | 595 |

3. Assume that the County of Katerah maintains its books and records in a manner that facilitates preparation of the fund financial statements. The County formally integrates the budget into the accounting system and uses the encumbrance system. All appropriations lapse at year-end. At the beginning of the fiscal year, the County had the following balances in its accounts. All amounts are in thousands.

REQUIRED: Prepare the necessary entries for the current fiscal year.

| | |
|--------------------------|-------|
| Cash | \$200 |
| Fund Balance-Unreserved | 50 |
| Reserve for Encumbrances | 150 |

- (a) The County made the appropriate entry to restore the prior year purchase commitments.
- (b) The County Board approved a budget with revenues estimated to be \$800 and expenditures of \$750.
- (c) The County received the items that had been ordered in the prior year at an actual cost of \$135.
- (d) The County ordered supplies at an estimated cost of \$50 and equipment at an estimated cost of \$70.
- (e) The County incurred salaries and other operating expenses during the year totaling \$600. The County paid these items in cash.
- (f) The County received the equipment at an actual cost of \$75.
- (g) The County earned and collected, in cash, revenues of \$810.

4. Kayla County prepares its general fund financial reports in accordance with generally accepted accounting principles (GAAP) but its budgetary basis for the general fund differs from GAAP. The Budget to Actual Statement for the general fund is presented below. All numbers are in thousands.

REQUIRED: Prepare the GAAP-basis operating statement for the general fund.

- (a) For budgetary purposes, the County recognizes encumbrances as expenditures in the year of the purchase commitment; it recognizes supplies as expenditures when acquired. For budgetary purposes the County recognizes all revenues in the fiscal year collected. For GAAP-basis financial reporting, the County recognizes supplies as expenditures as consumed. It recognizes property taxes as revenue if they are collected within 60 days of fiscal year end. All other revenues are recognized on the cash basis for GAAP.

- (b) The following additional information is available.

| | <u>Beginning of Year</u> | <u>End of Year</u> |
|---|--------------------------|--------------------|
| Encumbrances | \$ 30 | \$ 50 |
| Supplies Inventory on Hand | \$ 5 | \$ 20 |
| Property Taxes Expected to be Collected Within 60 days of Year End | \$ 50 | \$ 40 |

| | <u>Amended Budget</u> | <u>Actual (on Budget Basis)</u> |
|--------------------------------------|---------------------------|-------------------------------------|
| Property Tax Revenue | \$ 700 | \$ 710 |
| Other Revenue | <u>500</u> | <u>550</u> |
| Total Revenue | \$1200 | \$1260 |
| Expenditures | <u>1190</u> | <u>1150</u> |
| Excess of Revenues over Expenditures | <u>\$ 10</u> | <u>\$ 110</u> |

5. Geneva County authorized the issuance of bonds and contracted with the Chessie Construction Company (CCC) to build a new convention center. During 2006, 2007, and 2008, the County engaged in the transactions that follow. All were recorded in the County's capital projects fund.
- a. In 2006, the County issued \$350 million in bonds (and recorded them as bond proceeds, an account comparable to revenues.)
 - b. The County approved the contract proposal from CCC for \$350 million and encumbered the entire amount.
 - c. CCC billed the County for \$115 for construction to date.
 - d. The County paid CCC the amount due in full.
 - e. In 2007, CCC billed the County for additional construction to date of \$190 million.
 - f. The County paid the amount due in full.
 - g. In 2008, CCC completed construction of the convention center and billed the County an additional \$50 million. The County approved the additional costs, even though the total cost of the center was now \$355, \$5 million more than the contract initially provided for.
 - h. The County transferred \$5 million from its General Fund to the capital projects fund.
 - i. The County paid the \$50 million in full.

REQUIRED:

1. Prepare the journal entries to record these transactions in the capital projects fund, including closing entries. Assume that amounts originally encumbered are reappropriated each year. Hence the County need not reestablish encumbrances in each year after the first year. Instead, it can close the expenditures of the second and third years to reserve for encumbrances rather than to fund balances.
2. What other funds or schedules would be affected by the transactions listed?

6. The town of Terry began 2006 with an unreserved balance of \$10 million in its street repair fund, a capital projects fund. At the start of the year, the city council appropriated \$6 million to reconstruct portions of the roadbed for two of its major roads—Main Street and Koeller Avenue. Shortly after, the town signed contracts with two construction companies to perform the repairs for a total of \$6 million. During the year, the town received bills from the construction companies as follows:
 - a. \$3.2 million for the entire cost of repairs to Main Street. This amount is \$.2 higher than expected due to design changes approved by the town. The town did not encumber the additional \$.2 million.
 - b. \$2.0 million, representing a progress billing for repairs to Koeller Avenue, which were not completed at the end of 2006.

At the beginning of 2007, the town reappropriated the remaining \$1 million for the Koeller Avenue repairs. During the year, the town received this bill:

- c. \$.7 million, representing the final billing for the Koeller Avenue repairs. The final cost was less than anticipated by \$.3 million.

REQUIRED:

Prepare journal entries to record the events and transactions over the two-year period. Include entries to appropriate, reappropriate, encumber, and re-encumber the required resources, to record the payment of the bills, and to close the accounts at the end of each year.

Determine the reserved and unreserved fund balances for the capital projects fund at the end of the second year.

7. The Breast Cancer Fund, a not-for-profit organization, receives its funding primarily from government grants and private contributions. In turn, the Fund provides resources to other organizations and individuals for breast cancer research. Many of the government grants it receives are reimbursement-type. That is, the Fund must incur specific costs to be eligible for grants that reimburse those costs. The Fund makes the following estimates as to its next fiscal year:

- It will be awarded \$7 million in government grants; all but \$.5 million will be received during the fiscal year. The balance will be reimbursed in the first six months after year-end. The Institute will also receive \$.2 million in reimbursement grants related to the previous year.
- It will receive \$600,000 in pledges from private donors. It expects to collect \$450,000 during the year and \$125,000 in the following year. It estimates that \$25,000 will never be received. It also expects to collect \$80,000 in pledges made the prior year.
- It will pay \$7 million for outside research.
- It will purchase new computer equipment costing \$100,000. The Fund currently owns its own building, which it had purchased for \$800,000, and additional furniture and equipment that it acquired for \$250,000. The building has a useful life of twenty years; the furniture and equipment have useful lives of 5 years. It is the Fund's policy to record a full year of depreciation expense in the year that assets are placed in service.
- Employees will earn wages and salaries of \$340,000, of which they will be paid \$320,000 during the forthcoming year and the balance in the next year. It will also pay another \$15,000 in payroll costs incurred in the prior year.
- It will pay the \$75,000 insurance deductible on an employee-related lawsuit settled the previous year.
- It will incur operating costs of \$90,000, of which it will pay \$70,000 in the forthcoming year and \$20,000 in the following year. It will also pay another \$10,000 in costs incurred in the previous year.

REQUIRED:

1. Prepare two budgets, one on the cash basis, the other on the full accrual basis. Show both on the same schedule—the full accrual basis in the first column and the cash basis in the second column.
2. Comment on which budget better shows whether the Fund is covering the economic cost of the services it provides.
3. Which is likely to be more useful to Fund managers?

8. The following schedule shows the amounts related to supplies that the City of Pascal debited and credited to the indicated accounts during the year (not necessarily year-end balances), *before* closing entries. The City records its budget, encumbers all of its expenditures, and initially vouchers all payments. All revenue was collected in cash.

REQUIRED:

Some information is missing in the schedule below. Reconstruct (in summary) the entries the City must have made during the year to determine the missing data.

| | <i>(in thousands)</i> | |
|--------------------------|-----------------------|----------------|
| | Debits | Credits |
| Cash | \$ 117 | \$? |
| Estimated revenues | ? | 0 |
| Revenues | 0 | ? |
| Vouchers payable | 70 | 54 |
| Appropriations | 0 | ? |
| Encumbrances | ? | 58 |
| Expenditures | ? | 0 |
| Reserve for encumbrances | ? | 93 |
| Fund balance | 115 | 120 |

9. The data presented below were taken from the books and records of the village of Denaville. All amounts are in millions. The village encumbers all outlays. As is evident from the data, some goods or services that were ordered and encumbered have not yet been received. City regulations require that all appropriations lapse at year-end.

| | Estimated/ <u>Appropriated</u> | Amounts <u>Encumbered</u> | <u>Amounts Received</u> | | Actual <u>Revenues</u> |
|---|-----------------------------------|------------------------------|---------------------------------|------------------------------|---------------------------|
| | | | <u>Estimated</u> <u>Cost</u> | <u>Actual</u> <u>Cost</u> | |
| <u>Revenues</u> | | | | | |
| Property taxes | \$7,900 | | | | \$7,800 |
| Sales taxes | 3,900 | | | | 3,600 |
| Licenses | 300 | | | | 200 |
| Other | <u>700</u> | | | | <u>400</u> |
| | <u>12,800</u> | | | | \$12,000 |
| <u>Expenditures/Appropriations</u> | | | | | |
| General government | 3,000 | \$2,600 | \$2,400 | \$2,800 | |
| Public safety | 6,000 | 5,900 | 5,000 | 4,900 | |
| Recreation | 1,200 | 1,200 | 800 | 900 | |
| Health and sanitation | <u>2,300</u> | <u>2,200</u> | <u>2,200</u> | <u>2,100</u> | |
| | | | | <u>\$10,700</u> | |
| | <u>12,500</u> | \$11,900 | \$10,400 | <u>0</u> | |
| Excess of estimated revenues over appropriations | 300 | | | | |
| Beginning fund balance | <u>1,200</u> | | | | |
| Estimated ending fund balance | <u>\$1,500</u> | | | | |

- I. Prepare summary entries to record: a) the encumbrance of the goods and services
b). the receipt of the goods and services assuming all invoices were paid in cash.

- II. What would be the year-end: a) fund balance (unreserved)
b) reserve for encumbrance balance

III. Suppose a city accountant prepared a schedule comparing budgeted to actual revenues and expenditures. The city's mayor notes (correctly) that the very favorable variance between budgeted and actual expenditures was not merely a matter of luck – e.g., attributable to factors beyond the control of the city, such as less than usual snowfall and hence lower than usual snow removal costs. Rather, he boasts, it was due to a concerted effort on the part of his administration to “hold the line” on expenditures. Why, in governments and not-for-profit organization might favorable expenditure variances be an indication of inept rather than competent management?

ESSAYS (CHAPTER 3)

1. Many governments formally integrate the budget into the accounting system. Explain how this is accomplished. Also, explain why a government would formally integrate the budget into the accounting system.
2. Many governments budget on the cash basis. Explain why a government would budget on a cash basis rather than on a GAAP-basis. Discuss the advantages and disadvantages of cash-basis budgets.
3. GAAP require state and local governments to include in their annual financial reports a budget-to-actual comparison showing actual results and original and final appropriated budgets. What are the advantages of requiring both the original and final appropriated budget amounts?
4. Why do many governments not consider it necessary to prepare appropriation budgets for, and incorporate budgetary entries into the accounts of their capital projects funds?
5. Why may flexible budgets be more appropriate for a government's business-type activities?
6. An incumbent mayoral candidate for the City of Geneva boasts that the budgeted year-end excess of revenues over expenditures for the period just ended was significantly greater than expected. Why is this "favorable" result not necessarily a good thing?
 7. In what way will budgetary entries and encumbrances affect amounts reported in year-end GAAP balance sheets and operating statements of state and local governments?
 8. What are the possible differences that may occur between a state or local government's budgetary practices and GAAP?
9. A government's unreserved general fund balance at year-end is indicative of the amount that the government has available for appropriation in future years. Explain and provide an example to support your answer.
10. When governments adopt Statement No. 34, the "variance" column on general fund budget to actual statements will reflect only relatively small amounts. Do you agree? Explain.

ANSWERS TO TRUE/FALSE (CHAPTER 3)

1. T
2. F
3. T
4. T
5. F
6. T
7. F
8. T
9. T
10. F

ANSWERS TO MULTIPLE CHOICE (CHAPTER 3)

1. B
2. D
3. A
4. A
5. B
6. A
7. A
8. B
9. D
10. C
11. C
12. A
13. D
14. D
15. D
16. A
17. B
18. A
19. C
20. D
21. B
22. A
23. A
24. C
25. D
26. C
27. B
28. A
29. A
30. A
31. A
32. B
33. B
34. C
35. C
36. B

ANSWERS TO PROBLEMS (CHAPTER 3)

Problem 1

| | | |
|------------------------------|-----|-----|
| (a) Estimated Revenue | 600 | |
| Fund Balance | | 10 |
| Appropriations | | 590 |
| (b) Encumbrances | 45 | |
| Reserve for Encumbrances | | 45 |
| (c) Expenditures | 550 | |
| Cash | | 550 |
| (d) Reserve for Encumbrances | 25 | |
| Encumbrances | | 25 |
| Expenditures | 23 | |
| Cash | | 23 |
| (e) Cash | 595 | |
| Revenues | | 595 |

Problem 2

| | | |
|--------------------|-----|-----|
| (a) Appropriations | 590 | |
| Fund Balance | 10 | |
| Estimated Revenue | | 600 |
| (b) Revenues | 595 | |
| Fund Balance | | 2 |
| Expenditures | | 573 |
| Encumbrances | | 20 |

Balance Sheet

| | |
|------------------------------------|--------------|
| Cash | <u>\$172</u> |
| Accounts Payable | \$ 50 |
| Fund Balance | |
| Reserved for Encumbrances | \$ 20 |
| Unreserved | <u>102</u> |
| Total Liabilities and Fund Balance | <u>\$172</u> |

Problem 3

| | | |
|--------------------------|-------|-------|
| (a) Encumbrances | \$150 | |
| Fund Balance | | \$150 |
| (b) Estimated Revenue | 800 | |
| Fund Balance | | 50 |
| Appropriations | | 750 |
| (c) Expenditures | 135 | |
| Cash | | 135 |
| Reserve for Encumbrances | 150 | |
| Encumbrances | | 150 |
| (d) Encumbrances | 120 | |
| Reserve for Encumbrances | | 120 |
| (e) Expenditures | 600 | |
| Cash | | 600 |
| (f) Expenditures | 75 | |
| Cash | | 75 |
| Reserve for Encumbrances | 70 | |
| Encumbrances | | 70 |
| (g) Cash | 810 | |
| Revenues | | 810 |

Problem 4

| | <u>Actual (Budget Basis)</u> | <u>Adjustments</u> | <u>Actual (GAAP Basis)</u> |
|---|------------------------------|--------------------------|----------------------------|
| Property Tax Revenue | \$ 710 | -\$50 +40 | \$ 700 |
| Other Revenue | <u>550</u> | | <u>550</u> |
| Total Revenue | \$1260 | | \$1250 |
| Expenditures | | Encumbrances +\$30 -\$50 | |
| | <u>1150</u> | Supplies +\$ 5 -\$20 | <u>1115</u> |
| Excess of Revenues Over Expenditures | <u>\$ 110</u> | | <u>\$ 135</u> |

Problem 5

1. Journal entries:

2006

| | | |
|--|-------|-------|
| (a) Cash | \$350 | |
| Bond proceeds | | \$350 |
| <i>To record the issuance of the bonds</i> | | |

| | | |
|---|-------|-------|
| (b) Encumbrances | \$350 | |
| Reserve for encumbrances | | \$350 |
| <i>To encumber the cost of constructing the convention center</i> | | |

| | | |
|---|-------|-------|
| (c) Expenditure | \$115 | |
| Accounts Payable | | \$115 |
| <i>To record the construction expenditure</i> | | |

| | | |
|---|-------|-------|
| Reserve for encumbrance | \$115 | |
| Encumbrances | | \$115 |
| <i>To reverse the encumbrance entry for the portion of the contract completed</i> | | |

| | | |
|-----------------------------------|-------|-------|
| (d) Accounts Payable | \$115 | |
| Cash | | \$115 |
| <i>To record the cash payment</i> | | |

Closing entries—2006:

| | | |
|---|--------------|--|
| Fund balance | \$350 | |
| | Expenditures | |
| | \$115 | |
| | Encumbrances | |
| | 235 | |
| <i>To close expenditures and encumbrances</i> | | |

| | | |
|-------------------------------|--------------|--|
| Bond Proceeds | \$350 | |
| | Fund balance | |
| | \$350 | |
| <i>To close bond proceeds</i> | | |

2007

| | | |
|---|------------------|--|
| (e) Expenditures | \$190 | |
| | Accounts payable | |
| | \$190 | |
| <i>To record the construction expenditure</i> | | |

| | | |
|----------------------|-------|-------|
| (f) Accounts payable | \$190 | |
| | | Cash |
| | | \$190 |

To record the cash payment

Closing entries—2007:

| | | |
|-------------------------|-------|-------|
| Reserve for encumbrance | \$190 | |
| Expenditures | | \$190 |

To close expenditures

2008

| | | |
|------------------|-------|------------------|
| (g) Expenditures | \$ 50 | |
| | | Accounts payable |
| | | \$ 50 |

To record the construction expenditure

Note: Some governments would require an approved revenue source and a legislative appropriation before authorizing the cost overrun.

| | | |
|----------|------|-------------------------------|
| (h) Cash | \$ 5 | |
| | | Transfer-in from general fund |
| | | \$ 5 |

To record transfer of cash from general fund

| | | |
|----------------------|-------|-------|
| (i) Accounts payable | \$ 50 | |
| | | Cash |
| | | \$ 50 |

To record the cash payment

Closing entries—2008:

| | | |
|-------------------------|-------|-------|
| Reserve for encumbrance | \$ 45 | |
| Fund balance | 5 | |
| Expenditures | | \$ 50 |

To close expenditures

| | | |
|-------------------------------|------|------|
| Transfer-in from general fund | \$ 5 | |
| Fund balance | | \$ 5 |

To close the transfer-in account

- The transfer from the general fund would, of course, be recorded in the general fund. The construction in process, and the completed convention center would be recorded in the schedule of general fixed assets and in the government-wide statement of net assets. The bonds payable would be recorded in the schedule of general long-term debt and in the government-wide statement of net assets.

Problem 6

1. Journal Entries

Year 2006

| | | |
|----------------|-------|-------|
| Fund balance | \$6.0 | |
| Appropriations | | \$6.0 |

To record the budget (that is, appropriate the required resources)

| | | |
|--------------------------|-------|-------|
| Encumbrances | \$6.0 | |
| Reserve for encumbrances | | \$6.0 |

To encumber the estimated cost of repairs

| | | |
|--------------|-------|-------|
| Expenditures | \$5.2 | |
| Cash | | \$5.2 |

To record repairs expenditures

| | | |
|--------------------------|-------|-------|
| Reserve for encumbrances | \$5.0 | |
| Encumbrances | | \$5.0 |

To reverse the encumbrances upon recognition of the repairs expenditure (\$3.0 on Main Street and \$2.0 on Koeller Avenue.)

| | | |
|----------------|-------|-------|
| Appropriations | \$6.0 | |
| Fund balance | 0.2 | |
| Encumbrances | | \$1.0 |
| Expenditures | | 5.2 |

To close the appropriation, expenditure and encumbrance accounts

Year 2007

| | | |
|----------------|-------|-------|
| Fund balance | \$1.0 | |
| Appropriations | | \$1.0 |

To record the budget (that is, reappropriate the funds to complete the repairs on Koeller Avenue)

| | | |
|--------------|-------|-------|
| Encumbrances | \$1.0 | |
| Fund balance | | \$1.0 |

To restore the encumbrances of the prior year

| | | |
|--------------|-------|-------|
| Expenditures | \$0.7 | |
| Cash | | \$0.7 |

To record remaining repairs expenditures

| | | |
|--------------------------|-------|-------|
| Reserve for encumbrances | \$1.0 | |
| Encumbrances | | \$1.0 |

To reverse the encumbrances for the entire remaining balances in the encumbrance and reserve for encumbrance accounts.

| | | |
|----------------|-------|-------|
| Appropriations | \$1.0 | |
| Expenditures | | \$0.7 |
| Fund balance | | 0.3 |

To close the appropriation and expenditure accounts

2. The balance in the fund balance account is \$4.1 million — equal to the initial fund balance of \$10.0 million less total repair expenditures of \$5.9 million (\$3.2 million on Main Street plus \$2.7 million on Koeller Avenue).

Problem 7

1.

| | <u>Accrual</u> | <u>Cash</u> |
|--------------------------------------|----------------|-----------------|
| | (in thousands) | |
| Revenues: | | |
| Government grants | \$7,000 | \$6,700 |
| Private contributions | <u>575</u> | <u>530</u> |
| | <u>7,575</u> | <u>7,230</u> |
| Expenditures | | |
| Research | 7,000 | 7,000 |
| Furniture and equipment/Depreciation | 70* | 100 |
| Building/Depreciation | 40 | 0 |
| Wages and salaries | 340 | 335 |
| Claims and judgments | 0 | 75 |
| Other operating costs | <u>90</u> | <u>80</u> |
| | <u>7,540</u> | <u>7,590</u> |
| Excess of revenues over expenditures | <u>\$ 35</u> | <u>(\$ 360)</u> |

* $(\$100,000 + \$250,000) / 5 = \$70,000$

- The accrual-based budget better captures the long-term costs and provides a better match between revenues and costs. It measures both financial and economic resources. Yet the cash-based budget shows what is apparently a loss. Of the \$7 million in planned expenditures for research, only \$6.5 million will be matched by grant revenues. Similarly, the full cost of the new computers, which will last for 5 years, is reported as a cost in the year of acquisition.
- Internal managers will find the accrual-based budget useful in that it provides a long-term perspective on the institute and offers assurance that over an extended period the entity is covering its costs. Nevertheless, they would likely be more concerned with the cash-based budget. Organizations must pay their bills with cash. Most not-for-profits are engaged in a constant struggle to meet their day-to-day cash needs. Hence, managers are interested mainly in cash flows and see allocations of previous costs (i.e., depreciation) as being of little relevance to the decisions that they must make.

Problem 9

I. a). the encumbrance of the goods and services

| | | |
|--------------------------|--------|--------|
| Encumbrances | 11,900 | |
| Reserve for encumbrances | | 11,900 |

b) the receipt of the goods and services assuming all invoices were paid in cash.

| | | |
|--------------------------|--------|--------|
| Expenditures | 10,700 | |
| Cash | | 10,700 |
| Reserve for encumbrances | 10,400 | |
| Encumbrances | | 10,400 |

II.

fund balance (unreserved)

| | |
|------------------------|-----------------|
| Beginning fund balance | \$ 1,200 |
| Revenues | 12,000 |
| Expenditures | (10,700) |
| Encumbrances | <u>(1,500)</u> |
| Ending balance | <u>\$ 1,000</u> |

reserve for encumbrance balance

\$1,500

III.

It is not the objective of a government to minimize expenditures; it is to provide services. A favorable expenditure budget variance may indicate that the government spent less than was appropriated – and thereby thwarted the political process by not providing the services that were expected of it. (Obviously the variance could also indicate that the government provided the services expected of it but did so at less cost and hence more efficiently).

ANSWERS TO ESSAYS (CHAPTER 3)

1. A government formally integrates the budget into the accounting system by making an entry that debits Estimated Revenues and credits Appropriations. The entry is balanced by a debit or credit to Fund Balance or Budgetary Fund Balance depending on whether the government is projecting an operating deficit or surplus.

Generally revenue subsidiary ledgers have three columns—one for estimated revenue, one for actual revenue and one for the running balance. If the balance in the Revenue account is a debit balance, it means that actual revenues have been less than budgeted or estimated revenues. If the balance in the Revenue account is a credit balance, it means that actual revenues have exceeded the budgeted or estimated revenues.

Generally the expenditure subsidiary ledgers have four columns—one for appropriations (authorized expenditures), one for actual expenditures, one for encumbrances, and one for the running balance. If the expenditures subsidiary ledger account has a credit balance, it means that there the entity still has spending authority. If the expenditures subsidiary ledger account has a debit balance, it means that the entity has overspent or overcommitted its spending authority.

A government would integrate its budget into its accounting system as a control mechanism. The unencumbered account balances continuously reflect the remaining spending authority. Managers can easily see problem areas and concentrate their management efforts in managing the problem areas.

2. A government would budget on the cash basis because spending authority is based on cash. The government must pay its bills and make payments on prior commitments with cash. The government is concerned with its cash balance. Citizens generally do not like to give governments cash well in advance of the government's need for that cash. One example of expenditures that citizens may be reluctant to advance fund are those for accumulating vacation leave that will be taken in future periods. [AUTHOR'S NOTE: The examples that follow are not in the textbook and therefore most students will not refer to these example.] Two other examples include contributions to finance future employee retirement benefits and advance funding for costs to restore and monitor closed solid waste landfills.

Advantages of cash basis budgets are few. They are easy for many people to understand. They serve as forecasts for cash receipts and disbursements and can highlight cash flow problems. The disadvantages are many. Cash budgets can understate the economic consequences of current actions by the government. [AUTHOR'S NOTE: The example that follows is not in the textbook and therefore most students will not refer to this example.] Many years ago, a large U.S. city accounted for its pension costs on the pay-as-you-go basis (cash basis). Because there were no current period effects of enhanced pension benefits, pension benefits were increased regularly. Then those employees retired and the increased cash burden on the municipality was tremendous. Cash-basis budgets and cash accounting permit manipulations. Governments can delay payment of bills to 'balance the budget' in the current period. Similarly governments can create positive cash flows by advancing the due date of taxes or fees or by selling their own assets to newly created entities and leasing them back. These changes may have long-term adverse consequences.

3. The original budget can, and frequently is, amended during the year to allow spending for unanticipated events. For some governments, the final budget incorporates changes (amendments) authorized only after the government knew that authorized revenues or expenditures had been lower than or higher than original budgeted amounts. If the actual amounts were only compared to the final (amended) budget amounts, the ability of the government to do a good job of budgeting would be camouflaged.
4. Appropriation budgets and related budgetary entries are intended mainly to help control expenditures — to assure that governments do not spend more than was authorized in any particular year. Capital projects funds focus on controlling costs by project and may not be intended to control expenditures on the basis of periods. Moreover, necessary control can be adequately established by other means. The resources available for expenditure in a capital projects fund are normally either transferred-in from other funds or received as proceeds from bonds. Governments can control expenditures by limiting the amount of transfers in (through the budgets of the transferring funds) or by the amount of the bonds issued.
5. Flexible budgets are generally more appropriate for business-type activities because the level of their activity is driven by customer demand and can be expected to vary more widely. The level of government-type activities, by contrast, is often established by the budget. Like private enterprises, a government's business-type activities have both fixed and variable costs.
6. "Favorable" budget variances are not necessarily indicative of effective governmental management. The goal of a government is neither to maximize revenues nor to minimize expenditures. An excess of actual over budgeted revenues may be evidence that taxes were higher than necessary. An excess of budgeted over actual expenditures may denote that the quantity or quality of the services that the government provided were less than anticipated.
7. Budgetary entries have no effect on year-end financial statements. They are closed-out at year-end and not reported on either the balance sheet or operating statement. Encumbrances are also closed-out and have no effect on the operating statement. However, the related reserve for encumbrances is a reservation of fund balance and, accordingly, is reported on the balance sheet as part of fund equity.
8. There are four types of differences that can occur—basis of accounting, timing, perspective, and reporting entity differences.

Basis of accounting differences arise when the government prepares its budget on a cash or other basis not consistent with the modified accrual basis accounting required for GAAP financial statements of governmental funds.

Timing differences occur when governments appropriate resources for a particular project rather than for a particular period. In addition, governments may permit departments or functions to carry over resources not spent in one period to the next budgetary period.

Perspective differences occur when governments prepare their budgets based on the types of functions or programs it plans to provide, not based on the funds in which these activities are reported (which could include several funds).

Reporting entity differences occur when legally separate activities for which the government does not prepare a budget are required by GAAP to be included in the government's financial statements.

9. Unreserved fund balance is computed by rules of the GASB. These rules may differ from those applied by the government for purposes of budgeting. Hence, the reported fund balance, may not be indicative of the amount available for appropriation. For example, for purposes of reporting a government may not recognize an expenditure until supplies inventory is consumed. For purposes of budgeting, the expenditure may have to be recognized when supplies are purchased. Hence, insofar as there are supplies on hand (and the government does not established a reserve for them) the entire fund balance may not be available for appropriation.
10. The variance column will compare actual amounts with budgeted amounts per the final budget. Inasmuch as the budget can be amended until the last day of the year (and sometime even beyond), the probability of substantial variances is small.

Chapter 4

Recognizing Revenue in Governmental Funds

TRUE/FALSE (CHAPTER 4)

1. FIf an entity elects to focus on all economic resources, then it should adopt a modified accrual basis of accounting.
2. TThe budgetary measurement focus of governments is determined by applicable state or local laws.
3. FThe revenue-recognition issues facing governments are generally focused on the exchange transaction earning process, similar to those of businesses.
4. FGovernmental activities tend to derive the majority of their revenues from exchange transactions.
5. TIn accounting for property taxes, under the modified accrual basis, existing standards provide that, except in unusual circumstances, revenues should be recognized only if cash is expected to be collected within sixty days of year-end.
6. TAd valorem taxes are taxes that are based on value.
7. FIncome taxes are classified as ad valorem taxes.

8. TSales taxes are taxpayer assessed, that is, parties other than the beneficiary government determine the tax base.
9. FRevenues that cannot be classified as general revenues are by default considered program revenues.
10. TTaxes that are imposed on the reporting government's citizens are considered general revenues, even if they are restricted to specific programs.

MULTIPLE CHOICE (CHAPTER 4)

1. As used in governmental accounting, interperiod equity refers to a concept of
 - a) providing the same level of services to citizens each year.
 - b) measuring whether current year revenues are sufficient to pay for current year services.
 - c) levying property taxes at the same rate each year.
 - d) requiring that general fund budgets be balanced each year.
2. For fund financial statements, the measurement focus and basis of accounting used by governmental fund types are
 - a) current financial resources and modified accrual accounting.
 - b) economic resources and modified accrual accounting.
 - c) financial resources and full accrual accounting.
 - d) economic resources and full accrual accounting.
3. The modified accrual basis of accounting is used in presenting the fund financial statements of the governmental funds because
 - a) it is the superior method of accounting for the economic resources of any entity.
 - b) it provides information as to the extent the entity achieved interperiod equity.
 - c) it is budget oriented while facilitating comparisons among entities.
 - d) it results in accounting measurements based on the substance of transactions.
4. As used in defining the modified accrual basis of accounting, the term “available” means
 - a) received in cash.
 - b) will be received in cash within 60 days of year-end.
 - c) collection in cash is reasonably assured.
 - d) collected within the current period or expected to be collected soon enough thereafter to be used to pay liabilities of the current period.
5. Under the modified accrual basis of accounting, derived nonexchange revenues are recognized when
 - a) they are earned.
 - b) they are measurable and available to finance the expenditures of the current period.
 - c) the underlying exchange transaction occurs.
 - d) the underlying exchange transaction occurs and they are measurable and available to finance the expenditures of the current period.
6. Under the accrual basis of accounting, property tax revenues are recognized
 - a) when they are received in cash.
 - b) in the year for which they were levied.
 - c) in the year for which they were levied and when collection in cash is reasonably assured.
 - d) they are available to finance expenditures of the fiscal period.
7. Under the modified accrual basis of accounting, the amount of property tax revenues that should be recognized by a governmental entity in the current year related to the current year levy will be
 - a) the total amount of the levy.
 - b) the expected collectible portion of the levy.
 - c) the portion of the levy collected.
 - d) the portion of the levy collected in the current year or within sixty days of the fiscal period.

8. Under the modified accrual basis of accounting, investment revenues for the current period should include
- only interest and dividends received.
 - all interest and dividends received during the period plus all accruals of interest and dividends earned.
 - all interest and dividends received plus gains and losses on securities that were sold during the period.
 - all interest and dividends received, all gains and losses on securities sold and all changes in market values on securities held in the portfolio at year-end.**
9. Under the accrual basis of accounting used by governments, investment revenues for the current period should include
- only interest and dividends received.
 - all interest and dividends received during the period plus all accruals of interest and dividends earned.
 - all interest and dividends received plus gains and losses on securities that were sold during the period.
 - all interest and dividends received, all gains and losses on securities sold and all changes in market values on securities held in the portfolio at year-end.**
10. Under the modified accrual basis of accounting, imposed nonexchange revenues (such as fines) should be recognized
- when assessed.
 - when the government has an enforceable legal claim.
 - when collected.
 - when the government has an enforceable legal claim and when the collected within the current period or soon enough thereafter to be used to pay the liabilities of the current period.**
11. Under the accrual basis of accounting, imposed nonexchange revenues (such as fines) should be recognized
- when assessed.
 - when the government has an enforceable legal claim.**
 - when collected.
 - when the government has an enforceable legal claim and when the collected within the current period or soon enough thereafter to be used to pay the liabilities of the current period
12. Under the modified accrual basis of accounting, gains and losses on disposal of fixed assets
- are not recognized.**
 - are recognized when the proceeds (cash) of the sale are received (on the installment basis).
 - are recognized only if there is a gain.
 - are recognized when the sale occurs, regardless of when the cash is collected.
13. Under the accrual basis of accounting, gains and losses on disposal of fixed assets
- are not recognized.
 - are recognized when the proceeds (cash) of the sale are received (on the installment basis).
 - are recognized only if there is a gain.
 - are recognized when the sale occurs, regardless of when the cash is collected.**

14. Under the modified accrual basis of accounting, license fees, permits, and other miscellaneous revenue are generally recognized for practical purposes
- a) when cash is received.
 - b) when the exchange takes place.
 - c) over the period during which the government obtains an enforceable legal claim.
 - d) when related expenditures are incurred.
15. Ideally, under the accrual basis of accounting, license fees, permits, and other miscellaneous revenue should be recognized
- a) when cash is received.
 - b) when the exchange takes place.
 - c) over the period during which the government obtains an enforceable legal claim.
 - d) when related expenditures are incurred.
16. A city that has a 12/31 fiscal year end has adopted a policy of recognizing the maximum amount of property tax revenue allowable under GAAP. Property taxes of \$600,000 (of which 10% are estimated to be uncollectible) are levied in October 2007 to finance the activities of the fiscal year 2008. During 2008, cash collections related to property taxes levied in October 2007 were \$500,000. In 2009 the following amounts related to the property taxes levied in October 2007 were collected: January \$25,000; March, \$5,000. For the fiscal year ended 12/31/08, what amount should be recognized as property tax revenues related to the 2007 levy on the governmental fund financial statements?
- a) \$600,000.
 - b) \$540,000.
 - c) \$525,000.
 - e) \$500,000.
17. A city that has a 12/31 fiscal year end has adopted a policy of recognizing the maximum amount of property tax revenue allowable under GAAP. Property taxes of \$600,000 (of which 10% are estimated to be uncollectible) are levied in October 2007 to finance the activities of the fiscal year 2008. During 2008, cash collections related to property taxes levied in October 2007 were \$500,000. In 2009 the following amounts related to the property taxes levied in October 2007 were collected: January \$25,000; March, \$5,000. For the fiscal year ended 12/31/08, what amount should be recognized as property tax revenues related to the 2007 levy on the government-wide financial statements?
- a) \$600,000.
 - b) \$540,000.
 - c) \$525,000.
 - d) \$500,000.

18. A city that has a 12/31 fiscal year end has adopted a policy of recognizing property tax revenue consistent with the 60-day rule allowable period under GAAP. Property taxes of \$600,000 (of which none are estimated to be uncollectible) are levied in October 2007 to finance the activities of fiscal year 2008. Property taxes are due in two installments June 20 and December 20. Cash collections related to property taxes are as follows:

| | | |
|----------|--|-----------|
| 1/15/08 | for property taxes levied in 2006, due in 2007 | \$ 25,000 |
| 2/15/08 | for property taxes levied in 2006, due in 2007 | \$ 15,000 |
| 3/15/08 | for property taxes levied in 2006, due in 2007 | \$ 10,000 |
| 6/20/08 | First installment of taxes levied in 2007, due 6/20/08 | \$350,000 |
| 12/20/08 | Second installment of taxes levied in 2007, due 12/20/08 | \$150,000 |
| 1/15/09 | for property taxes levied in 2007, due in 2008 | \$ 15,000 |
| 2/15/09 | for property taxes levied in 2007, due in 2008 | \$ 10,000 |
| 3/15/09 | for property taxes levied in 2007, due in 2008 | \$ 5,000 |

The *total* amount of property tax revenue that should be recognized in the governmental fund financial statements in 2008 is:

- a) \$600,000.
 - b) \$575,000.
 - c) **\$535,000.**
 - d) \$525,000.
19. A city that has a 12/31 fiscal year end has adopted a policy of recognizing property tax revenue consistent with the 60-day rule allowable period under GAAP. Property taxes of \$600,000 (of which none are estimated to be uncollectible) are levied in October 2007 to finance the activities of fiscal year 2008. Property taxes are due in two installments June 20 and December 20. Cash collections related to property taxes are as follows:

| | | |
|----------|--|-----------|
| 1/15/08 | for property taxes levied in 2006, due in 2007 | \$ 25,000 |
| 2/15/08 | for property taxes levied in 2006, due in 2007 | \$ 15,000 |
| 3/15/08 | for property taxes levied in 2006, due in 2007 | \$ 10,000 |
| 6/20/08 | First installment of taxes levied in 2007, due 6/20/08 | \$350,000 |
| 12/20/08 | Second installment of taxes levied in 2007, due 12/20/08 | \$150,000 |
| 1/15/09 | for property taxes levied in 2007, due in 2008 | \$ 15,000 |
| 2/15/09 | for property taxes levied in 2007, due in 2008 | \$ 10,000 |
| 3/15/09 | for property taxes levied in 2007, due in 2008 | \$ 5,000 |

The *total* amount of property tax revenue that will be recognized in the government-wide financial statements in 2008 is:

- a) **\$600,000.**
- b) \$575,000.
- c) \$535,000.
- d) \$525,000.

20. Under GAAP, property taxes levied in one fiscal period to finance the activities of the following fiscal period are recognized as revenue in the governmental fund financial statements
- in the year levied.
 - in the year for which they are intended to finance the activities.
 - when collected, regardless of when levied.
 - in the year for which they are intended to finance the activities, if collected within that period or within a period no greater than 60 days after the close of the fiscal year.
21. Under GAAP, property taxes levied in one fiscal period to finance the activities of the following fiscal period are recognized as revenue in the government-wide financial statements
- in the year levied.
 - in the year for which they are intended to finance the activities.
 - when collected, regardless of when levied.
 - in the year for which they are intended to finance the activities, if collected within that period or within a period no greater than 60 days after the close of the fiscal year.
22. A City levies a 2% sales tax. Sales tax must be remitted by the merchants to the City by the 20th day of the month following the month in which the sale occurred. Cash received by the City related to sales tax is as follows:

| | |
|---|-------|
| Amount received 1/20/07, applicable to December 2006 sales | \$ 50 |
| Amount received 2/20/07, applicable to January 2007 sales | \$ 15 |
| Amount received during 2007 related to February-November 2007 sales | \$200 |
| Amount received 1/20/08 for December 2007 sales | \$ 55 |
| Amount received 2/20/08 for January 2008 | \$ 20 |

Assuming the City uses the same period to define “available” as the maximum period allowable for property taxes, what amount should it recognize in the governmental fund financial statement as sales tax revenue for the fiscal year ended 12/31/07.

- \$215.
- \$265.
- \$270.
- \$275.

23. A City levies a 2% sales tax. Sales tax must be remitted by the merchants to the City by the 20th day of the month following the month in which the sale occurred. Cash received by the City related to sales tax is as follows:

| | |
|---|-------|
| Amount received 1/20/07, applicable to December 2006 sales | \$ 50 |
| Amount received 2/20/07, applicable to January 2007 sales | \$ 15 |
| Amount received during 2007 related to February-November 2007 sales | \$200 |
| Amount received 1/20/08 for December 2007 sales | \$ 55 |
| Amount received 2/20/08 for January 2008 | \$ 20 |

Assuming the City uses the same period to define “available” as the maximum period allowable for property taxes, what amount should it recognize in the government-wide financial statement as sales tax revenue for the fiscal year ended 12/31/07.

- a) \$215.
 - b) \$265.
 - c) **\$270.**
 - d) \$275.
24. A City levies a 2% sales tax that is collected for them by the State. Sales tax must be remitted by the merchants to the State by the 20th day of the month following the month in which the sale occurred. The State has a policy of remitting sales taxes to the City within 30 days of collection by the State. Cash received by the State related to sales tax is as follows:

| | |
|--|-------|
| Amount received 1/20/07, applicable to December 2006 sales | \$ 50 |
| Amount received 2/20/07, applicable to January 2007 sales | \$ 15 |
| Amount received 3/20/07, applicable to February 2007 sales | \$ 10 |
| Amount received during 2007 related to March-November 2007 sales | \$190 |
| Amount received 1/20/08 for December 2007 sales | \$ 55 |
| Amount received 2/20/08 for January 2008 | \$ 20 |
| Amount received 3/20/08 for February 2008 | \$ 5 |

Assuming the City uses the same period to define “available” as the maximum period allowable for property taxes, what amount should it recognize as sales tax revenue in its governmental fund financial statements for the fiscal year ended 12/31/07.

- a) \$215.
- b) \$265.
- c) **\$270.**
- d) \$275.

25. A City levies a 2% sales tax that is collected for them by the State. Sales tax must be remitted by the merchants to the State by the 20th day of the month following the month in which the sale occurred. The State has a policy of remitting sales taxes to the City within 30 days of collection by the State. Cash received by the State related to sales tax is as follows:

| | |
|--|-------|
| Amount received 1/20/07, applicable to December 2006 sales | \$ 50 |
| Amount received 2/20/07, applicable to January 2007 sales | \$ 15 |
| Amount received 3/20/07, applicable to February 2007 sales | \$ 10 |
| Amount received during 2007 related to March-November 2007 sales | \$190 |
| Amount received 1/20/08 for December 2007 sales | \$ 55 |
| Amount received 2/20/08 for January 2008 | \$ 20 |
| Amount received 3/20/08 for February 2008 | \$ 5 |

Assuming the City uses the same period to define “available” as the maximum period allowable for property taxes, what amount should it recognize as sales tax revenue in its government-wide financial statements for the fiscal year ended 12/31/07.

- a) \$215.
 b) \$265.
 c) **\$270.**
 d) \$275.
26. During 2007, a state has the following cash collections related to state income taxes

| | |
|--|-------|
| Payroll withholdings and estimated payments related to 2007 income | \$360 |
| 4/15/07 Balance of 2006 (net of \$10 refunds) income taxes | \$ 40 |
| 1/15/08 payroll withholdings and estimated payments related to 2007 income | \$ 30 |
| 2/15/08 payroll withholdings and estimated payments related to 2007 income | \$ 35 |
| 3/15/08 payroll withholdings and estimated payments related to 2008 income | \$ 25 |
| 4/15/08 Balance of 2007 (net of \$5 refunds) income taxes | \$ 45 |

Assuming that the state defines available as the maximum period allowable for property taxes, what is the amount of revenue that will be recognized in the 2007 governmental fund financial statements related to state income taxes?

- a) \$400.
 b) \$405.
 c) **\$430.**
 d) \$465.

27. During 2007, a state has the following cash collections related to state income taxes

| | |
|--|-------|
| Payroll withholdings and estimated payments related to 2007 income | \$360 |
| 4/15/07 Balance of 2006 (net of \$10 refunds) income taxes | \$ 40 |
| 1/15/08 payroll withholdings and estimated payments related to 2007 income | \$ 30 |
| 2/15/08 payroll withholdings and estimated payments related to 2007 income | \$ 35 |
| 3/15/08 payroll withholdings and estimated payments related to 2007 income | \$ 25 |
| 4/15/08 Balance of 2007 (net of \$5 refunds) income taxes | \$ 45 |

Assuming that the state defines available as the maximum period allowable for property taxes, what is the amount of revenue that will be recognized in the 2007 government-wide financial statements related to state income taxes?

- a) \$400.
- b) \$475.
- c) \$430.
- d) \$465.

28. Under GAAP, income tax revenues should be recognized in the governmental fund financial statements in the accounting period

- a) when collected in cash by the taxing authority.
- b) in which the underlying income was earned, regardless of when collected.
- c) in which the underlying income was earned, if collected in the current period or soon enough thereafter to pay liabilities of the current period.
- d) when earned.

29. Under GAAP, income tax revenues should be recognized in the government-wide financial statements in the accounting period

- a) when collected in cash by the taxing authority.
- b) in which the underlying income was earned, regardless of when collected.
- c) in which the underlying income was earned, if collected in the current period or soon enough thereafter to pay liabilities of the current period.
- d) when earned.

30. A city with a 12/31 fiscal year-end requires that restaurants buy a license, renewable yearly. Proceeds of the license fees are intended to pay the salaries of inspectors in the health department. Licenses are issued for a fiscal year from October 1 to September 30. During 2007, cash collections related to licenses were as follows

| | |
|---|-------|
| Licenses issued during 2006 for the 10/1/06-9/30/07 fiscal year | \$ 20 |
| Licenses issued during 2006 for the 10/1/07-9/30/08 fiscal year | \$120 |

It is anticipated that during 2008 the amount collected on licenses for the 10/1/07-9/30/08 fiscal year will be \$30. In September 2006 the amount collected related to 10/1/06-9/30/07 licenses was \$96. What amount should be recognized as revenue in the fund financial statements for the fiscal year ended 12/31/07?

- a) \$120.
- b) \$122.
- c) \$140.
- d) \$150.

31. During 2007, the city issued \$300 in fines for failure to keep real property in 'acceptable' condition. During that period the city spent \$200 to mow and clean up the unoccupied properties for which the fines were assessed. The city estimates that \$30 of the fines issued in 2005 will be uncollectible. During 2007 the city collected \$230 related to 2007 fines and \$20 related to 2006 fines. The amount of revenue that the city should recognize in its 2007 governmental fund financial statements related to fines is
- a) \$230.
 - b) \$250.
 - c) \$270.
 - d) \$300.
32. A city receives a \$200,000 grant from the state to purchase vans to transport physically challenged individuals. During the current year the city receives the entire \$200,000 and purchases one bus for \$85,000 and issues a purchase order for another van for \$80,000. The grant revenue that the city should recognize on the government-wide financial statements in the current year is
- a) \$-0-.
 - b) \$ 85,000.
 - c) \$165,000.
 - d) \$200,000.
33. A city receives notice of a \$200,000 grant from the state to purchase vans to transport physically challenged individuals. Although the city did not receive any of the grant funds during the current year, the city purchased one bus for \$85,000 and issues a purchase order for another van for \$80,000. The grant revenue that the city should recognize in the government-wide financial statements in the current year is
- a) \$-0-.
 - b) \$ 85,000.
 - c) \$165,000.
 - d) \$200,000.
34. Payments made to a state pension plan by the state government on behalf-of a local government should
- a) not be displayed or disclosed in the local government financial statements.
 - b) be displayed as a revenue in the local government financial statements.
 - c) be displayed as both a revenue and an expenditure in the local government financial statements.
 - d) should be disclosed, but not displayed, in the local government financial statements.
35. Unrestricted grant revenues with a time requirement should be recognized
- a) when the award is announced.
 - b) when the cash is received.
 - c) in the period in which the grant is required to be used.
 - d) when expenditures are recognized on grant-related activities.
36. Reimbursement-type grant revenues are recognized in the accounting period in which
- a) the award is made.
 - b) the cash is received.
 - c) the grantee is notified of the award.
 - d) expenditures are recorded on grant-related activities.

37. At the beginning of its fiscal year, a local government owned an investment with a historical cost of \$85 and a fair value of \$95. During the year, dividends of \$2 were received. At the end of the year, the investment had a fair value of \$100. The amount that should be recognized on the governmental fund financial statements for the year as investment income is

- a) \$-0-.
- b) \$7.
- c) \$15.
- d) \$17.

38. A local governmental entity began the year with a portfolio of securities with an historical cost of \$600 and a fair value of \$620. During the year the government acquired an additional security at a cost of \$130 and sold for \$100 a security that had an historical cost of \$86 and a fair value at the beginning of the year of \$95. At the end of the year, the securities portfolio had a fair value of \$665. The amount that should be recognized on the financial statements for the year as investment income is

- a) \$5.
- b) \$10.
- c) \$14.
- d) \$15.

39. Under GAAP, investment income for governmental entities must include

- a) only dividends and interest received during the period.
- b) only dividends and interest earned during the period.
- c) only realized gains and losses.
- d) dividends and interest received during the period and both realized and unrealized gains and losses

40. A governmental entity is the recipient of a bequest of a multi-story office building that the government intends to use as a new city hall. The building has a historical cost of \$425,000; a book value in the hands of the benefactor of \$350,000; and a fair value of \$525,000. The city should recognize on its governmental fund financial statements, donations revenue of

- a) \$-0-.
- b) \$350,000.
- c) \$425,000.
- d) \$525,000.

41. A governmental entity is the recipient of a bequest of a multi-story office building that the government intends to sell to support program activities. The building has a historical of \$425,000; a book value in the hands of the benefactor of \$350,000; and a fair value of \$525,000. The city had not yet begun to try to sell the building when its annual financial statements were issued. The city should recognize on its governmental fund financial statements, donations revenue of

- a) \$-0-.
- b) \$350,000.
- c) \$425,000.
- d) \$525,000.

42. A city is the recipient of a cash bequest of \$500,000 that must be used to plant flowers and shrubs in the city parks. During the year only \$200,000 is actually received from the bequest and \$150,000 is spent on shrubs. The amount that should be recognized as revenue by the city in its government-wide financial statements in the current year is
- \$-0-
 - \$150,000.
 - \$200,000.
 - \$500,000.
43. Governmental entities should recognize revenue from donated fixed assets that will be sold to support programs of the entity at which amount in their government-wide financial statements?
- historical cost to the donor.
 - book value in the hands of the donor.
 - fair value of the donated assets.
 - zero.
44. State governments should recognize food stamp revenue
- when it receives the food stamps.
 - when food stamps are distributed by the state to eligible recipients.
 - when the recipient uses the food stamps
 - never. Food stamps are not financial resources.
45. Endowments are provided to governments with the specification that only the revenues generated from—not the contributed assets—may be used to finance specific programs. A government should recognize revenue from the initial endowment when
- it receives the assets (cash).
 - when it receives the pledge.
 - ratably over 30 years.
 - never. The contributions themselves cannot be used to support the government's programs.
46. For purposes of recognizing property tax revenues in governmental funds, “available” is defined as
- revenues received within 90 days of year-end.
 - revenues received within 60 days of year-end.
 - revenues received within 120 days of year-end.
 - being up to the judgment of the preparer.
47. Which of the following is not characterized as non-exchange?
- Sales taxes
Property taxes
Fines and forfeits
Charges for services
48. Which of the following is a derived tax revenue?
- Income taxes
Sales taxes
Both of the above
Neither of the above

49. A wealthy philanthropist donates three buildings to H-Town. Each of the buildings has a fair market value of \$5 million. H-Town plans to use Building 1 as a new fire station, but sell Buildings 2 and 3.

Building 2 is sold after year-end, but within the availability period. Building 3 fails to sell by the time H-Town issues the financial statements. As a result, which of the following represents the correct way to record revenue from the three buildings?

- | | | |
|---------------------------|--------------|--------------|
| a). Dr Buildings | \$15 million | |
| Cr Deferred revenue | | \$5 million |
| Cr Revenue from donations | | \$10 million |
| b). Dr Land held for sale | \$10 million | |
| Cr Deferred revenue | | \$5 million |
| Cr Revenue from donations | | \$5 million |
| c). Dr Land held for sale | \$5 million | |
| Cr Deferred revenue | | \$5 million |
| d). Dr Land held for sale | \$5 million | |
| Cr Revenue from donations | | \$5 million |

PROBLEMS (CHAPTER 4)

1. Property Taxes

Assuming that the City maintains the books and record in a manner that facilitates the preparation of the fund financial statements, prepare all necessary journal entries to record the following events related to property tax revenues for the year ended 12/31/2008. The city has adopted the 60-day rule for all revenue recognition for which it is appropriate.

- a. On January 3, the City Council levied property taxes of \$1 million to support general government operations, due in two equal installments on June 20th and December 20th. The property taxes were levied to finance the 2008 budget, which had been adopted on November 3, 2007. Historically 2% of property taxes are uncollectible.
- b. The City collected the following amounts related to property taxes

| | |
|--|------------|
| Delinquent 2007 taxes collected in January, 2008 | \$ 11,000 |
| Delinquent 2007 taxes collected in March 2008 | \$ 12,500 |
| 2008 taxes collected in June 2008 | \$ 540,000 |
| 2008 taxes collected in December 2008 | \$ 400,000 |
| Delinquent 2008 taxes collected in January 2009 | \$ 10,000 |
| Delinquent 2008 taxes collected in March 2009 | \$ 15,000 |
- c. Delinquent 2008 property taxes were reclassified as delinquent after the June payment date.
- d. \$2,000 of 2006 taxes were written off during 2008.

2. Sales Tax Revenues

Assuming that the City of Kayla maintains its books and records in a manner that facilitates the preparation of the fund financial statements, prepare all necessary journal entries to record the City's sales tax revenues for the year ended 12/31/2008. The city has adopted the 60-day rule for all revenue recognition for which it is appropriate. The City levies a local sales tax that is collected by the merchants and remitted to the City by the 20th day of the month following the month of sale.

- a.) On January 20, the City receives sales tax returns and related payments of \$7,000 from the merchants of the City for the month of December 2007.
- b.) On February 20, the City receives sales tax returns and related payments of \$3,000 from the merchants of the City for the month of January 2008.
- c.) During 2008 the City receives sales tax returns and related payments of \$40,000 from the merchants for the months of February-November 2008.
- d.) On January 20, 2009 the City receives sales tax returns and related payments of \$7,500 from the merchants of the City for the month of December 2008.

3. Assuming that the City of Katerah maintains its books and records in a manner that facilitates the preparation of the fund financial statements, prepare all necessary journal entries to record the City's revenues for the year ended 12/31/2007. The city has adopted the 60-day rule for all revenue recognition for which it is appropriate.
 - a.) On January 15, the City received notification that it was the recipient of a \$200,000 federal grant to assist in the operation of its "Meals on Wheels" program. The federal government expects to send the cash in about 3 months. This is not a reimbursement type grant, and all eligibility requirements have been met.
 - b.) In February the City spent \$21,000 on "Meals on Wheels."
 - c.) In March, fines of \$1,200 were issued for parking tickets. Payment must be made within 30 days, when the City has an enforceable legal claim to the amounts.
 - d.) In April, the City received the \$200,000 from the federal government.
 - e.) Payments of \$800 were received in April in payment of March parking tickets. \$100 in tickets were contested and court dates have been set. The City expects that \$100 in tickets will be uncollectible and the remaining amounts will be paid eventually.
 - f.) Restaurant licenses are issued for a one-year period. The licenses are valid for one year from July 1 to June 30. The license fees are used to pay restaurant inspectors. In June, \$7,500 in restaurant license fees was received.

4. Assuming that the City of Jolie maintains its books and records in a manner that facilitates the preparation of the fund financial statements, prepare all necessary journal entries to record the City's investment income and related transactions for the year ended 12/31/2007. The City has a 12/31 fiscal year-end. The City has adopted the 60-day rule for all revenue recognition for which it is appropriate. All of the City's investments are required to be reported at fair value. The beginning securities portfolio held by the general fund was as follows:

| | January 1, 2007 | |
|-------------------|------------------------|---------------------|
| <u>Securities</u> | <u>Historical Cost</u> | <u>Market Value</u> |
| A | \$90 | \$ 95 |
| B | \$110 | \$100 |
| C | \$300 | \$330 |
| D | \$120 | \$125 |

- a.) Dividends received related to investments held in the general fund, \$75.
- b.) On March 1, Security B is sold for \$102.
- c.) On April 1, Security E is purchased for \$130
- d.) On May 1 Security D is sold for \$135.
- e.) On December 31, necessary adjusting entries are made to recognize appropriate amounts of gains/losses associated with the securities. The market value of the securities at year-end were as follows:

| | Dec. 31, 2007 | |
|-------------------|------------------------|---------------------|
| <u>Securities</u> | <u>Historical Cost</u> | <u>Market Value</u> |
| A | \$90 | \$90 |
| C | \$300 | \$310 |
| E | \$130 | \$135 |

5. The City of Chessie received two contributions during its current fiscal year:
- A developer contributed 10 acres of land as part of an agreement with the City to allow more houses to be built per acre than current zoning laws permit. The City will use the land to build a park. The developer purchased the land for \$1.5 million. The fair value of the land at the time of the contribution was \$1.9 million.
 - A local resident contributed 30 acres of land to the City. The City agreed that it would sell the land and use the proceeds to add a new wing to the City's senior center. The resident paid \$500,000 for the land. When it was contributed, it had a fair value of \$1.5 million. The City sold the land to several developers a month after its fiscal year-end for \$1.7 million.
- a. Prepare journal entries to record each of these contributions in the City's general fund.
 - b. Comment on and justify any differences in the way in which you recognized each of these transactions.
 - c. Would your answer on the contribution for the senior center be different if the City had been unable to sell the land before its financial statements were issued?
 - d. How would each of these transactions be reported in the City's government-wide financial statements?

6. Catlett County reported the following transactions during its fiscal year ended December 31, 2006:

- On February 16, 2006, the County purchased a 15 year \$100,000 bond for \$99,800 with cash held in a debt sinking fund. During the year, the County received \$5,000 in interest. At year-end, the market value of the bond was \$99,950.
- In December 2005, the Kiplinger Foundation pledged up to \$3 million to support the County's Art Museum. The Foundation will contribute \$1 for every \$2 in admissions revenue generated by the Art Museum. During 2006, the Art Museum reported \$3.0 million in admissions revenue. During January and February 2007, it reported an additional \$1.0 million. The County received the matching contributions for both admissions amounts.
- During the year, the County agreed to impose a license fee on all tanning salons operated in the County. Licenses cover the period July 1, 2006 to June 30, 2007. The County received license revenues of \$200,000.
- The County sold 2 police cars for salvage totaling \$7,500. It had purchased the cars 5 years earlier at \$30,000 each. The County had fully depreciated the police cars in its government-wide financial statements, and a total salvage value of \$5,000 had been anticipated.
- The County received a \$2.5 million grant from the state to reimburse the cost of its DARE program. The County incurred DARE program costs of \$2.0 million during 2006 and an additional \$.5 million in January and February 2007.

Match the items below with the amounts that follow. All amounts are for the year ended December 31, 2006. An amount may be selected once, more than once, or never.

- a. Amount of investment income (interest, dividends, realized and unrealized gains and losses) recognized by the County in its debt service fund.
- b. Amount of investment income (interest, dividends, realized and unrealized gains and losses) recognized by the County in its government-wide financial statements.
- c. Amount recognized in the County's general fund on the sale of its police cars.
- d. Gain/loss recognized on the sale of police cars in the County's government-wide financial statements.
- e. DARE grant revenues recognized in the County's government-wide financial statements.
- f. DARE grant revenues recognized in the County's special revenue fund.
- g. Contributions from the Kiplinger Foundation in the County's Museum Fund (a special revenue fund).
- h. Contributions from the Kiplinger Foundation reported in the County's government-wide financial statements.
- i. License fee revenue reported in the County's general fund.
- j. License fee revenue reported in the County's government-wide financial statements.
- k. Reported value at 12/31/2006 of the County's investment.

1. \$0
2. \$5,150
3. \$5,000
4. \$200,000
5. \$1,500,000
6. \$2,000,000
7. \$3,000,000

- 8. \$500,000
- 9. \$100,000
- 10. \$99,950
- 11. \$99,800
- 12. \$2,500,000
- 13. \$7,500
- 14. \$2,500

7. GASB Statement 33 describes several categories of revenues (e.g. derived non exchange revenue). For each of the following revenues (recognized by a city) indicate the category into which its best fits.

A. A state grant that the city must accept and used to hire air pollution inspectors

B. Revenue from fees charged by the police department to monitor a charity bicycle ride

C. Fines for traffic violations

ESSAY (CHAPTER 4)

1. Governmental entities use modified accrual accounting to determine when transactions and events will be recognized in the financial statements of the governmental fund types.

Required:

- a.) What is modified accrual accounting and how does it affect revenue recognition for the following types of revenue: property taxes; sales and income taxes; fines; grants of all types; and investment income.
- b.) In your opinion is modified accrual accounting the best basis of accounting for governmental entities? Why or why not? Defend your answer.

2. Answer the following questions with regard to preparation of the fund financial statements.

At fiscal year-end, a city holds an investment portfolio in its general fund that has a fair market value of \$15 million and a historical cost of \$28 million. The portfolio had a fair value of \$18 million at the beginning of the current fiscal year. The portfolio is composed of a variety of bonds with a face value \$29 and a due date five years in the future. The bonds were acquired to meet a \$29 million debt due five years in the future. Although the bonds have the usual market risk, the credit risk is minimal.

Required:

- a.) At what amount should the portfolio be valued on the balance sheet?
- b.) What amount, if any, should appear on the operating statement?
- c.) Defend the valuation method required by GAAP.
- d.) Argue against the valuation method required by GAAP.
- e.) At what amount would the City want to record the investments on their financial statements? Why?

3. Answer the following questions with regard to preparation of the fund financial statements. A local government receives three grants from the State. One grant is received in cash but must be used only for the acquisition of two vans specifically equipped to transport physically challenged citizens who use wheelchairs as a means of mobility. The second grant provides for reimbursement of costs incurred in operating a public transit system. The third grant is a distribution of State general fund revenues allocated to each City in the State based on the population of the City. This last grant is to be used in general government operations. The City also receives a federal grant which must be passed through by the City to smaller units of government who meet the eligibility requirements. The City must monitor these smaller units of government for compliance with grant requirements.

Required:

- a.) Discuss the various methods of revenue recognition for grants and other similar revenues.
- b.) Discuss the appropriate basis for revenue recognition for each of these grants.
- c.) Discuss the rationale for each of these methods of revenue recognition.

ANSWERS TO TRUE/FALSE (CHAPTER 4)

1. False
2. True
3. False
4. False
5. True
6. True
7. False
8. True
9. False
10. True

ANSWERS TO MULTIPLE CHOICE (CHAPTER 4)

1. B
2. A
3. C
4. D
5. D
6. B
7. D
8. D
9. D
10. D
11. B
12. A
13. D
14. A
15. B
16. C
17. B
18. C
19. A
20. D
21. B
22. C
23. C
24. C
25. C
26. C
27. C
28. C
29. B
30. C
31. B
32. A
33. D
34. C
35. C
36. D

- 37. B
- 38. D
- 39. D
- 40. D
- 41. A
- 42. A
- 43. C
- 44. B
- 45. B
- 46. B
- 47. D
- 48. C
- 49. D

ANSWERS TO PROBLEMS (CHAPTER 4)

Problem 1

- (a) Property Tax Receivable \$1,000,000
 Allowance for Uncollectible Taxes \$ 20,000
 Property Tax Revenue OR
 *Deferred Property Tax Revenue \$ 980,000
 (to record property tax levy for 2008)
 *Revenue could be deferred until the due dates, when there is an enforceable legal claim.
- (b) Cash \$ 23,500
 Delinquent Property Tax Receivable \$ 23,500
 (to record 2007 delinquent taxes receipts)
- Deferred Property Tax Revenue \$ 12,500
 Property Tax Revenue \$ 12,500
 (to record 2007 revenue not “available” in 2007)
 (this entry may be needed if there was a deferred account)
- Cash \$ 940,000
 Property Tax Receivable \$ 940,000
 (to record 2008 property tax receipts)
- *[needed if Deferred Property Tax Revenue used in (a)]
 Deferred Property Tax Revenue \$ 940,000
 Property Tax Revenue \$ 940,000
 (to recognize 2008 property tax revenue)
- *[needed if Deferred Property Tax Revenue used in (a)]
 Deferred Property Tax Revenue \$ 10,000
 Property Tax Revenue \$ 10,000
 (to recognize 2008 tax revenue that meets “available” test)
- [the following entry is NOT NEEDED if Deferred Property Tax Revenue used in (a)]
 Revenue \$ 30,000
 Deferred Property Tax Revenue \$ 30,000
 (to report 2008 property tax revenues not “available” to finance the current period)
- (c) Delinquent Property Tax Receivable \$ 60,000
 Property Tax Receivable \$ 60,000
 (to reclassify tax receivables as delinquent)
- Allowance for Uncollectible Taxes \$ 20,000
 Allowance for uncollectible Tax-Del. \$ 20,000
 (to reclassify allowance for delinquent tax accounts receivable)
- (d) Allowance for Uncollectible Tax-Del. \$ 2,000
 Delinquent property Tax Receivable \$ 2,000
 (to write-off delinquent tax receivables)

Problem 2

| | | | |
|-----|----------------------|----------|----------|
| (a) | Cash | \$ 7,000 | |
| | Sales Tax Receivable | | \$ 7,000 |
| (b) | Cash | \$ 3,000 | |
| | Sales Tax Revenue | | \$ 3,000 |
| (c) | Cash | \$40,000 | |
| | Sales Tax Revenue | | \$40,000 |
| (d) | Cash | \$ 7,500 | |
| | Sales Tax Receivable | | \$ 7,500 |

Problem 3

| | | | |
|-----|--|-----------|-----------|
| (a) | Federal Grant Receivable | \$200,000 | |
| | Grant Revenue | | \$200,000 |
| (b) | Expenditures | \$ 21,000 | |
| | Cash | | \$ 21,000 |
| (c) | No Entry Required. No enforceable legal claim. | | |
| (d) | Cash | \$200,000 | |
| | Federal Grant Receivable | | \$200,000 |
| (e) | Cash | \$ 800 | |
| | Fines receivable | 300 | |
| | Fines Revenue | | \$ 800 |
| | Allow. for doubtful accounts—fines | | 100 |
| | Deferred revenues—fines | | 200 |
| (f) | Cash | \$ 7,500 | |
| | License Revenue | | \$ 7,500 |

Problem 4

| | | | |
|-----|--|-------|-------|
| (a) | Cash | \$ 75 | |
| | Dividend Revenue | | \$ 75 |
| (b) | Cash | \$102 | |
| | Investments | | \$102 |
| Or | Cash | \$102 | |
| | Investments | | \$100 |
| | Investment Gains and Losses | | \$ 2 |
| (c) | Investments | \$130 | |
| | Cash | | \$130 |
| (d) | Cash | \$135 | |
| | Investments | | \$135 |
| Or | Cash | \$135 | |
| | Investments | | \$125 |
| | Investment Gains and Losses | | \$ 10 |
| (e) | Loss on Investments | \$ 8 | |
| | Investments | | \$ 8 |
| | (to recognize realized and unrealized changes in fair value of investments*) | | |
| Or | Investment Gains and Losses | \$ 20 | |
| | Investments | | \$ 20 |
| | (to recognize changes in fair value in investments) | | |

*Change in fair value is calculated as follows:

| | | | |
|----------|-----------------------------------|------------|--------------|
| Outputs: | | | |
| | Fair value at 12/31/2007 | \$535 | |
| | Sales | <u>237</u> | |
| | Total outputs | | \$772 |
| Inputs: | | | |
| | Fair value at 1/1/2007 | \$650 | |
| | Purchases | <u>130</u> | |
| | Total inputs | | <u>\$780</u> |
| | Increase (decrease) in fair value | | \$ (8) |

Problem 5

a.

Land to be used as a park

No entry necessary. General fixed assets are not recognized in governmental funds.

Land to be sold

| | | |
|------------------------|-------|-------|
| Land held for sale | \$1.5 | |
| Revenue from donations | | \$1.5 |

To record donation of land (at fair market value at time of contribution)

| | | |
|---------------------------|-------|-----|
| Cash | \$1.7 | |
| Land held for sale | | 1.5 |
| Gain on sale of land sold | | 0.2 |

To record the sale of the land in the second year

- b. Fixed assets are not generally recorded in governmental funds because their measurement focus is on financial resources. However, owing to the intent of the City, the land held for sale has the characteristics of an investment rather than a fixed asset. Therefore it should be accounted for as an investment and recorded in a governmental fund.
- c. Yes, the entry at fair value at the time of contribution would have been to deferred revenue, not revenue from donations.
- d. In the City's government-wide statements, both parcels of land would be recorded as assets and correspondingly both gifts would be recognized as revenue at their fair value at the date that they were contributed.

Problem 6

- a. 2
- b. 2
- c. 13
- d. 14
- e. 6
- f. 6
- g. 5
- h. 5
- i. 4
- j. 4
- k. 10

Problem 7

A. A state grant that the city must accept and used to hire air pollution inspectors

Government-mandated non-exchange

B. Revenue from fees charged by the police department to monitor a charity bicycle ride

Exchange transaction _____

C. Fines for traffic violations

Government imposed _____

ANSWERS TO ESSAY (CHAPTER 4)

1.

- (a) Basis of accounting refers to when transactions and events are recognized. Modified accrual accounting is a basis of accounting that recognizes expenditures when the related fund liability is incurred or asset used and recognizes revenues when they are measurable and available. Measurable has the general meaning of that word. Available means 'collectible within the current period or soon enough thereafter to be used to pay liabilities of the current period.' Because many revenue sources in governmental accounting are not 'earned' in the traditional sense of the word, timing of revenue recognition is more difficult to determine.

Current standards require that property tax revenues be recognized in the budgetary period for which the taxes were levied, provided they are measurable and available. Available means receivable within the current period or expected to be collected soon enough thereafter to be used to pay liabilities of the current period, so long as they are received within 60 days of year-end.

Current standards require that sales and income tax revenues be recognized in the accounting period in which the underlying exchange transaction occurs provided they are 'available.'

Fines are generally recognized on the cash basis because standards require that they be recognized when an "enforceable legal claim arises" and that date is difficult to determine in practice.

Unrestricted grants and grants with a purpose restriction are generally recognized as revenue as soon as they are announced, if their collectibility is reasonably assured. Grants with eligibility requirements are generally recognized as revenue when all eligibility requirements have been met. (For reimbursement grants that generally means when the related expenditures are incurred.)

Current standards require that investment income, including changes in fair value, be reported in the operating statement of the fund. Unrealized holding gains and losses are netted against realized gains and losses and included in the operating statement. Dividends and interest are generally reported on the cash basis.(b) [**Note:** The answer to this question will obviously differ among students.] Students supporting modified accrual accounting will probably emphasize the importance of the budget and budgetary compliance. Students supporting full accrual accounting will probably emphasize the importance of interperiod equity. Students supporting the cash basis will probably emphasize the importance of cash in liquidating liabilities.

2.

- (a) The portfolio should be valued on the balance sheet at \$15 million.
- (b) A \$3 million loss should appear on the current operating statement.
- (c) The reasons for valuing investments at the fair value on the balance sheet and recognizing unrealized gains and losses on the operating statement are as follows.
 - Fair value is generally more relevant than historical cost for decision-making
 - Investments are often held as cash substitutes
 - Fair values are objective
 - Performance of the investment managers should be measured by total return—dividends, interest, and changes in fair value.
- (d) The reasons for not valuing investments at their fair value on the balance sheet and recognizing unrealized gains and losses on the operating statement are as follows.
 - Changes in fair value are irrelevant if investments are to be held to maturity
 - Recognizing unrealized gains on the balance sheet could lead governments into believing they have more resources to appropriate than they actually have
 - Fair values fluctuate in response to market rates of interest. Use of fair value incorporates unnecessary variability into financial reporting
- (e) The City would want to record the investments at historical cost since that is a higher value. Reporting the loss reduces the amount of revenues that can be allocated to programs during the current year. Since these investments are intended to be held to maturity and are timed to meet a liability, the investments could be carried on the financial statements at amortized historical cost.

3.

- (a) Unrestricted grants and grants with a purpose restriction are generally recognized as revenue at the time they are announced, or at the time when the local government feels assured that it will eventually receive the granted funds. Grants with eligibility requirements (including reimbursement grants) are generally recognized as revenue when all eligibility requirements have been met (For reimbursement grants this generally means when the related expenditures are incurred). Pass-through grants are generally recognized as both a revenue and an expenditure in the period in which the expenditures are incurred. Only in rare cases may pass-through grants be recorded in agency funds (which have no operating statement).
- (b) The grant for acquisition of the vans will be recognized as revenue when it is announced. The grant for reimbursement of expenses incurred in operating the transit system should be treated as a grant with eligibility requirements and should be recognized as revenue when all eligibility requirements are met. The State grant is probably an unrestricted grant and revenue should be recognized when the grant is announced. The federal grant is a pass-through grant that should be recognized as a revenue and an expenditure in the period in which the funds are passed through to the smaller units of government.
- (c) One of the difficulties with governmental revenue recognition is in determining what constitutes the 'earning' process. Unrestricted grants and grants with purpose restrictions are considered 'earned' when they become payable to the City. Grants with eligibility requirements are 'earned' by fulfilling the eligibility requirements, in this case by spending on the required program and becoming eligible for reimbursement. Pass-through grants are a more difficult issue. If the City is simply a conduit for the cash, and if the City has no administrative involvement, then the City can record the activity as an agency activity. If, however, the City has administrative involvement with the pass-through grant, then the City 'earns' the grant by incurring related expenditures (passing through the funds). The responsibility for monitoring is evidence of administrative involvement.

Chapter 5

Recognizing Expenditures in Governmental Funds

TRUE/FALSE (CHAPTER 5)

1. TExpenditures are generally recognized when resources are acquired; expenses when resources are consumed.
2. TGovernmental fund liabilities are considered current only when they must be liquidated with expendable available financial resources—not, as in businesses and in the government-wide statements, when they must be paid within a year.
3. TIn a governmental fund, expenditures for wages and salaries should be recognized in the period in which the employees earn them.
4. FWhen accounting for inventory items in a governmental fund, GASB standards permit the use of the consumption method only.
5. FThe purchases method is consistent with full accrual basis of accounting.
6. FWhen accounting for inventory items in a governmental fund, a reservation of fund balance is always required when the consumption method is used.
7. TIn budgeting for governmental funds, governments appropriate the resources for general capital assets in the periods when they are to be purchased, not in the periods in which the assets will be used.
8. TPer GASB standards, governments do not report general capital assets or depreciation in governmental funds.
9. FIf recording a general long-term liability in a governmental fund upon issuing a bond, the credit should be to a bonds payable account.
10. TMost governments budget (appropriate) resources for principal and interest only for the period in which a payment is due—not for future payments.
11. TGovernment-wide statements present revenues and expenses from the perspective of the government, not of individual funds.

MULTIPLE CHOICE (CHAPTER 5)

1. Which of the following funds would use the modified accrual basis of accounting in preparing its fund financial statements?
 - a) City Electric Utility Enterprise Fund.
 - b) **City Hall Capital Project Fund.**
 - c) City Motor Pool Internal Service Fund.
 - d) City Employee Pension Trust Fund.

2. Which of the following funds would use the accrual basis of accounting in preparing its fund financial statements?
 - a) City General Fund.
 - b) City Hall Capital Project Fund.
 - c) **City Motor Pool Internal Service Fund.**
 - d) None of the above.

3. As used in governmental accounting, expenditures are decreases in
 - a) Net Assets.
 - b) Net Financial Resources.
 - c) **Net Cash.**
 - d) Net Economic Resources.

4. Assume that the City of Juneau maintains its books and records to facilitate the preparation of its fund financial statements. The City pays its employees bi-weekly on Friday. The fiscal year ended on Wednesday, June 30. Employees had been paid on Friday, June 25. The employees paid from the General Fund had earned \$120,000 on Monday, Tuesday, and Wednesday (June 28, 29, and 30). What entry, if any, should be made in the City's General Fund?
 - a) **Debit Expenditures; Credit Wages and Salaries Payable.**
 - b) Debit Expenses; Credit Wages and Salaries Payable.
 - c) Debit Expenditures; Credit Encumbrances.
 - d) No entry is required.

5. Assume that the City of Juneau maintains its books and records to facilitate the preparation of its government-wide financial statements. The City pays its employees bi-weekly on Friday. The fiscal year ended on Wednesday, June 30. Employees had been paid on Friday, June 25. The employees paid from the General Fund had earned \$120,000 on Monday, Tuesday, and Wednesday (June 28, 29, and 30). They will earn \$80,000 on Thursday and Friday (July 1 and 2). What entry, if any, should be made on June 30?
 - a) Debit Expenditures \$120,000; Credit Wages and Salaries Payable \$120,000.
 - b) Debit Expenditure \$200,000; Credit Wages and Salaries Payable \$200,000.
 - c) **Debit Expenses \$120,000; Credit Wages and Salaries Payable \$120,000.**
 - d) No entry is required.

6. Employees of the City of Orleans earn ten days paid leave for each 12 months of employment. The City has a policy that employees must take their vacation days during the year following the year in which it is earned. If they do not take vacation in the allotted period, they forfeit the vacation pay benefit. Traditionally, employees have taken 80% of the vacation days earned. During the current year, employees of the City of Orleans earned \$400,000 in vacation pay. Assuming the city maintains its books and records in a manner to facilitate the preparation of its fund financial statements, which of the following entries is the correct entry in the General Fund to record the vacation pay earned during the current period?
- a) Debit Expenditures \$400,000; Credit Vacation Payable \$400,000.
 - b) Debit Expenses \$400,000; Credit Vacation Payable \$400,000.
 - c) Debit Expenditures \$320,000; Credit Vacation Pay Payable \$320,000.
 - d) **No entry required.**
7. Employees of the City of Orleans earn ten days paid leave for each 12 months of employment. The City has a policy that employees must take their vacation days during the year following the year in which it is earned. If they do not take vacation in the allotted period, they forfeit the vacation pay benefit. Traditionally, employees have taken 80% of the vacation days earned. During the current year, employees of the City of Orleans earned \$400,000 in vacation pay. Assuming the city maintains its books and records in a manner to facilitate the preparation of its government-wide financial statements, which of the following entries should be made to record the vacation pay earned during the current period?
- a) Debit Expenditures \$400,000; Credit Vacation Payable \$400,000.
 - b) Debit Expenses \$400,000; Credit Vacation Payable \$400,000.
 - c) **Debit Expenses \$320,000; Credit Vacation Pay Payable \$320,000.**
 - d) No entry required.
8. Employees of the General Fund of Scott City earn ten days of vacation for each 12 months of employment. The City permits employees to carry the vacation days forward as long as they wish. During the current year employees earned \$800,000 of vacation benefits, of which the City estimates that \$500,000 will be taken in the next year and the balance will be carried forward. Assuming that the City maintains its books and records in a manner that facilitates the preparation of its fund financial statements, which of the following entries is the correct entry in the General Fund to record the vacation pay earned during the current period?
- a) Debit Expenditures \$800,000; Credit Vacation Pay Payable \$800,000.
 - b) Debit Expenditures \$500,000; Credit Vacation Pay Payable \$500,000.
 - c) Debit Vacation Expense \$800,000; Credit Vacation Pay Payable \$800,000.
 - d) **No entry required.**

9. Employees of the General Fund of Scott City earn ten days of vacation for each 12 months of employment. The City permits employees to carry the vacation days forward as long as they wish. During the current year employees earned \$800,000 of vacation benefits, of which the City estimates that \$500,000 will be taken in the next year and the balance will be carried forward. Assuming that the City maintains its books and records in a manner that facilitates the preparation of its government-wide financial statements, which of the following entries should be made to record the vacation pay earned during the current period?
- a) Debit Expenditures \$800,000; Credit Vacation Pay Payable \$800,000.
 - b) Debit Expenditures \$500,000; Credit Vacation Pay Payable \$500,000.
 - c) **Debit Vacation Expense \$800,000; Credit Vacation Pay Payable \$800,000.**
 - d) No entry required.

Use the following information to Questions 10 through 13:

Lincoln City has a 6/30 fiscal year-end. The City has a policy of recognizing revenues/expenditures when collected/paid or if expected to be collected/paid within 60 days of year-end. The City has a sick leave benefit policy for its employees. The policy allows City employees one day of paid sick leave per month and permits them to accumulate sick leave they do not take. Sick leave vests at the completion of the fifth year of employment, and unused sick leave is paid in cash upon termination or retirement. During the fiscal year ended 6/30/07, City employees who are paid from the General Fund, earned \$1.4 million of sick leave, of which \$.5 was taken. Of the balance, the City estimates \$.1 million will be taken in the next sixty days, \$.3 million will be taken in the next five years, \$.2 million will vest, and \$.3 million will never be taken.

10. The amount of sick pay expenditure that should appear on the General Fund financial statements for the fiscal year ended 6/30/07 is
- a) \$1.4 million.
 - b) \$1.3 million.
 - c) \$.6 million.
 - d) **\$.5 million.**
11. The amount of sick pay liability that should appear on the General Fund balance sheet at 6/30/07 is
- a) \$.6 million.
 - b) \$.2 million.
 - c) \$.1 million.
 - d) **No liability should appear.**
12. The amount of sick pay expense that should appear on the government-wide financial statements for the fiscal year ended 6/30/07 is
- a) \$1.4 million.
 - b) \$1.3 million.
 - c) \$.6 million.
 - d) **\$.7 million.**
13. The amount of sick pay liability that should appear on the government-wide financial statements at 6/30/07 is
- a) \$.6 million.
 - b) **\$.2 million.**
 - c) \$.1 million.
 - d) No liability should appear.

14. State Community College, a public college, grants faculty members a one-year sabbatical leave after each seven years of service. There are no requirements for research, study or service during the compensated sabbatical leave. A particular faculty member earns \$40,000 per year. Assuming that the college maintains its books and records in a manner that facilitates the preparation of the fund financial statements and assuming that any appropriate accruals have been made, what is the appropriate entry to record the employee's salary paid while on sabbatical?
- a) Debit Expenditures \$40,000; Credit Cash \$40,000.
 - b) Debit Sabbatical Leave Payable \$40,000; Credit Cash \$40,000.
 - c) Debit Expenditures \$40,000; Credit Sabbatical Leave Payable \$40,000.
 - d) No entry required.
15. State Community College, a public college, grants faculty members a one-year sabbatical leave after each seven years of service. There are no requirements for research, study or service during the compensated sabbatical leave. A particular faculty member earns \$40,000 per year. Assuming that the college maintains its books and records in a manner that facilitates the preparation of the government-wide financial statements and assuming that any appropriate accruals have been made, what is the appropriate entry to record the employee's salary paid while on sabbatical?
- a) Debit Expenditures \$40,000; Credit Cash \$40,000.
 - b) Debit Sabbatical Leave Payable \$40,000; Credit Cash \$40,000.
 - c) Debit Expenditures \$40,000; Credit Cash \$40,000.
 - d) No entry required.
16. State University, a public university, has a policy of granting faculty members a one-year paid sabbatical leave after a period of seven years continuous employment. The leave is for further study, research or public service. A particular faculty member earns \$70,000 per year. Assuming that the college maintains its books and records in a manner that facilitates the preparation of the fund financial statements and assuming that any appropriate accruals have been made, what is the appropriate entry to record the employee's salary paid while on sabbatical leave?
- a) Debit Expenditures \$70,000; Credit Cash \$70,000.
 - b) Debit Expenses \$70,000; Credit Cash \$70,000.
 - c) Debit Sabbatical Leave Payable \$70,000; Credit Cash \$70,000.
 - d) No entry required.
17. State University, a public university, has a policy of granting faculty members a one-year paid sabbatical leave after a period of seven years continuous employment. The leave is for further study, research or public service. A particular faculty member earns \$70,000 per year. Assuming that the college maintains its books and records in a manner that facilitates the preparation of the government-wide financial statements and assuming that any appropriate accruals have been made, what is the appropriate entry to record the employee's salary paid while on sabbatical leave?
- a) Debit Expenditures \$70,000; Credit Cash \$70,000.
 - b) Debit Expenses \$70,000; Credit Cash \$70,000.
 - c) Debit Sabbatical Leave Payable \$70,000; Credit Cash \$70,000.
 - d) No entry required.

18. State University, a very large public university, has a policy of granting faculty members a one-year sabbatical leave after a period of seven years of continuous employment. The leave is to be used for further study, research, or service. During the fiscal year ended 6/30/07, the university paid \$3 million to faculty members on sabbatical leave and estimated that faculty members currently not on sabbatical leave earned \$3.5 million toward sabbatical leaves they are likely to take in the future. The amount of sabbatical expenditures for the year ended 6/30/07 should be
- a) \$0 million.
 - b) \$3 million.**
 - c) \$3.5 million.
 - d) \$6.5 million.
19. Culver City recognizes as revenues/expenditures those amounts collected/paid during the year or within 60 days of fiscal year-end. The City offers a pension benefit to its employees who meet certain age and years of employment criteria. The City participates in the State Pension Plan. The City's actuarially determined contribution requirement to the State Pension Plan for the fiscal year ended 6/30/07 is \$4 million. Due to cash inflow shortages the City, which budgeted \$4 million for pension payments, paid only \$3 million in the fiscal year ended 6/30/07. The City paid the remaining amount on September 30, 2007. Assuming the City maintains its books and records in a manner that facilitates the preparation of its fund financial statements, what is the appropriate entry to record the pension payments and recognize any associated liability?
- a) Debit Expenditures \$4 million; Credit Cash \$3 million and Pension Payable \$1 million.
 - b) Debit Expenses \$4 million; Credit Cash \$3 million and Pension Payable \$1 million.
 - c) Debit Expenditures \$3 million; Credit Cash \$3 million.**
 - d) Debit Expenses \$3 million; Credit Cash \$3 million.
20. Culver City recognizes as revenues/expenditures those amounts collected/paid during the year or within 60 days of fiscal year-end. The City offers a pension benefit to its employees who meet certain age and years of employment criteria. The City participates in the State Pension Plan. The City's actuarially determined contribution requirement to the State Pension Plan for the fiscal year ended 6/3/07 is \$4 million. Due to cash inflow shortages the City, which budgeted \$4 million for pension payments, paid only \$3 million in the fiscal year ended 6/30/07. The City paid the remaining amount on September 30, 2007. Assuming the City maintains its books and records in a manner that facilitates the preparation of the government-wide financial statements, what is the appropriate entry to record the pension payments and recognize any associated liability?
- a) Debit Expenditures \$4 million; Credit Cash \$3 million and Pension Payable \$1 million.
 - b) Debit Expenses \$4 million; Credit Cash \$3 million and Pension Payable \$1 million.**
 - c) Debit Expenditures \$3 million; Credit Cash \$3 million.
 - d) Debit Expenses \$3 million; Credit Cash \$3 million.
21. The amount of pension expenditures that should be recognized in the General Fund financial statements during the current year is
- a) The amount paid.
 - b) The amount paid plus the amount that will be paid with available expendable financial resources.**
 - c) The amount paid so long as it does not exceed the actuarially determined amount.
 - d) The actuarially determined amount.

22. The amount of pension expenditures that should be recognized in the government-wide financial statements during the current year is
- a) The amount paid.
 - b) The amount paid plus the amount that will be paid with available expendable financial resources.
 - c) The amount paid so long as it does not exceed the actuarially determined amount.
 - d) **The actuarially determined amount.**
23. This year, Port City was sued for injuries sustained when a citizen slipped and broke her hip on the icy City Hall steps. The City attorney estimates the City will be held liable by the courts and a judgment of \$200,000 will result. Because of the nature of the case it will likely be four years before the City makes any payment related to the accident. The present value of the likely future payment is \$167,000. In the General Fund, at the end of the current fiscal year, Port City should recognize a liability of
- a) \$200,000.
 - b) \$167,000.
 - c) **\$0.**
 - d) \$50,000.
24. This year, Port City was sued for injuries sustained when a citizen slipped and broke her hip on the icy City Hall steps. The City attorney estimates the City will be held liable by the courts and a judgment of \$200,000 will result. Because of the nature of the case it will likely be four years before the City makes any payment related to the accident. The present value of the likely future payment is \$167,000. In the government-wide financial statements, at the end of the current fiscal year, Port City should recognize a liability of
- a) **\$200,000.**
 - b) \$167,000.
 - c) \$0.
 - d) \$50,000.
25. Several years ago, Grant County was sued by a former County employee for wrongful discharge. Although it was to be contested by the County, at the time of the lawsuit the attorneys believed that the County was likely to lose the suit and the estimated amount of the ultimate judgment would be \$100,000. This year, the case was finally settled with a judgment against the County of \$150,000, which was paid. Assuming that the County maintains its books and records in a manner to facilitate the preparation of its fund financial statements, the entry in the current year should be
- a) **Debit Expenditures \$150,000; Credit Cash \$150,000.**
 - b) Debit Expenses \$150,000; Credit Cash \$150,000.
 - c) Debit Expenditures \$50,000 and Claims Payable \$100,000; Credit Cash \$150,000.
 - d) Debit Expenses \$50,000 and Claims Payable \$100,000; Credit Cash \$150,000.

26. Several years ago, Grant County was sued by a former County employee for wrongful discharge. Although it was to be contested by the County, at the time of the lawsuit the attorneys believed that the County was likely to lose and the estimated amount of the ultimate judgment would be \$100,000. This year, the case was finally settled with a judgment against the County of \$150,000, which was paid. Assuming that the County maintains its books and records in a manner to facilitate the preparation of its government-wide financial statements, the entry in the current year should be

- a) Debit Expenditures \$150,000; Credit Cash \$150,000.
- b) Debit Expenses \$150,000; Credit Cash \$150,000.
- c) Debit Expenditures \$50,000 and Claims Payable \$100,000; Credit Cash \$150,000.
- d) **Debit Expenses \$50,000 and Claims Payable \$100,000; Credit Cash \$150,000.**

27. The City of Upper Falls accounts for its inventory using the purchases method. During the year the City bought \$400,000 of supplies, for which it owed \$100,000 at year-end. The City will pay for the supplies from available expendable financial resources. The entry that should be recorded in the City's General Fund is

- a) **Debit Expenditures \$400,000; Credit Cash \$300,000 and Accounts Payable \$100,000.**
- b) Debit Expenditures \$300,000; Credit Cash \$300,000.
- c) Debit Supplies Inventory \$400,000; Credit Cash \$300,000 and Accounts Payable \$100,000.
- d) Debit Supplies Inventory \$300,000; Credit Cash \$300,000.

28. Bay City uses the purchases method to account for supplies. At the beginning of the year the City had no supplies on hand. During the year the City purchased \$600,000 of supplies for use by activities accounted for in the General Fund. The City used \$400,000 of those supplies during the year. Assuming that the city maintains its books and records in a manner that facilitates the preparation of its fund financial statements, at fiscal year-end the appropriate account balances related to supplies expenditures and supplies inventory would be

- a) **Expenditures \$600,000; Supplies Inventory \$200,000.**
- b) Expenditures \$600,000; Supplies Inventory \$0.
- c) Expenditures \$400,000; Supplies Inventory \$200,000.
- d) Expenditures \$400,000; Supplies Inventory \$0.

29. Shoshone County uses the consumption method to account for supplies. At the beginning of the year the City had no supplies on hand. During the year the City purchased \$600,000 of supplies for use by activities accounted for in the General Fund. The City used \$400,000 of those supplies during the year. At fiscal year-end, the appropriate account balances on the General Fund financial statements would be

- a) Expenditures \$600,000; Supplies Inventory \$200,000.
- b) Expenditures \$600,000; Supplies Inventory \$0.
- c) **Expenditures \$400,000; Supplies Inventory \$200,000.**
- d) Expenditures \$400,000; Supplies Inventory \$0.

30. Shoshone County uses the consumption method to account for supplies. At the beginning of the year the City had no supplies on hand. During the year the City purchased \$600,000 of supplies for use by activities accounted for in the General Fund. The City used \$400,000 of those supplies during the year. At fiscal year-end the appropriate account balances on the government-wide financial statements would be
- Expenses \$600,000; Supplies Inventory \$200,000.
 - Expenses \$600,000; Supplies Inventory \$0.
 - Expenses \$400,000; Supplies Inventory \$200,000.**
 - Expenses \$400,000; Supplies Inventory \$0.
31. Sugar City uses the purchases method to record all prepayments. The City has a 6/30 fiscal year-end. On 12/31/06, the City purchased a three-year insurance policy covering all city owned vehicles accounted acquired by the General Fund to be used in general government activity. Cost of the policy was \$360,000. After the 6/30/07 closing entries, the appropriate balance sheet accounts and balances associated with this transaction are in the City's General Fund:
- Prepaid Insurance \$300,000; Expenditure \$60,000.
 - Prepaid Insurance \$300,000; Expenditures \$360,000
 - Prepaid Insurance \$0; Expenditure \$360,000.**
 - Prepaid Insurance \$0; Expenditures \$60,000.
32. Campbell County uses the consumption method to record all inventories and prepayments. The County has a 9/30 fiscal year-end. On April 1, 2007, the County purchased a two-year insurance policy at a total cost of \$400,000, paying for the policy out of the General Fund. In the fund financial statements, the amount of insurance expenditures for the fiscal year ended 9/30/07 would be
- \$400,000.
 - \$300,000.
 - \$200,000.
 - \$100,000.**
33. On July 1, Gilbert County bought computer equipment for use in the administrative offices of the County. The equipment has an estimated useful life of three years and salvage of \$10,000. Gilbert County has a 6/30 fiscal year-end. Assuming that the County maintains its books and records in a manner that facilitates the preparation of fund financial statements, the \$70,000 cost of this equipment would require which of the following entries?
- Debit Expenditures \$70,000; Credit Cash \$70,000.**
 - Debit Equipment \$70,000; Credit Cash \$70,000.
 - Debit Expenses \$70,000; Credit Cash \$70,000.
 - No entry in the City's governmental funds.

34. On July 1, Gilbert County bought computer equipment for use in the administrative offices of the County. The equipment has an estimated useful life of three years and salvage of \$10,000. Gilbert County has a 6/30 fiscal year-end. Assuming that the County maintains its books and records in a manner that facilitates the preparation of government-wide financial statements, the \$70,000 cost of this equipment would require which of the following entries?

- a) Debit Expenditures \$70,000; Credit Cash \$70,000.
- b) **Debit Equipment \$70,000; Credit Cash \$70,000.**
- c) Debit Expenses \$70,000; Credit Cash \$70,000.
- d) No entry is required.

35. The City of Roswell has a 6/30 fiscal year-end. The City uses the consumption method for recognizing inventories and prepayments. On July 1, 2006, the City leased computer equipment for use in the City's general activities. The lease is a three-year lease that qualifies as an operating lease. The City prepaid the entire three-year rental fee of \$45,000. At June 30, 2007, the appropriate account balances in the General Fund associated with this transaction would be

- a) Prepaid Lease \$0; Expenditures \$45,000; Fund Balance Reserved for Prepaid Lease \$0.
- b) Prepaid Lease \$30,000; Expenditures \$15,000; Fund Balance Reserved for Prepaid Lease \$30,000.
- c) Prepaid Lease \$30,000; Expenditures \$45,000; Fund Balance Reserved for Prepaid Lease \$30,000.
- d) **Prepaid Lease \$30,000; Expenditures \$15,000; Fund Balance Reserved for Prepaid Lease \$0.**

36. Pocahontas School District, an independent public school district, financed the acquisition of a new school bus by signing a note for \$90,000 plus interest on the unpaid balance at 6%. Annual principal payments of \$30,000, plus interest, are due each July 1. Assuming that the District maintains its books and records in a manner that facilitates the preparation of the fund financial statements, the appropriate entry in the General Fund at the date of acquisition is

- a) Debit Expenditures \$90,000; Credit Notes Payable \$90,000.
- b) Debit Fixed Assets \$90,000; Credit Notes Payable \$90,000.
- c) **Debit Expenditures \$90,000; Credit Other Financing Sources \$90,000.**
- d) Debit Fixed Assets \$90,000; Credit Other Financing Sources \$90,000.

37. Pocahontas School District, an independent public school district, financed the acquisition of a new school bus by signing a note for \$90,000 plus interest on the unpaid balance at 6%. Annual principal payments of \$30,000, plus interest, are due each July 1. Assuming that the District maintains its books and records in a manner that facilitates the preparation of the government-wide financial statements, the appropriate entry at the date of acquisition is

- a) Debit Expenditures \$90,000; Credit Notes Payable \$90,000.
- b) **Debit Fixed Assets \$90,000; Credit Notes Payable \$90,000.**
- c) Debit Expenditures \$90,000; Credit Other Financing Sources \$90,000.
- d) Debit Fixed Assets \$90,000; Credit Other Financing Sources \$90,000.

38. Star City leased a bulldozer for use in activities accounted for in the General Fund. The City paid \$30,000 and agreed to pay \$30,000 per year for 3 years. The bulldozer has a useful life of six years. The lease qualified as a capital lease. Assuming that the city maintains its books and records in a manner that facilitates the preparation of the fund financial statements, the appropriate entry in the General Fund at the date of acquisition would be

- a) Debit Expenditures \$120,000; Credit Cash \$30,000 and Other Financing Sources \$90,000.
- b) Debit Expenditures \$30,000 and Prepaid Lease \$90,000; Credit Cash \$30,000 and Other Financing Sources \$90,000.
- c) Debit Equipment \$120,000; Credit Cash \$30,000 and Other Financing Sources \$90,000.
- d) Debit Expenditures \$120,000; Credit Cash \$30,000 and Lease Payable \$90,000.

39. Star City leased a bulldozer for use in activities accounted for in the General Fund. The City paid \$30,000 and agreed to pay \$30,000 per year for 3 years. The bulldozer has a useful life of six years. The lease qualified as a capital lease. Assuming that the city maintains its books and records in a manner that facilitates the preparation of the government-wide financial statements, the appropriate entry at the date of acquisition would be

- a) Debit Expenditures \$120,000; Credit Cash \$30,000 and Other Financing Sources \$90,000.
- b) Debit Expenditures \$40,000 and Prepaid Lease \$80,000; Credit Cash \$30,000 and Other Financing Sources \$90,000.
- c) Debit Equipment \$120,000; Credit Cash \$30,000 and Lease Payable \$90,000.
- d) Debit Expenditures \$120,000; Credit Cash \$30,000 and Lease Payable \$90,000.

40. The City of Hiawatha issued \$10 million of term bonds as of April 1, 2004. The bonds bear interest at 6%, due and payable each October 1 and April 1. Assuming the City maintains its books and records in a manner that facilitates the preparation of its fund financial statements the appropriate entry to record interest on the debt at June 30, 2007 (the City's fiscal year-end) is

- a) Debit Expenditures \$300,000; Credit Interest Payable \$300,000.
- b) Debit Expenditures \$300,000; Credit Other Financing Uses \$300,000.
- c) Debit Expenditures \$300,000; Credit Due to Bondholders \$300,000.
- d) No entry required.

41. Banker County has outstanding \$5 million of term bonds that bear interest at 6% payable semiannually each January 30 and July 30. The County's fiscal year-end is 12/31. On December 28, 2006, the County transferred \$300,000 to the Debt Service Fund. At December 31, the maximum amount the Debt Service Fund may recognize as interest expenditure is

- a) \$150,000
- b) \$300,000.
- c) \$125,000.
- d) \$0.

42. Several years ago, Durham City issued \$1 million in zero coupon bonds due and payable in 2010. The bonds were sold at an amount to yield investors 6% over the life of the bonds. During the current year, how much interest expenditures would Durham City recognize related to these bonds?
- Difference between the present value of the bonds at the beginning of the period and the present value of the bonds at the end of the period.
 - Face amounts of bonds times 6%.
 - Book value of bonds times 6%.
 - None.**
43. The City of Holbrook transferred \$100,000 from the General Fund to the Debt Service Fund for payment of interest. The appropriate entry in the General Fund to record this transfer would be
- Debit Expenditures \$100,000; Credit Cash \$100,000.
 - Debit Other Financing Uses—Transfer Out \$100,000; Credit Cash \$100,000.**
 - Debit Fund Balance—Transfer Out \$100,000; Credit Cash \$100,000.
 - Debit Other Financing Sources—Transfer In \$100,000; Credit Cash \$100,000.
44. The City of Holbrook transferred \$100,000 from the General Fund to the Debt Service Fund for payment of interest. The appropriate entry in the Debt Service Fund to record this transfer would be
- Debit Cash \$100,000; Credit Revenue \$100,000.
 - Debit Cash \$100,000; Credit Other Financing Uses—Transfer Out \$100,000.
 - Debit Cash \$100,000; Credit Fund Balance—Transfer In \$100,000.
 - Debit Cash \$100,000; Credit Other Financing Sources—Transfer In \$100,000.**
45. Harris County transferred \$200,000 from the General Fund to the Motor Pool Internal Service Fund to pay for the use of automobiles during the first six months of FY 2007. The appropriate entry in the General Fund to record this transfer of cash would be
- Debit Expenditures \$200,000; Credit Cash \$200,000.**
 - Debit Other Financing Uses—Transfer Out \$200,000; Credit Cash \$200,000.
 - Debit Fund Balance—Transfer Out \$200,000; Credit Cash \$200,000.
 - Debit Other Financing Sources—Transfer In \$200,000; Credit Cash \$200,000.
46. Which of the following items is NOT an example of an item that would be reported as Other Financing Sources/Uses in the General Fund?
- \$10 million received from the issuance of bonds.
 - \$7,000 received from the sale of a used bulldozer.
 - \$200,000 capital lease obligation for a new bulldozer.
 - \$100,000 paid to a Motor Pool Internal Service Fund for automobile usage during the period.**
47. Other financing sources/uses would appear on which of the following statements?
- Balance sheet.
 - Statement of Revenues, Expenditures, and Changes in Fund Balance.**
 - Cash flow statement.
 - None of the above.

48. State employees earn \$10 million in vacation leave. \$7 million is paid in the current year and the remaining amount is deferred to future years. Which of the following the accounts will be **credited** in the general fund entry and the government-wide entry?

General Fund

Government-wide

- | | |
|--------------------------------|-----------------------------|
| a) Cash | Cash & Accrued Vacation Pay |
| b) Cash & Accrued Vacation Pay | Cash |
| c) Cash | Cash |
| d) Cash | No Entry |
| e) No Entry | Cash |

49. The construction of a Bike Path in Bay City was accounted for in a capital projects fund. Financing for the project came from the following sources:

| | |
|---|-----------|
| Transfer from Bay City's general fund | \$10,000 |
| Proceeds from general obligation bond issue | \$100,000 |
| Grant from state government | \$50,000 |

Which of the following amounts should appear in this year's governmental funds statement of revenues, expenditures, and changes in fund balances for Other Financing Sources?

- a) \$160,000
- b) **\$110,000**
- c) \$100,000
- d) \$10,000
- e) \$60,000

PROBLEMS (CHAPTER 5)

1. Employees of the City of Hastings are paid from the general fund semi-monthly on the 15th day and the last day of the month. The City provides numerous employee benefits. Employees earn ten vacation days for each 12 months of employment. The employee can take the vacation during any summer months (May-September) prior to retirement. The employees also earn one sick day for each month of employment. Sick pay vests at the completion of five years of continuous service. Vested unused sick pay will be paid upon retirement or termination. The City contributes to a retirement plan that is administered by the State. Each year the City gets a statement from the State explaining the actuarially determined contribution required.

The City recognizes revenues/expenditures when collected/paid or if collected/paid within 60 days of year-end. The City's fiscal year end is December 31. At the beginning of the current year employees had \$.4 of earned vacation time and \$7 million of vested earned sick leave. The City uses the FIFO method of accounting for vacation and sick days.

REQUIRED: Assuming that the City maintains its books and records in a manner to facilitate the preparation of its fund financial statements, record the following transactions related to employee salaries and benefits. Be sure to make ALL necessary entries.

- a. During the year employees of the City earned \$50 million. At year-end all but \$2 had been paid to the employees.
- b. During the year the employees of the City earn \$2 million in vacation pay. By year-end the employees had taken \$1.5 million of vacation. Of the balance of vacation pay due to the employees, the City estimates that \$.3 will be taken during the next year and \$.2 will be deferred until later.
- c. During the year the employees of the City earned \$3 million in sick pay, of which \$2.5 is expected to vest. Of the 2.5 million, employees are expected to take \$2.0 million and \$.5 is expected to be paid to employees upon their termination or retirement. During the year employees took \$1 million in sick days.
- d. The City received a statement from the State requiring a contribution to the Retirement Plan of \$7 million for the current year. Because of a cash shortage the City paid \$5 of the required contribution during the year, \$1.5 million on February 15 of the following year and \$.5 in June of the following year.

2. During the year the City of Hamburg engaged in the following transactions. The City uses the consumption method of recording inventories and prepayments. The City has a 6/30 fiscal year end. REQUIRED: Record the following transactions related to supplies, prepaid items and fixed asset acquisitions. Be sure to make ALL necessary entries.
- a. During the year the City purchases \$600,000 of expendable supplies.
 - b. On September 1 the City paid \$360,000 for a three-year insurance policy to cover some assets used in general government activities.
 - c. On December 1 the City purchased four pickup trucks for general government activities. The trucks cost \$100,000 in total.
 - d. On January 1 the City leased some office equipment for use in the administrative offices. The lease qualified as a capital lease. The present value of the minimum lease payments is \$96,000.
 - e. On April 1 the City leased a copying machine. The lease qualified as an operating lease. The terms of the lease require yearly payments of \$2,000 each April 1 for 5 years. The City prepaid the entire five years of the lease.

3. The City of Jonesboro engaged in the following transactions during the fiscal year ended September 30, 2007. **REQUIRED:** Record the following transactions related to interfund transfers. Be sure to make ALL necessary entries and to indicate in which fund the entry is being made.
 - a. The City transferred \$300,000 from the General Fund to the Debt Service Fund to make the interest payments due during the fiscal year. The payments due during the fiscal year were paid. The City also transferred \$150,000 from the General Fund to the Debt Service Fund to advance fund the \$150,000 interest payment due October 15, 2006.
 - b. The City transferred \$75,000 from the Air Operations Special Revenue Fund to the General Fund to close out the operations of that fund.
 - c. The City transferred \$130,000 from the General Fund to the City Electric Utility Enterprise Fund to pay for the utilities used by the general and administrative offices during the year.
 - d. The City transferred the actuarially determined pension contribution of \$2 million from the General Fund to the City's Pension Trust Fund.
 - e. The City deposited into the General Fund the proceeds of a \$5.5 million dollar bond issue. The bonds were sold for \$5.6 million.

4. During the year, the City of Pittsboro engaged in the following transactions. The City has a 12/31 fiscal year end. REQUIRED: assuming that the City maintains its books and records in a manner to facilitate the preparation of its fund financial statements, record the following transactions related to fixed asset acquisition and payments on long-term debt.
- a. On April 1, 2007, the City acquired a piece of equipment for \$140,000. The equipment will be used by the Street Department. The City financed the purchases by borrowing \$140,000 from the local bank at 5% interest. Principal payments of \$20,000 plus interest are due yearly each April 1.
 - b. The City paid \$30,000 to employees who retired during the current year. These payments were made to compensate the employees for sick pay that had been earned but unused over the many years of the employees' service to the City
 - c. The City transferred \$1,500,000 from the General Fund to the Debt Service Fund to make principal and interest payments during the current year.
 - d. The City made payments of \$1 million principal and \$500,000 interest on bonds that had been outstanding for several years.
 - e. On June 1, the City paid \$4,000 on account. The City owed for supplies purchased in May.
 - f. On September 1, 2007, the City acquired several computers through a leasing agreement that qualified as a capital lease. The terms of the lease require yearly annual payments. The present value of the minimum lease payments is \$50,000.

5. A State has the following transactions during its fiscal year ending June 30, 2007. The State defines available as within 60 days of year-end. REQUIRED: Prepare journal entries to record each of these transactions in the State's General Fund. Comment on how each of these transactions would be different when reported in the State's government-wide financial statements.

a. The State issues \$50 million of 30-year debt to finance renovations to its capitol building. Due to changes in interest rates, the State receives only \$49.2 million in cash.

b. The State workers earn \$45 million in wages during the year. However, in an effort to balance its budget, the State defers payment of \$2 million in wages until July 5, 2007.

c. Required contributions for pension benefits for 2007 are \$7 million, which the state transfers to its pension trust fund.

d. The State makes grants of \$5.5 million based on a formula to school districts within its boundaries. The schools must use these grants to finance operating expenditures incurred during the current fiscal year.

e. The State agrees to share \$6.0 million of its 2007 sales (derived tax) revenues with all towns within its boundaries based on a formula established by the legislature. The resources must be used by the towns during the state's next fiscal year (2008).

f. The state makes interest and principal payments on its bonded debt during the period of \$17.0 million.

6. The Sadie School District is considering six different options for purchasing new computer equipment. REQUIRED: Show the journal entries that would be required in the District's General Fund to both recognize the acquisition of the new computers and to pay for it under each of these options. Which of these options would best achieve interperiod equity for the District? Why?

a. Buy the computers outright with cash; cost will be \$60,000

b. Buy the computers and finance them with a \$60,000, three-year, 10% note. The District will repay the note and pay the entire interest with a single payment of \$79,860 when the note matures.

c. Buy the computers and finance them with a \$60,000, three-year 10% installment note. The district will repay the note (plus interest) in three annual installments of \$24,127 each.

d. Lease the computers under an operating lease, but prepay the entire rent (\$60,000) in advance. (Assume it is the District's policy to use the purchases method for reporting prepayments.)

e. Lease the computers under a capital lease, requiring three end-of-year payments of \$24,127.

f. Lease the computers under an operating lease, making three end-of-year payments of \$24,127.

7. The following schedule shows the amounts related to supplies that a city debited and credited to the indicated accounts during a year (not necessarily the year-end balances), excluding closing entries. The organization records its budget, encumbers all of its expenditures, and initially vouchers all payments. It accounts for supplies on a **purchases** basis.
- D. Some information is missing. By reconstructing the entries that the organization made during the year, you are to determine the missing data. You need not show the entries; simply fill in the blanks. The city began the year with \$5,000 of supplies in inventory and ended the year with \$6,500.

| | <i>Debits</i> | <i>Credits</i> |
|--------------------------------|-----------------------|----------------|
| | <i>(in thousands)</i> | |
| Cash | \$ 0 | \$ 70 |
| Vouchers payable | — | — |
| Appropriations | 0 | 115 |
| Encumbrances | — | — |
| Expenditures | 58 | 0 |
| Reserve for encumbrances | 58 | 93 |
| Fund balance | — | 0 |
| Reserve for supplies inventory | — | — |

- E. Assume instead that the city accounts for supplies on a **consumption** basis.
1. Which of the above amounts (assuming that appropriations remained unchanged) would be different. What would be the new value(s)?
 2. When applying the consumption method, some governments either elect or are required to offset “supplies inventory” with “fund balance – reserved for inventory” rather than “fund balance – unreserved.” What is the rationale for such practice?
- C. The mayor of the city requests your advice as to whether it is actually necessary to (1) incorporate the budget into the accounting system and (2) use fund accounting. What would be your response?

8. The following relate to the Central School District.

In January 2007, the district acquires \$300,000 of equipment by way of a capital lease. The lease, which incorporates an annual interest rate of 6 percent, requires the district to make four annual payments of \$86,577. The equipment has a useful life of four years with no expected salvage value. In 2007, the district makes the first of the required payments.

1. Prepare all journal entries that the district should make in an appropriate **governmental fund** to record the acquisition of the equipment and the first lease payment.
2. How much expense relating to the equipment should the district recognize in its 2007 **government-wide** statements? Specify the account or accounts to be charged and the amount to be charged to each account.

ESSAYS (CHAPTER 5)

1. When a governmental entity finances the purchases of a fixed asset, the acquisition is treated as an expenditure and reduces net financial resources during the year of acquisition. During the years that principal and interest payments are being made on the debt incurred to finance the fixed asset acquisition, the amount of the principal and interest is also treated as expenditures. This appears to reduce the net financial resources by twice the cost of the fixed asset. Discuss these transactions and their overall effect on the net financial resources of the governmental entity.
2. In the governmental fund types, expenditures are generally recognized when resources are acquired. Liabilities are generally recognized if they will be liquidated with available expendable financial resources. Define 'available.' Relate the definition of available to the recognition of liabilities and expenditures in governmental fund-type financial statements. Discuss the reporting deficiencies that are directly associated with the use of the 'available' criterion in the governmental fund-types.
3. Paid vacations, paid sick-leave, and pensions are employee benefits frequently offered by governmental entities. Discuss the reporting requirements related to each of these benefits and explain, if necessary, any differences between reporting for vacation pay earned but unused, sick leave earned but unused, and pensions earned during the current period.

ANSWERS TO TRUE/FALSE (CHAPTER 5)

1. True
2. True
3. True
4. False
5. False
6. False
7. True
8. True
9. False
10. True
11. True

ANSWERS TO MULTIPLE CHOICE (CHAPTER 5)

1. B
2. C
3. B
4. A
5. C
6. D
7. C
8. D
9. C
10. D
11. D
12. D
13. B
14. A
15. B
16. A
17. B
18. B
19. C
20. B
21. B
22. D
23. C
24. A
25. A
26. D
27. A
28. A
29. C
30. C
31. C
32. D
33. A
34. B

- 35. D
- 36. C
- 37. B
- 38. A
- 39. C
- 40. D
- 41. C
- 42. D
- 43. B
- 44. D
- 45. A
- 46. D
- 47. B
- A

49. B

ANSWERS TO PROBLEMS (CHAPTER 5)

Problem 1

| | | | |
|----|------------------------------|---------------|---------------|
| a. | GENERAL FUND | | |
| | Salary Expenditures | \$50 million | |
| | Cash | | \$48 million |
| | Salaries Payable | | \$ 2 million |
| b. | GENERAL FUND | | |
| | Vacation Pay Expenditures | \$1.5 million | |
| | Cash | | \$1.5 million |
| | SCHEDULE OF LONG-TERM DEBT | | |
| | Vacation Pay Payable | | \$.5 million |
| c. | GENERAL FUND | | |
| | Sick Pay Expenditures | \$ 1 million | |
| | Cash | | \$ 1 million |
| | SCHEDULE OF LONG-TERM DEBT | | |
| | Sick Pay Payable | | \$.5 million |
| d. | GENERAL FUND | | |
| | Pension Expenditure | \$6.5 million | |
| | Cash | | \$ 5 million |
| | Pension payable | | \$1.5 million |
| | SCHEDULE OF LONG-TERM DEBT | | |
| | Pension Contribution Payable | | \$.5 million |

Problem 2

| | | |
|--------------------------------|-----------|-----------|
| a. GENERAL FUND | | |
| Supplies Inventory | \$600,000 | |
| Cash | | \$600,000 |
| b. GENERAL FUND | | |
| Prepaid Insurance | \$360,000 | |
| Cash | | \$360,000 |
| c. GENERAL FUND | | |
| Expenditures | \$100,000 | |
| Cash | | \$100,000 |
| | | |
| SCHEDULE OF LONG-TERM ASSETS | | |
| Equipment | \$100,000 | |
| d. GENERAL FUND | | |
| Expenditures | \$ 96,000 | |
| Other Financing Sources-Leases | | \$ 96,000 |
| | | |
| SCHEDULE OF LONG-TERM DEBT | | |
| Obligation under Capital Lease | | \$ 96,000 |
| | | |
| SCHEDULE OF LONG-TERM ASSETS | | |
| Equipment | \$ 96,000 | |
| e. GENERAL FUND | | |
| Prepaid Lease | \$ 10,000 | |
| Cash | | \$ 10,000 |

Problem 3

| | | |
|---------------------------------------|---------------|---------------|
| a. GENERAL FUND | | |
| Other Financing Uses—Transfer Out | \$450,000 | |
| Cash | | \$450,000 |
| DEBT SERVICE FUND | | |
| Cash | \$450,000 | |
| Other Financing Sources—Transfer in | | \$450,000 |
| DEBT SERVICE FUND | | |
| Expenditures | \$450,000 | |
| Cash | | \$300,000 |
| Interest payable | | 150,000* |
| b. GENERAL FUND | | |
| Cash | \$ 75,000 | |
| Other Financing Source—Transfer in | | \$ 75,000 |
| SPECIAL REVENUE FUND | | |
| Other Financing Uses—Transfer out | \$ 75,000 | |
| Cash | | \$ 75,000 |
| c. GENERAL FUND | | |
| Expenditures** | \$130,000 | |
| Cash | | \$130,000 |
| ENTERPRISE FUND | | |
| Cash | \$130,000 | |
| Revenue** | | \$130,000 |
| d. GENERAL FUND | | |
| Expenditures | \$2 million | |
| Cash | | \$2 million |
| PENSION TRUST FUND | | |
| Cash | \$2 million | |
| Revenue | | \$2 million |
| e. GENERAL FUND | | |
| Cash | \$5.6 million | |
| Other Financing Sources—Bond Proceeds | | \$5.6 million |
| SCHEDULE OF LONG-TERM DEBT | | |
| Bonds Payable | | \$5.5 million |

*Accruing a debt service payment that is due early in the next year is optional. Students may not include this entry.

**Students may treat these as having been previously accrued. If so, the entries will be to Due to or Due from accounts.

Problem 4

| | | |
|---|---------------|---------------|
| a. GENERAL FUND OR SPECIAL REVENUE FUND | | |
| Cash | \$140,000 | |
| Other Financing Source—Loan Proceeds | | \$140,000 |
| Expenditure | \$140,000 | |
| Cash | | \$140,000 |
| | | |
| SCHEDULE OF LONG-TERM ASSETS | | |
| Equipment | 140,000 | |
| | | |
| SCHEDULE OF LONG-TERM DEBT | | |
| Notes Payable | \$140,000 | |
| | | |
| b. GENERAL FUND | | |
| Expenditures | \$ 30,000 | |
| Cash | | \$ 30,000 |
| | | |
| SCHEDULE OF LONG-TERM DEBT | | |
| Sick Pay Liability | \$ (30,000) | |
| | | |
| c. GENERAL FUND | | |
| Other Financing Uses—Transfer Out | \$1.5 million | |
| Cash | | \$1.5 million |
| | | |
| DEBT SERVICE FUND | | |
| Cash | \$1.5 million | |
| Other Financing Sources—Transfer In | | \$1.5 million |
| | | |
| d. DEBT SERVICE FUND | | |
| Expenditure | \$1.5 million | |
| Cash | | \$1.5 million |
| | | |
| e. GENERAL FUND | | |
| Accounts Payable | \$ 4,000 | |
| Cash | | \$ 4,000 |
| | | |
| f. GENERAL FUND | | |
| Expenditure | \$ 50,000 | |
| Other Financing Source—Capital Lease | | \$ 50,000 |
| | | |
| SCHEDULE OF LONG-TERM ASSETS | | |
| Computers | \$ 50,000 | |
| | | |
| SCHEDULE OF LONG-TERM DEBT | | |
| Lease Obligation | \$ 50,000 | |

Problem 5

| | | | |
|----|---------------------------------------|------|------|
| a. | Cash | \$50 | |
| | Other Financing Sources—Debt proceeds | | \$50 |

In its government-wide statements, debt proceeds would be reported as a liability on the statement of net assets, not as a financing source.

| | | | |
|----|---------------|------|------|
| b. | Expenditures | \$45 | |
| | Cash | | \$43 |
| | Wages payable | | 2 |

The effect of this transaction would be identical in the government-wide statements.

| | | | |
|----|--------------|------|------|
| c. | Expenditures | \$ 7 | |
| | Cash | | \$ 7 |

The effect of this transaction would be identical in the government-wide statements.

| | | | |
|----|--------------|--------|--------|
| d. | Expenditures | \$ 5.5 | |
| | Cash | | \$ 5.5 |

The effect of this transaction would be identical in the government-wide statements.

e. No entry is required. Because the grant resources have a time requirement that has not yet been met, the effect of this transaction would be identical in the government-wide statements.

| | | | |
|----|--------------|------|------|
| f. | Expenditures | \$17 | |
| | Cash | | \$17 |

This transaction would be separated into two for purposes of the government-wide financial statements. The portion representing interest would be reported as a reduction of interest payable (if accrued) and as interest expense. The portion representing principal repayments would be reported as a reduction of long-term liabilities.

in the third year. (The effect of issuing the debt and reporting an expenditure for the entire cost of the capital asset in the first year has zero effect on fund balance.) Options c, e, and f all charge a portion of the cost of the computers to each year. Assuming the computers have a three-year life, this is an appropriate allocation comparable to depreciation expense.

Problem 7

A.

| | <u>Debits</u> <i>(in thousands)</i> | <u>Credits</u> |
|-----------------------------------|--|----------------|
| Cash | \$ 0 | \$ 70 |
| Vouchers payable | <u>70</u> | <u>58</u> |
| Appropriations | 0 | 115 |
| Encumbrances | <u>93</u> | <u>58</u> |
| Expenditures | 58 | 0 |
| Reserve for encumbrances | 58 | 93 |
| Fund balance | <u>115</u> | 0 |
| Reserve for supplies inventory | <u>5.0*</u> | <u>6.5*</u> |
| <i>*Or simply a credit of 1.5</i> | | |

B.

1. Expenditures would be \$1,500 less – i.e. \$56,500
2. Governments are required to offset inventory when they must maintain a minimum inventory balance that is not available for use and therefore cannot be expended. Even when not required, many government establish the reserve to indicate that the fund balance offsetting the inventory is not available for appropriation.

C.

Both budgetary entries and fund accounting are means to enhance internal controls. They help assure that (1) the government does not overspend its budget and (2) that restricted resources are expended only for appropriate purposes. The key issue is whether the added inconvenience (and cost) of budgetary entries and fund accounting is worth the added benefits.

Problem 8

| | | |
|---|---------|--------|
| 1. Expenditure – acquisition of equipment | 300,000 | |
| Other financing sources – Capital lease | 300,000 | |
| Interest expenditure | 18,000 | |
| Principal expenditure | 68,577 | |
| Cash | | 86,577 |
| 2. | | |
| Depreciation expense | 75,000 | |
| Interest expense | 18,000 | |

ANSWERS TO ESSAY (CHAPTER 5)

1. Although it does appear that the cost of the asset has been expensed twice, the apparent double counting of the expenditures does not misstate fund balance. At the time of acquisition the asset is treated as an expenditure and reduces fund balance by the amount of the acquisition. Simultaneously, the financing mechanism (note proceeds, bond proceeds, capital lease obligations, etc.) are treated as an Other Financing Source which increases fund balance by the amount of the financing. In the year of acquisition, a fully financed asset will have zero effect on fund balance even though it is treated as an expenditure. During the following periods, the principal payments on the financing mechanism are treated as expenditures and reduce fund balance (usually in a debt service fund) over the financing period.
2. Expenditures are generally recognized as resources are acquired. This means that supplies, prepaid items, and fixed assets acquired during the period are generally treated as expenditures and appear on the operating statement as reductions of fund balance. Liabilities are recognized if they will use available expendable financial resources. Since 'available' means 'collectible within the current period or soon enough thereafter to be used to pay liabilities of the current period,' problems arise when items are acquired in the current period but will not require the use of available expendable resources until future periods. Since there is no notion of 'current' related to the governmental fund-types, it is difficult to determine what expenditures and their associated liabilities should be recognized in the current period. Vacation benefits, sick pay benefits to be paid upon termination, pension obligations, and claims to be paid in the future are but a few examples of costs associated with the current period that may not be recognized in the governmental-fund operating statements of the current period. The liabilities are recognized in governmental activities column in the government-wide statement of net assets, but no expenditure or liability is recognized in the governmental funds. The current standards frequently understate the costs incurred by the government in the current period. As a result it is easier for governments to pass on to future generations the costs of goods and services consumed by current period taxpayers. Interperiod equity is generally not accomplished by using the current accounting model. Fortunately, the requirement to fully report all these obligations in the government-wide financial statements ameliorates this shortcoming.

3. The value of all employee benefits should be accrued as a liability as the benefits are earned by the employees if both of the following benefits are met:
 - The employees' rights to receive compensation are attributable to services already rendered.
 - It is probable that the employer will compensate the employees for the benefits through paid time off or some other means, such as cash payments at termination or retirement.

Problems arise because many of these benefits are recorded in governmental funds, which do not permit recognition of certain long-term liabilities. This means that only vacation pay earned but unused that will be paid out of available expendable resources is recorded as an expenditure and a liability in governmental funds. Fortunately, the entire liability for vacation pay is reported in the governmental activities column of the government-wide statement of net assets.

Sick pay earned but unused is recorded on the accrual basis if it will be paid upon termination or retirement. Payment of any remaining days earned is contingent upon a future and uncertain event and is not given recognition until the event (illness) occurs. In the governmental funds, sick pay is recorded as an expenditure and a liability only when it is due and payable (for example, when an employee retires or plans to retire soon after year-end). The entire obligation for vested benefits is reported in the governmental activities column in the government-wide statement of net assets.

Pensions earned by employees in the current period, to be paid by the government in distant future periods, are recognized as expenditures and a liability in governmental funds only to the extent that required contributions to the plan are made or will be made from available expendable financial resources. Unpaid required contributions are reported as liabilities in the governmental activities column in the government-wide statement of net assets.

Such a system can grossly understate the costs associated with the current period. Citizens can be misled about the cost of having governmental employees. If tax levies ignore the noncurrent portion of these obligations, future taxpayers will be left to pay them. Fortunately, the new government-wide financial statements require recognition of all expenses and obligations on the full accrual basis of accounting.

Chapter 6

Accounting for Capital Projects and Debt Service

TRUE/FALSE (CHAPTER 6)

1. TThe resources to service all general long-term debts of the governmental entity are typically accounted for in debt service funds.
2. TWhen governments establish capital projects funds, they may choose to maintain a separate fund for each major project, or they may choose to combine two or more projects in a single fund.

3. T Governments are required to integrate budgetary account information in their debt service and capital projects funds only when control cannot readily be established by means other than a budget.
4. T Capital projects funds do not report long-term obligations in the fund.
5. T When bonds are issued at a premium, the capital projects fund can transfer those excess resources to the debt service fund.
6. F When bonds are issued at a discount, the debt service fund usually transfers an amount to the capital projects fund to make up for the deficiency.
7. F In accounting for costs incurred on a major construction project in a capital projects fund, the construction outlays would be reported in the fund as general capital assets.
8. T Debt service funds are maintained to account for resources accumulated to pay interest and principal on general long-term debt—that is, long-term debt associated primarily with governmental activities.
9. T In contrast to the accounting for debt service fund expenditures, the interest revenue on bonds held as investments should be accrued in the period the revenue is earned.
10. T Special assessments are imposed nonexchange transactions, similar to property tax levies.
11. F The interest paid on debt issued for public purposes by state and local governments is generally subject to federal taxation.
12. T Nongovernmental not-for-profits must account for defeasances differently than governments.

MULTIPLE CHOICE (CHAPTER 6)

1. The capital projects fund of a governmental entity is accounted for using which of the following bases of accounting?
 - a) **Budgetary basis.**
 - b) Cash basis.
 - c) Modified accrual basis.
 - d) Accrual basis.

2. In which fund type would a governmental entity's capital projects fund be found?
 - a) **Governmental fund type.**
 - b) Proprietary fund type.
 - c) Fiduciary fund type.
 - d) Governmental activities.

3. The debt service fund of a governmental entity is accounted for using which of the following bases of accounting?
 - a) Budgetary basis.
 - b) **Cash basis.**
 - c) Modified accrual basis.
 - d) Accrual basis.

4. In which fund type would a governmental entity's debt service fund be found?
 - a) **Governmental fund type.**
 - b) Proprietary fund type.
 - c) Fiduciary fund type.
 - d) Governmental activities.

5. With regard to the resources dedicated to the acquisition of fixed assets that will be used in general government activities, which of the following is true?
 - a) **Governments must maintain capital projects funds for resources that are legally restricted to the acquisition of fixed assets.**
 - b) Governments may maintain capital projects funds for resources that are legally restricted to the acquisition of fixed assets.
 - c) Governments may account for any resources dedicated (whether legally or not) to the acquisition of fixed assets in any of the governmental funds.
 - d) Government must account for all resources set aside for fixed asset acquisition in a capital projects fund.

6. Salt City issued \$5 billion of bonds at face value to fund the reconstruction of the major interstate highways in and around their city. The bond underwriters withheld \$2 million for underwriting fees and remitted the balance to the City. Assuming the City maintains its books and records in a manner that facilitates the preparation of fund financial statements, how would the underwriting fee be accounted for in the capital projects fund?
 - a) Reduce Other Financing Sources by \$2 million.
 - b) Reduce Bonds Payable by \$2 million.
 - c) **Increase Expenditures by \$2 million.**
 - d) It would not be accounted for in the capital projects fund.

7. Sugar City issued \$2 million of bonds to fund the construction of a new city office building. The bonds have a stated rate of interest of 5% and were sold at 101. Which of the following entries should be made in the Capital Projects Fund to record this event?
- Debit Cash \$2.02 million; Credit Bonds Payable \$2 million and Premium on Bonds Payable \$.02 million.
 - Debit Cash \$2.02 million; Credit Bonds Payable \$2 million and Other Financing Sources \$.02 million.
 - Debit Cash \$2.02 million; Credit Other Financing Sources \$2.02 million.**
 - Debit Cash \$2.02 million; Credit Other Financing Sources \$2 million and Revenue \$.02 million.

Use the following information to answer questions #8 and #9

Voters in Lincoln School District approved the construction of a new high school and approved a \$10 million bond issue with a stated rate of interest of 6% to fund the construction. Bids were received and the low bid was \$10 million. When the bonds were issued, they sold for face value less bond underwriting fees of \$.5 million. The School Board voted to fund the balance of the construction by a transfer from the general fund.

8. The entry in the capital projects fund to record the receipt of the bond proceeds would be
- Debit Cash \$9.5 million; Credit Bonds Payable \$9.5.
 - Debit Cash \$9.5 million; Credit Other Financing Sources \$9.5.
 - Debit Cash \$9.5 million and Expenditures \$.5 million; Credit Bonds Payable \$10 million.
 - Debit Cash \$9.5 million and Expenditures \$.5 million; Credit Other Financing Sources \$10.**
9. The entry in the capital projects fund to record the additional funding for the construction would be
- Debit Due from General Fund \$.5 million; Credit Other Financing Sources—Transfer \$.5 million.**
 - Debit Due from General Fund \$.5 million; Credit Revenue \$.5 million.
 - Debit Cash \$.5 million; Credit Due to General Fund \$.5 million.
 - Debit Other Financing Sources \$.5 million; Credit Due to General Fund \$.5 million.

Use the following information to answer questions #10 and #11

Voters in Phillips City approved the construction of a new city hall building and approved a \$10 million bond issue with a stated rate of interest of 6% to fund the construction. When the bonds were issued, they sold for 101. What are appropriate entries related to the premium?

10. In the capital projects fund
- Debit Cash \$100,000; Credit Revenues \$100,000; no other entries required.
 - Debit Cash \$100,000; Credit Other Financing Sources—Transfer \$100,000; No other entries required.
 - Debit Cash \$100,000; Credit Revenues; ALSO Debit Other Financing Uses—Transfer \$100,000; Credit Cash \$100,000.
 - Debit Cash \$100,000; Credit Other Financing Sources—Bond Premium \$100,000; ALSO Debit Other Financing Uses—Transfer \$100,000; Credit Cash \$100,000.**

11. In the debt service fund
- a) Debit Cash \$100,000; Credit Revenues \$100,000; no other entries required.
 - b) **Debit Cash \$100,000; Credit Other Financing Sources—Transfer \$100,000; No other entries required.**
 - c) Other Financing Sources—Transfer \$100,000; credit Cash \$100,000.
 - d) No entry in the Debt Service Fund.

Use the following information to answer question #12 and #13.

The voters in Ohio City approved the construction of a new city hall building and approved a \$10 million bond issue with a stated rate of interest of 6% to fund the construction. When the bonds were issued, they sold for 99. Assuming that the City's has agreed to transfer money from its General Fund to make up the difference, what are appropriate entries related to the discount?

12. In the capital projects fund
- a) Debit Due from General Fund \$100,000; Credit Revenues \$100,000.
 - b) **Debit Due from General Fund \$100,000; Credit Other Financing Sources—Transfer \$100,000; No other entries required.**
 - c) Debit Other Financing Uses—Transfer \$100,000; Credit Cash \$100,000.
 - d) No entry in the Capital Projects Fund.

13. In the debt service fund
- a) Debit Cash \$100,000; Credit Revenues \$100,000; no other entries required.
 - b) Debit Cash \$100,000; Credit Other Financing Sources—Transfer \$100,000; No other entries required.
 - c) Other Financing Sources—Transfer \$100,000; credit Cash \$100,000.
 - d) **No entry in the Debt Service Fund.**

14. Sister City was notified by the State that they had been awarded a \$6 million grant to aid in the construction of a senior citizens center. At the time of the notification what is the appropriate entry in the capital projects fund (assuming that the City has met all eligibility requirements and maintains its books and records in a manner to facilitate the preparation of the fund financial statements)?
- a) No entry at the time of the notification.
 - b) **Debit Grants Receivable \$6 million; Credit Revenue \$6 million.**
 - c) Debit Grants Receivable \$6 million; Credit Deferred Revenue \$6 million.
 - d) Debit Grants Receivable \$6 million; credit Other Financing Sources—Transfer \$6 million.

15. Previously Rose City issued bonds with a face value of \$10 million to construct a new city maintenance facility. Assuming that the City maintains its books and records in a manner that facilitates the preparation of the fund financial statements, what is the appropriate entry when the City receives a progress billing from the contractor?

- a) Debit Building; Credit Cash
 - b) Debit Building; Credit Accounts Payable.
 - c) **Debit Expenditure; Credit Accounts Payable.**
 - d) No entry is required.

16. Previously Atomic City had issued bonds with a face value of \$10 million to construct a new city hall. Because the money will not be needed for several months, the city invested the bond proceeds in U.S. Government securities. Assuming that the city maintains its books and records in a manner that facilitates the preparation of the fund financial statements, what is the appropriate entry when the City receives interest on the investments?
- a) Debit Cash; Credit Revenue.
 - b) Debit Cash; Credit Other Financing Source
 - c) Debit Cash; Credit Deferred Revenue
 - d) No entry required.
17. A City issued bonds for the purpose of financing a major capital improvement. Which fund is the most appropriate fund in which to record the receipt of the bond proceeds?
- a) General Fund.
 - b) Special Revenue Fund.
 - c) Capital Projects Fund.
 - d) Debt Service Fund.
18. Use of a Debt Service Fund is required
- a) When financial resources are being accumulated for the purpose of paying for capital asset acquisition.
 - b) When financial resources are being accumulated for the purpose of paying principal and interest when it matures.
 - c) For all bonded debt service payments.
 - d) For all debt service payments.
19. Six years ago Hill City issued \$10 million of 6% term bonds, due 30 years from the date of issue. Interest on the bonds is payable semi-annually on January 1 and July 1. Hill City has a September 30 fiscal year end. The amount of interest payable that would be included on the balance sheet for the debt service fund of Hill City at September 30 would be
- a) \$ -0-.
 - b) \$150,000.
 - c) \$300,000.
 - d) \$600,000.

Use the following information to answer questions #20 and #21.

Several years ago, the City of Russell issued \$5 million of 6% serial bonds at 101. Principal payments of \$250,000 are due each June 30 for 20 years. Interest on the bonds is payable each December 31 and June 30. As of June 30, 2006, the City has not paid the June 30 principal and interest payment.

20. The amount of interest payable (assuming an outstanding balance of \$4,000,000 of bonds) that would be included on the balance sheet for the debt service fund of the City of Russell at June 30, 2006 would be
- a) \$ -0-
 - b) **\$120,000.**
 - c) \$150,000.
 - d) \$300,000.
21. The amount of bonds payable that should be included on the balance sheet for the debt service fund of the City of Russell at June 30, 2006 would be
- a) **\$0.**
 - b) \$250,000.
 - c) \$500,000.
 - d) \$2,250,000.
22. Sue City has outstanding \$5 million in general obligation term bonds used to finance the construction of the new City Library. Sue City has a June 30 fiscal year-end. Interest at 6% is payable each January 1 and July 1. The principal of the bonds is due 10 years in the future. The City budgeted the July 1, 2006 interest payment in the budget for the fiscal year ended June 30, 2006. On June 30, cash was transferred from the General Fund to the Debt Service Fund to make the required payment. The maximum amount of interest payable that may be included on the balance sheet of the debt service fund of Sue City at June 30 would be
- a) \$ -0-
 - b) **\$150,000.**
 - c) \$300,000.
 - d) \$3,000,00.

Use the following information to answer questions #23 and #24

Lewis County uses a fiscal agent to distribute payments of interest to bondholders. Interest payments are due on July 1 of each year. The fiscal agent requires the County to transfer by June 20 the cash necessary to make the July 1 payments.

23. How would Lewis County account for the amount transferred on June 20 if the County maintains its books and records in a manner that facilitates the preparation of the fund financial statements?
- a) Debit Cash with Fiscal Agent and Expenditures; Credit Cash and Interest Payable.
 - b) **Debit Cash with Fiscal Agent and Interest Expense; Credit Cash and Interest Payable.**
 - c) Debit Expenditures; Credit Cash.
 - d) Debit Cash with Fiscal Agent; Credit Cash.
24. What entry would be made on June 30 related to this transfer?
- a) Debit Interest Payable; Credit Cash.
 - b) **Debit Interest Payable; Credit Cash with Fiscal Agent.**
 - c) Debit Expenditure; Credit Cash with Fiscal Agent.
 - d) No entry required.

25. Cascade County issued \$1 million of 6% term bonds at 101. These bonds will be used to finance the construction of highways. The entry in the debt service fund to record the receipt of cash should be
- a) **Debit Cash \$10,000; Credit Revenue, \$10,000.**
 - b) Debit Cash \$10,000; Other Financing Sources—Transfer, \$10,000.
 - c) Debit Cash \$1,010,000; Credit Bonds Payable \$1,000,000 and Premium on Bonds \$10,000.
 - d) Debit Cash \$1,010, 000; Credit Other Finances Sources—Transfer \$1,010,000.

Use the following information to answer questions #26 and #27

Calhoun County makes annual transfers from the general fund to the debt service fund to pay principal and interest on long-term debt.

26. When the County makes the transfer the entry in the debt service fund should be
- a) Debit Cash; Credit Revenue.
 - b) **Debit Cash; Credit Other Financing Sources—Transfer.**
 - c) Debit Cash; Credit Interest Payable.
 - d) Debit Cash with Fiscal Agent; Credit Other Financing Sources—Transfer.
27. In the debt service fund, what is the appropriate entry when the principal payment is made?
- a) Debit Bonds Payable; Credit Cash.
 - b) **Debit Expenditures; Credit Cash.**
 - c) Debit Other Financing Uses—Transfer; Credit Cash.
 - d) No entry is required.

Use the following information to answer questions #28 - #29.

The citizens of a specific area of the City of Arlington approved the construction of sidewalks in their residential neighborhood and approved a \$1 million bond issue to finance construction of those sidewalks. The citizens agreed to assess themselves for 20 years in an amount sufficient to pay principal and interest on the bonds. The City will oversee the construction of the sidewalks and act as agent for servicing the debt. The City does not guarantee the debt nor does it assume any legal or moral obligation for the bonds.

28. The proceeds of the bond issue should be recorded in which fund of the City of Arlington?
- a) Agency Fund.
 - b) Special Assessment Fund.
 - c) **Capital Projects Fund.**
 - d) Debt Service Fund.
29. When the City collects the special assessment, it should be accounted for in which fund of the City of Arlington?
- a) **Agency Fund.**
 - b) Special Assessment Fund.
 - c) Capital Projects Fund.
 - d) Debt Service Fund.

Use the following information to answer questions #30 - #32.

The citizens of a specific area of the City of Arlington approved the construction of sidewalks in their residential neighborhood and approved a \$1 million bond issue to finance construction of those sidewalks. The citizens agreed to a special assessment on their property for 20 years in an amount sufficient to pay principal and interest on the bonds. The City will oversee the construction of the sidewalks and act as agent for servicing the debt. If the special assessment is not sufficient to make the principal and interest payments, the City will assume the obligations.

30. The proceeds of the bond issue should be recorded in which fund of the City of Arlington?
- Agency Fund.
 - Special Assessment Fund.
 - Capital Projects Fund.**
 - Debt Service Fund.
31. When the City collects the special assessment, it should be accounted for in which fund of the City of Arlington?
- Agency Fund.
 - Special Assessment Fund.
 - Capital Projects Fund.
 - Debt Service Fund.**
32. When the City of Arlington levies the special assessment tax, the best entry would be
- Debit Special Assessments Receivable; Credit Revenues.
 - Debit Special Assessments Receivable; Credit Deferred Revenues.
 - Debit Special Assessments Receivable; Credit Liability.**
 - Debit Special Assessments Receivable; Credit Fund Balance.
33. Adams County has outstanding \$10 million in bonds issued by the County to construct a sewer system in a specific area of the county. The taxpayers in that area voted for the construction and the bonds and agreed to assess themselves to pay the principal and interest on the bonds. The County contracted for the construction and issued the bonds but the City assumed no legal or moral obligation for the bonds. If the special assessment payments are not sufficient to make the required principal and interest payments, the County will not make up the difference. The \$10 million of bonds should appear in which fund financial statements or schedule?
- Capital Projects Fund.
 - Special Assessment Fund.
 - Schedule of Long-term Obligations.
 - The bonds should not appear on the face of the financial statements of Adams County.**
34. The City of Twin Falls issued \$5 in special assessment bonds to finance major reconstruction of the turbines and facilities used in generating electricity that is sold to the citizens in the surrounding area. The electric power distribution activities are accounted for in an Enterprise Fund. The Enterprise Fund will service the debt. If the City is legally obligated for the debt, the appropriate entry in the City's Electric Enterprise Fund to record this event is
- Debit Plant Assets; Credit Bonds Payable.**
 - Debit Plant Assets; Credit Contributed Capital.
 - Debit Plant Assets; Credit Contributed Revenue.
 - No entry should be made in the Electric Enterprise Fund.

35. The City of Twin Falls issued \$5 in special assessment bonds to finance major reconstruction of the turbines and facilities used in generating electricity that is sold to the citizens in the surrounding area. The electric power distribution activities are accounted for in an Enterprise Fund. The Enterprise Fund will service the debt. If the City is NOT legally obligated for the debt, the appropriate entry in the City's Electric Enterprise Fund to record this event is
- a) Debit Plant Assets; Credit Bonds Payable.
 - b) Debit Plant Assets; Credit Capital Contributions.
 - c) Debit Plant Assets; Credit Retained Earnings.
 - d) **No entry should be made in the Electric Enterprise Fund.**
36. In early 2006, Jackson City issued \$10 million of 6% term bonds to finance a highway construction project. Because of problems related to the Endangered Species Act, the City deferred highway construction that year. In early 2007, the City entered into contracts for construction that will begin in summer 2007 and be completed by summer 2008. When the City realized they would not need the bond proceeds in 2007, they invested the proceeds in risk-free federal government securities bought to yield 7%. What potential arbitrage liability, if any, should the City recognize as a result of the year 2006 transactions?
- a) **None.**
 - b) The amount of the earnings from the federal government securities.
 - c) The amount of the interest paid on the term bonds.
 - d) The difference between the earnings from the federal government securities and the interest paid on the bonds.
37. Harbor City issued 6% tax-exempt bonds and used the proceeds to acquire federal government securities yielding 7%. After paying the interest on the tax-exempt bonds, the City cleared 1%. This is an example of
- a) An illegal act.
 - b) Poor fiscal management.
 - c) **Arbitrage.**
 - d) Debt refunding.
38. The City of St. Joe had outstanding \$5 million of 6% bonds with a call provision. Due to changes in the prevailing interest rates, the City issued new bonds at 4.5% and used the proceeds to call the 6% bonds. This is an example of
- a) Debt retirement.
 - b) **Debt refunding.**
 - c) In-substance defeasance.
 - d) Economic defeasance.

Use the following information to answer question #39 and #40.

Due to changes in the prevailing interest rates, Washington County has decided to issue new 5% bonds and place the proceeds with a trustee in a manner structured to satisfy all the GASB requirements for an in-substance defeasance of an existing 6.5% bond issue. The 6.5% bonds were originally issued to fund highway projects and the debt is reported in the Schedule of Long-term Obligations and in the governmental activities column of the government-wide financial statements. The old 6.5% bonds are still actively traded in the bond market and will be until their maturity. The new 5% bonds will be sold to an institutional buyer who may also sell them in the bond market.

39. What amount of gain or loss should be recognized on this transaction?
- a) None.
 - b) The difference between the total principal and interest payments on the old debt and the total principal and interest payments on the new debt.
 - c) **The difference between the present value of the principal and interest payments on the old debt and the present value of the principal and interest payments on the new debt.**
 - d) The difference between the economic cost and the call price.
40. Which bonds should be recognized in the Schedule of Long-Term Obligations?
- a) Neither the 6.5% nor the 5% bonds.
 - b) **Both the 6.5% bonds and the 5% bonds.**
 - c) Only the 6.5% bonds.
 - d) Only the 5% bonds.
41. A governmental entity has elected to issue new debt and use the proceeds to redeem existing debt because there is an economic gain in doing so. There is, however, an “accounting loss” associated with these events. An accounting loss is defined as
- a) **The present value of the principal and interest payments on the new debt less the present value of the principal and interest payments on the old debt.**
 - b) The present value of the principal and interest payments on the old debt less the present value of the principal and interest payments on the new debt.
 - c) The cash paid to redeem the old debt less the book value of the old debt.
 - d) The face value of the new debt less the cash paid to redeem the old debt.
42. The City of Williamsburg decided to defease old 6% bonds carried in its Electric Enterprise Fund with new 4.5% bonds. As a result of the defeasance, the City incurred an accounting loss. This loss should be recognized
- a) As an adjustment to retained earnings since it is applicable to prior periods.
 - b) In the year of the defeasance.
 - c) Over the remaining life of the old bonds or the new bonds, whichever is shorter.
 - d) **It should not be recognized.**

43. Assuming that the government is not obligated in any manner, the debt service transactions of a special assessment bond issue should be reported in a(n)

- a) Debt service fund
- b) Enterprise fund
- c) Special revenue fund
- d) Agency fund

44. Characteristics of capital projects include:

- a) Involves long-lived assets
- b) Usually requires long-range planning and extensive financing
- c) Usually has a year-to-year focus
- d) All of the above
- e) A & B only

PROBLEMS (CHAPTER 6)

1. The voters of Salt Lake City authorized the construction of a new north-south expressway for a total cost of no more than \$75 million. The voters also approved the issuance of \$50 million of 5% general obligation bonds. The balance of the necessary funds will come from the following sources: \$15 million from a federal grant and \$10 million from a state grant. The City controls expenditures in capital project funds through project management. The City does not formally incorporate budgetary entries in the capital projects fund but it does use encumbrance accounting for control purposes. **REQUIRED:** Assuming the City maintains its books and records in a manner that facilitates the preparation of the fund financial statements, prepare journal entries, in the Capital Projects Fund, for the following transactions.

- (a) The City issued \$50 million of 5% general obligation bonds at 101.
- (b) The City transferred the premium to the appropriate fund.
- (c) The City incurred bid-related expenditures of \$1,000.
- (d) The City signed a contract with the lowest competent bidder for \$48 million.
 - (e) The city received notice from the State that the grant had been approved and the proceeds will be forwarded to the City in the State's current fiscal year.
 - (f) The City received the federal grant in full.
- (g) The City received a progress billing from the contractor for \$10 million. The City pays the billing.

2. The City of Eugene has the following balances in the accounts of its capital projects fund at year-end before closing entries. All accounts have normal balances. All amounts are in millions of dollars.

- REQUIRED:**
- (a) Prepare an operating statement for the capital projects fund.
 - (b) Prepare a Balance Sheet for the capital projects fund.

| | |
|--------------------------|-------|
| Cash | \$ 68 |
| Deferred Revenue | \$ 5 |
| Encumbrances | \$ 38 |
| Expenditures | \$ 10 |
| Fund Balance—Unreserved | \$ 14 |
| Grants Receivable | \$ 10 |
| Other Financing Sources | \$ 50 |
| Other Financing Uses | \$ 1 |
| Reserve for Encumbrances | \$ 38 |
| Revenues | \$ 20 |

3. In 2006, the voters of Southside City authorized the construction of a new swimming pool for a total cost of no more than \$5 million. The voters also approved the issuance of \$5 million of 5% general obligation serial bonds to be repaid by a special property tax. Interest on these bonds is payable annually on June 30. On June 30, 2006, the City sold the bonds at 101 and signed contracts for the construction of the swimming pool. Principal payments of \$250,000 are due each June 30, beginning in 2007. If the property tax is not sufficient to make the necessary principal and interest payments, the City is obligated to transfer the necessary monies from the general fund to the debt service fund. The City does not formally incorporate budgetary entries in the debt service fund but it does use encumbrance accounting for control purposes. The City has a June 30 fiscal year end.

REQUIRED: Assuming that the City maintains its books and records in a manner that facilitates the preparation of the fund financial statements, prepare journal entries, in the Debt Service Fund, for the following transactions.

- (a) The City immediately transferred the premium to the Debt Service Fund. The Debt Service Fund may not use the premium to pay principal or interest until the year 2021.
- (b) On June 30, the City invested the premium in a 10-year 5% Certificate of Deposit at a local financial institution. The Certificate pays interest annually on June 30. The interest is automatically reinvested in the Certificate.
- (c) Property taxes in the amount of \$300,000 were collected by June 30, 2007. The City expects to collect another \$50,000 by August 31.
- (d) The City transferred, to the debt service fund, the cash necessary to make the June 30, 2007 principal and interest payments. The checks will be mailed on July 1.
- (e) The City recognizes interest earned on the Certificate of Deposit.
- (f) The City recognizes the appropriate liabilities in the debt service fund.

4. A City received voter approval to issue \$10 million of 5% bonds to construct a city office building. The estimated total cost of construction is \$15 million. The City hopes to raise the balance needed through private donations. The City has a June 30 fiscal year-end. REQUIRED: Assuming that the City maintains its books and records in a manner that facilitates the preparation of the fund financial statements, prepare journal entries to record the following transactions. Indicate in which fund the entry is being made.
- (a) On July 1 the City issued \$10 million of 5% serial bonds at face to fund construction of the new office buildings. The bonds pay interest on January 1 and July 1. The first principal payments are due five years hence.
 - (b) On July 15 the City signed a \$15 million contract with a local construction company for construction of the buildings.
 - (c) On September 1 a local benefactor donated \$5 million cash for the office buildings.
 - (d) On October 1, the contractor requested a progress payment of \$2 million for the earthwork and foundation work on the new buildings. The City paid the contractor.
 - (e) On January 1, the City transferred from the general fund the amount necessary to make the first interest payment. The City made the first interest payment on the bonds.
 - (f) On June 1 the contractor requested, and received, a progress payment of \$10 million.
5. Krauss County had outstanding \$35 million in Series 1991 general obligation bonds on June 30, 2007. The bonds were issued at an interest rate of 10 percent with interest payable on June 30 and December 31. In July 2007, interest rates had declined substantially, and the County issued refunding bonds in the amount of \$35 million at 5 percent. The proceeds of the new refunding bonds were placed in escrow along with \$2,800,000 held in the County's debt service fund as a sinking fund for the 1991 debt. The proceeds of the refunding bonds and the sinking fund amount would be used in December 2007 (the call date) to purchase the 1991 debt at a 3 percent call premium, totaling \$1,050,000, plus accrued interest of \$1,750,000. The County had \$250,000 of unamortized debt issue costs on the 1991 bonds, which it reported in its government-wide financial statements. This amount combined with the call premium resulted in a \$3,050,000 "loss" on the refunding. REQUIRED:
- (a) What journal entries should the County make in July 2007 to record the in-substance defeasance of the 1991 debt in its debt service fund?
 - (b) What debt should be reported in the County's government-wide financial statements at July 2007?
 - (c) What journal entry should be made in the County's debt service fund in December 2007 to record the purchase of the old debt at the call date?
 - (d) How should the "loss" on the refunding be recognized in the government-wide financial statements? Why did the GASB choose this method of recognition?

6. In 2007, the citizens living on Coolidge Avenue agreed to a capital improvement special assessment to replace sidewalks on both sides of the avenue. The City will oversee the construction, issue special assessment debt to pay for it, and bill (assess) homeowners for their portion of the cost. The estimated cost of the project is \$3.0 million. The City itself will be responsible for 25 percent of the cost (\$750,000). However, the City also has indicated that it will be responsible for any defaults on the part of homeowners. Because the City uses a separate capital projects fund for the project, it does not integrate budgetary accounts. However it does use encumbrance accounting. REQUIRED: Provide journal entries for the City's funds and discussion as follows. Be sure to indicate which fund would record the entry.
- The City puts the project out for bid and accepts the lowest competent bid of \$2.8 million.
 - The contractor does the work and bills the City for \$2.9 million, \$0.1 million over contracted amount. The City Council approves the overage. The City lends resources from its General Fund to pay the bill, pending issuance of special assessment debt.
 - The City issues \$3.0 million in 10-year special assessment debt. The City receives \$2.9 million, an amount that is net of debt issue costs of \$0.1 million.
 - The Capital Projects Fund repays the City's General Fund.
 - The City assesses taxpayers on Coolidge Avenue a total of \$2.75 million in special assessments. The City has an enforceable legal claim against those taxpayers on the date of the assessment.
 - Several taxpayers pay their assessment immediately. During the 2007, the City receives a total of \$.775 million in special assessment revenues.
7. A government held the following equity securities in its debt service fund as of January 1, 2007. During 2007 it engaged in the following transactions as indicated.

| <u>Security</u> | <u>Beginning Bal.</u> | | <u>Purch.</u> | <u>Sales</u> | <u>Ending Bal.</u> | |
|-----------------|-----------------------|------------|---------------|--------------|--------------------|------------|
| | <u>Cost</u> | <u>FMV</u> | | | <u>Cost</u> | <u>FMV</u> |
| A | 600 | 800 | | | 600 | 840 |
| B | 380 | 300 | | | 380 | 275 |
| C | 100 | 140 | | 150 | | - |
| D | | | 700 | | 700 | 710 |
| Total | 1,080 | 1,240 | 700 | 150 | 1,680 | 1,825 |

- Ignoring dividends, what would be the impact of the transactions on 2007 debt service fund revenues or expenditures?
- What would be the impact of the transactions on 2007 government-wide revenues or expenses?

8. To construct a new junior high school, the Central Scholl District, on October 1, 2007, issued, at par, \$20 million of 6 percent bonds. The first interest payment of \$600,000 is due on March 31, 2008. In December 2007 the district transferred \$600,000 from its general fund to a debt service fund to cover the March 2008 interest payment. How much interest expense/expenditure should the district recognize for 2007 in its

- 3. general fund _____
- 4. debt service fund _____
- 5. government-wide statements _____

ESSAYS (CHAPTER 6)

1. The citizens of a defined geographical area of the City of Sale authorized a special assessment to be levied on their property to finance the reconstruction of the sewer system infrastructure that serves the area. The City will solicit bids, oversee reconstruction, issue the debt in the name of the City, and service the debt. The City is NOT obligated in any manner for the debt but will collect the special assessments and make principal and interest payments to the bondholders. Discuss the appropriate accounting for the construction phase and the debt service phase of this project. Justify the required accounting and financial reporting for these two phases of this project.
2. What is arbitrage? What are its potential uses and/or abuses? How are potential abuses regulated?
3. How should governments report their capital projects and debt service activities in their government-wide financial statements?
4. Governments often receive interest on the temporary investment of capital debt proceeds. Some believe that governments are inconsistent in the way they report interest and other earnings on investments compared to interest on their debt. Explain this comment. Do you believe it is inconsistent?

ANSWERS TO TRUE/FALSE (CHAPTER 6)

1. True
2. True
3. True
4. True
5. True
6. False
7. False
8. True
9. True
10. True
11. False
12. True

ANSWERS TO MULTIPLE CHOICE (CHAPTER 6)

1. C
2. A
3. C
4. A
5. A
6. C
7. C
8. D
9. A
10. D
11. B
12. B
13. D
14. B
15. C
16. A
17. C
18. C
19. A
20. B
21. A
22. B
23. B
24. B
25. A
26. B
27. B
28. C
29. A
30. C
31. D
32. C
33. D
34. A
35. D
36. A
37. C
38. B
39. C
40. B
41. A
42. D
43. D
44. E

ANSWERS TO PROBLEMS (CHAPTER 6)

Problem 1

| | | |
|---------------------------------------|----------------|----------------|
| (a) Cash | \$50.5 million | |
| Other Financing Sources—Bond Proceeds | | \$50.5 million |

[NOTE: Students may make two separate credit entries—one for the face value and one for the premium.]

| | | |
|-----------------------------------|---------------|---------------|
| (b) Other Financing Uses—Transfer | \$.5 million | |
| Cash | | \$.5 million |

| | | |
|------------------|----------------|----------------|
| (b) Expenditures | \$.001 million | |
| Cash | | \$.001 million |

| | | |
|--------------------------|--------------|--------------|
| (c) Encumbrances | \$48 million | |
| Reserve for Encumbrances | | \$48 million |

| | | |
|----------------|--------------|--------------|
| (e) Receivable | \$10 million | |
| Revenue | | \$10 million |

| | | |
|----------|--------------|--------------|
| (f) Cash | \$15 million | |
| Revenue | | \$15 million |

| | | |
|------------------------------|--------------|--------------|
| (g) Reserve for Encumbrances | \$10 million | |
| Encumbrances | | \$10 million |

| | | |
|--------------|--------------|--------------|
| Expenditures | \$10 million | |
| Cash | | \$10 million |

Problem 2

| | | |
|-----|---|-------------|
| (a) | <u>Statement of Revenues, Expenditures, and Changes in Fund Balance</u> | |
| | Revenues | \$20 |
| | Less: Expenditures | <u>10</u> |
| | Excess of Revenues over Expenditures | 10 |
| | Other Financing Sources and Uses | |
| | Sources | +50 |
| | Uses | <u>- 1</u> |
| | | \$59 |
| | Beginning Fund Balance | <u>14</u> |
| | Ending Fund Balance | <u>\$73</u> |

(

{continued on next page}

| | | |
|----|------------------------------------|-------------------------|
| b) | <u>Balance Sheet</u> | |
| | Cash | \$68 |
| | Grants Receivable | <u>\$10</u> |
| | Total Assets | <u>\$78</u> |
| | Deferred Revenue | \$ 5 |
| | Fund Balance | |
| | Unreserved | \$35 |
| | Reserved for Encumbrances | <u>\$38</u> <u>\$73</u> |
| | Total Liabilities and Fund Balance | <u>\$78</u> |

Problem 3

| | | | |
|-----|----------------------------------|-----------|-----------|
| (a) | Cash | \$ 50,000 | |
| | Other Financing Sources—Transfer | | \$ 50,000 |
| (b) | Investment | \$ 50,000 | |
| | Cash | | \$ 50,000 |
| (b) | Cash | \$300,000 | |
| | Property Tax Receivable | 50,000 | |
| | Revenues | | \$350,000 |
| (c) | Cash | \$200,000 | |
| | Other Financing Sources—Transfer | | \$200,000 |
| (d) | Investment | \$ 2,500 | |
| | Investment revenues | | \$ 2,500 |
| (e) | Expenditures | \$500,000 | |
| | Matured Interest Payable | | \$250,000 |
| | Matured Principal Payable | | \$250,000 |

[NOTE: Students may make separate entries.]

Problem 4

| | | |
|---|----------------|----------------|
| (a) CAPITAL PROJECTS FUND | | |
| Cash | \$10 million | |
| Other Financing Source—Bond Proceeds | | \$10 million |
| (b) [No Entry Required—Students may encumber if they so desire] | | |
| (b) CAPITAL PROJECTS FUND | | |
| Cash | \$ 5 million | |
| Contributions revenue | | \$ 5 million |
| (d) CAPITAL PROJECTS FUND | | |
| Expenditure | \$ 2 million | |
| Cash | | \$ 2 million |
| [If encumbered, reverse the encumbrance] | | |
| (e) DEBT SERVICE FUND | | |
| Cash | \$.25 million | |
| Other Financing Sources—Transfer | | \$.25 million |
| Expenditure | \$.25 million | |
| Cash | | \$.25 million |
| GENERAL FUND | | |
| Other Financing Uses—Transfer | \$.5 million | |
| Cash | | \$.5 million |
| (f) CAPITAL PROJECTS FUND | | |
| Expenditures | \$10 million | |
| Cash | | \$10 million |
| [If encumbered, reverse the encumbrance] | | |

Problem 5

- a. DEBT SERVICE FUND
- | | | |
|--|----------------|----------------|
| Cash | \$35 million | |
| Other Financing Sources—Refunding | | |
| Bond Proceeds | | \$35 million |
| Other Financing Uses—payment to escrow agent | \$37.8 million | |
| Cash | | \$37.8 million |
- b. The \$35,000,000 million issued in July 2007.
- c. No entry is required.
- d. No loss would be recognized. The County would amortize the \$3,050,000 as a component of interest expense over the life of the new debt or the old debt, whichever is shorter. The GASB approach assumes that the in-substance defeasance is merely a substitution of new debt for existing debt with a corresponding adjustment in interest rates.

Problem 6

| | | | |
|----|--------------------------------------|------------------|------------------|
| a. | | | |
| | CAPITAL PROJECTS FUND | | |
| | Encumbrances | \$2.8 million | |
| | Reserve for Encumbrances | | \$2.8 million |
| b. | | | |
| | GENERAL FUND | | |
| | Due from capital projects fund | \$2.9 million | |
| | Cash | | \$2.9 million |
| | CAPITAL PROJECTS FUND | | |
| | Cash | \$2.9 million | |
| | Due to General Fund | | \$2.9 million |
| | Expenditures | \$2.9 million | |
| | Reserve for encumbrances | 2.8 million | |
| | Cash | | \$2.9 million |
| | Encumbrances | | 2.8 million |
| c. | | | |
| | CAPITAL PROJECTS FUND | | |
| | Cash | \$2.9 million | |
| | Debt issue costs (expenditure) | .1 million | |
| | Other financing source—debt proceeds | | \$3.0 million |
| d. | | | |
| | CAPITAL PROJECTS FUND | | |
| | Due to General Fund | \$2.9 million | |
| | Cash | | \$2.9 million |
| | GENERAL FUND | | |
| | Cash | \$2.9 million | |
| | Due from Capital Projects Fund | | \$2.9 million |
| e. | | | |
| | DEBT SERVICE FUND | | |
| | Assessments receivable | \$2.75 million | |
| | Deferred Revenue | | 2.75 million |
| f. | | | |
| | DEBT SERVICE FUND | | |
| | Cash | \$ 0.775 million | |
| | Deferred revenue | \$ 0.775 million | |
| | Assessments receivable | | \$ 0.775 million |
| | Assessment revenue | | \$ 0.775 million |

Problem 7

A.

Outputs

| | | |
|-------------------|--------------|-------|
| Sales | 150 | |
| Ending Bal. @ FMV | <u>1,825</u> | 1,975 |

Inputs

| | | |
|-----------------|------------|--------------|
| Beg. Bal. @ FMV | 1,240 | |
| Purchases | <u>700</u> | <u>1,940</u> |

| | | |
|--|--|-----------|
| Increase (Decrease) in FMV – (Revenues) | | <u>35</u> |
|--|--|-----------|

B. The same

Problem 8

| | | |
|---|----------------------------|----------------|
| 1 | general fund | <u>0</u> |
| 2 | debt service fund | <u>0</u> |
| 3 | government-wide statements | <u>300,000</u> |

ANSWERS TO ESSAYS (CHAPTER 6)

1. Debt service activities of special assessments debt for which the City is not obligated in any manner are accounted for differently than are debt service activities of special assessments for which the City is obligated.

The construction phase would be accounted for in the same manner, whether or not the City guaranteed the debt, with one exception. The construction phase is generally accounted for in a capital projects fund. The cost of the fixed asset would be reported as an expenditure, listed in the Schedule of Fixed Assets, and reported in the governmental activities column in the government-wide statement of net assets. However, the proceeds of the special assessment debt would be recorded as Contributions from Property Owners (a revenue) rather than as Other Financing Sources—Proceeds of Bonds.

Because the City does not guarantee the debt, the debt service activities will be accounted for in an agency fund. Agency funds have only assets and liabilities, no fund balance or operating statement accounts. When the special assessment is levied, Special Assessments Receivable would be debited and a liability account would be credited. When debt service payments are made Cash will be reduced and the liability account will be reduced.

Because the City does not guarantee the debt, the debt should not be listed in the Schedule of Long-Term Obligations or reported in the government-wide statement of net assets. The City should disclose in the notes to the financial statements the amount of debt and its role as an agent of the property owners.

2. Arbitrage refers to the issuance of debt at relatively low, tax-exempt rates of interest and investment of the proceeds in taxable securities yielding a higher return. The major abuse of arbitrage would be to borrow at tax-exempt rates (generally lower than taxable bond rates) and reinvesting the proceeds in taxable securities (which are not taxed to the municipality). The difference between the interest rate paid and the returns earned would be available to the governmental entity to finance government programs or activities. There are no really justifiable uses of arbitrage other than the investment of temporary cash reserves for short periods of time or permanent cash reserves required to be held by the government as part of the bond agreement.

The federal government has complex tax provisions to permit the legitimate temporary investment of funds, yet at the same time prevent arbitrage abuse. There are arbitrage restrictions that prohibit arbitrage (with provisions for legitimate investments of temporary excess cash). There are also arbitrage rebate requirements, which require that all bond proceeds, with some exceptions, be spent within a short period of time and require certain arbitrage earnings to be remitted to the federal government.

3. In their government-wide statements, governments would consolidate their capital projects and debt service funds with their other governmental funds. Both revenues and expenses are recognized on a full accrual basis. Accordingly, both long-lived assets and the related long-term debt would be reported on the government-wide statement of net assets—not as expenditures and other financing sources—bond proceeds. Depreciation and interest expense would be reported on the accrual basis in the statement of activities.

4. Interest on investments is generally recognized when revenue is earned, i.e., on a full accrual basis. Changes in the fair value of investments due to accrued interest are also recognized at year-end when all investments are required to be restated at fair value. The GASB requires this recognition because these investments are financial resources. Interest expenditure, by contrast, is recognized only when it is due and payable with available financial resources (the modified accrual basis). The rationale for recognizing the expenditure only as the interest is due is that most jurisdictions will not appropriate the resources to pay the interest, or transfer them to the debt service fund, until then. That is, financial resources will not be used until that point. “To accrue the debt service fund expenditure and liability in one period but record the transfer of financial resources for debt service purposes in a later period would be confusing and would result in overstatement of debt service fund expenditures and liabilities and understatement of the fund balance,” according to GASB standards. However, if the resources have been transferred in to the debt service fund, then interest may (it does not have to) be accrued.

Although they may appear inconsistent, these recognition requirements focus on financial resources, which is the required measurement focus for governmental funds.

Chapter 7

Long-lived Assets and Investments in Marketable Securities

TRUE/FALSE (CHAPTER 7)

1. General capital assets are distinguished from the capital assets of proprietary funds and fiduciary funds.
2. General capital assets are excluded from governmental funds, themselves, because of the funds' measurement focus (current financial resources).
3. In governmental funds, the capital asset costs are reported as expenses when the assets are acquired.
4. At the government-wide level, governments must depreciate inexhaustible assets, such as land, works of art, or historical treasures.
5. Governments do not have to depreciate infrastructure assets if they can demonstrate they are preserving them at a specified condition level.
6. Unlike businesses, governments should not capitalize interest on general capital assets that they construct themselves.
7. Most infrastructure assets are the responsibility of the federal government, not state and local governments.
8. Prior to the issuance of GASB Statement No. 34, state and local governments provided virtually no information as to most of their infrastructure.
9. Governments invest in marketable securities for much the same reason that businesses do—to earn a return on cash that would otherwise be unproductive.

10. Governments are prohibited from entering into reverse repurchase agreements.

MULTIPLE CHOICE (CHAPTER 7)

1. The objectives of financial reporting for fixed assets should be to provide information
 - a) About a governmental entity's physical resources.
 - b) That can be used to assess the service potential of a governmental entity's physical resources.
 - c) To help users assess a government's long- and short-term capital needs.
 - d) All of the above.

2. A governmental entity may record long-term assets in which of the following funds or account groups?
 - a) General Fund
 - b) Internal service funds.
 - c) Capital Project Fund
 - d) Debt Service Fund.

3. General fixed assets are excluded from governmental funds because
 - a) The measurement focus of governmental funds is on financial resources.
 - b) They are not used to generate revenues.
 - c) The basis of accounting is accrual.
 - d) None of the above.

4. Jefferson County bought a new backhoe using General Fund cash. When the asset was acquired, what was the appropriate entry that was made in the General Fund, assuming that the entity maintains its books and records in a manner to facilitate the preparation of fund financial statements?
 - a) Debit Equipment; Credit Cash.
 - b) Debit Equipment; Credit Investment in Fixed Assets.
 - c) Debit Expenditure; Credit Cash.
 - d) Debit Expenditure; Credit Investment in Fixed Assets.

5. The City of Shiloh sold a used police car. The police car had a historical cost of \$17,000, a fair value of \$12,000, and was sold for \$5,000. Assuming that the City maintains its books and records in a manner to facilitate the preparation of the fund financial statements, what is the appropriate entry in the General Fund to record this sale?
 - a) Debit Cash \$5,000; Credit Revenue \$5,000.
 - b) Debit Cash \$5,000 and Loss on Sale \$7,000; Credit Automotive Equipment \$12,000.
 - c) Debit Cash \$5,000; Credit Other Financing Sources—Sale of Asset \$5,000.
 - d) Debit Cash \$5,000; Credit Automotive Equipment \$5,000.

6. Lakeview School District, a governmental entity, received 10 computers from Computer Hut, a local computer firm. The computers were a donation to the District by Computer Hut. The cost to Computer Hut for each computer is \$2,500. The retail value of each computer is \$3,000. Assuming that the District maintains its books and records in a manner that facilitates the preparation of the fund financial statements, what is the appropriate entry in the General Fund to record this donation?
- Debit Computer Equipment \$25,000; Credit Donation Revenue \$25,000.
 - Debit Computer Equipment \$30,000; Credit Other Financing Sources—Donation \$30,000.
 - Debit Computer Equipment \$30,000; Credit Donation Revenue \$30,000.
 - No entry is required. The computers are not financial resources.
7. Which of the following costs will **NOT** be included in the cost of fixed assets on the government-wide financial statements?
- Purchase price (invoice amount).
 - Cost of demolishing existing structures that cannot be used.
 - Interest on self-constructed items.
 - Engineering costs.
8. Donated assets are reported in the government-wide financial statements at
- Historical cost to the donor.
 - Book value in the hands of the donor.
 - Fair value on date of donation.
 - Zero value because they were not purchased.

[**NOTE:** Guidance on the calculation of gain or loss in the next two series of questions is not covered in this chapter but is from APB Opinion 29. Students should be familiar with this pronouncement from their intermediate accounting classes.]

Use the following information to answer questions #9 - #11

9. Monroe County traded in a used pickup for a new pickup truck with a sticker price of \$29,000. The old pickup had a fair value of \$17,000, historical cost of \$30,000, and accumulated depreciation of \$12,000. The dealer took the old truck and \$10,000 for the new truck. The new truck should be reported on the **government-wide financial statements** at
- \$10,000.
 - \$28,000.
 - \$29,000.
 - \$27,000.
10. The amount of gain or loss that should be recognized on this transaction in the **General Fund financial statements** is:
- \$0.
 - \$1,000.
 - \$3,000.
 - \$10,000.

11. The amount of gain or loss that should be recognized on this transaction in the **government-wide financial statements** is
- a) \$0.
 - b) \$1,000.
 - c) \$2,000.
 - d) \$8,000.

Use the following information to answer questions #12 - #14

Rapid City traded in a used pickup for a new pickup with a sticker price of \$33,000. The old truck had a historical cost of \$30,000, accumulated depreciation of \$12,000, and a fair value of \$20,000. The dealer took the old truck and \$10,000 cash for the new truck.

12. At what value should the new truck be reported in the **government-wide** financial statements?
- a) \$33,000.
 - b) \$32,000.
 - c) \$30,000.
 - d) \$28,000.
13. What is the amount of gain/loss that should be reported in the **General Fund** financial statements?
- a) \$0.
 - b) \$2,000 gain.
 - c) \$2,000 loss.
 - d) \$5,000 gain.
14. What is the amount of gain/loss that should be reported in the **government-wide** financial statements?
- a) \$0.
 - b) \$2,000 gain.
 - c) \$2,000 loss.
 - d) \$5,000 gain.
15. The city of Rapid Creek acquired a used front-end loader from a road contractor for use at the landfill (which is accounted for in an Enterprise Fund). The loader had a fair value of \$45,000 and a historical cost of \$75,000. The city paid the contractor \$40,000 for the loader. At what amount should the front-end loader be reported in the government-wide financial statements?
- a) \$40,000.
 - b) \$45,000.
 - c) \$75,000.
 - d) It should not be reported in the government-wide financial statements.

16. To elect not to capitalize works of art and similar assets, a government must see that the assets meet all of the following criteria EXCEPT
- The assets must be held for public exhibition, education, or research in furtherance of public service, rather than for financial gain.
 - The assets must be protected, kept unencumbered, cared for and preserved.
 - The assets must be subject to an organizational policy that requires the proceeds from sales of the collection items be used to acquire very similar items for the collection.
 - The assets must be subject to an organizational policy that requires the proceeds from sales of the collection items be used to acquire other items for the collection.
17. If a government elects to capitalize certain works of art and similar assets, which of the following statement is true relative to depreciation on those assets?
- Donated assets cannot be depreciated.
 - All of the capitalized assets must be depreciated.
 - All exhaustible works of art and similar assets must be depreciated.
 - The government may elect to omit all depreciation.
18. Which of the following is **NOT** an infrastructure asset?
- Roads.
 - Sidewalks.
 - Buildings.
 - Bridges.
19. If a government receives a donation of a work of art, the government must recognize revenue in its government-wide financial statements
- Only if it elects to capitalize its collection.
 - Only if it elects NOT to capitalize its collection.
 - On all donations of works of art.
 - It is not permitted to recognize revenue from donations.
20. For a government that elects NOT to capitalize its works of art and similar assets, the appropriate entry when receiving a contribution of a work of art in the government-wide financial statements is
- No entry is required for contributed assets.
 - Debit Asset; Credit Revenues.
 - Debit Asset; Credit Equity.
 - Debit Expense, Credit Revenue.
21. For a government that elects to capitalize its works of art and similar assets, the appropriate entry when receiving a contribution of a work of art in the government-wide financial statements is
- No entry is required for contributed assets.
 - Debit Asset; Credit Revenues.
 - Debit Asset; Credit Equity.
 - Debit Expenditures; Credit Revenues.

22. Which of the following is true with regard to deferred maintenance?
- a) Deferred maintenance costs are delayed repair, or upkeep, measured by the outlay required to restore a plant or individual asset to full operating characteristics.
 - b) Deferred maintenance costs should be measured as the amount necessary to bring the assets up to their expected operating condition.
 - c) Deferred maintenance costs may be interpreted as a potential call upon government resources—an obligation that is being passed on to taxpayers of the future.
 - d) Deferred maintenance costs are not useful information to readers of financial statements because they are not objective and verifiable and thus violate one of the basic qualitative characteristics of accounting information.
23. GASB standards require that depreciation be reported on all capital assets except
- a) Infrastructure accounted for using the standard approach.
 - b) Infrastructure assets accounted for using the modified approach.
 - c) Donated assets.
 - d) Capitalized works of art.
24. With regard to capitalization of infrastructure, which of the following is true?
- a) All infrastructure assets must be capitalized on the financial statements before GASB Statement 34 can be implemented.
 - b) Only large governments must capitalize infrastructure assets on the date they implement GASB Statement 34.
 - c) Only small- and medium-size government may elect to delay capitalization of infrastructure assets.
 - d) Small governments may omit capitalizing infrastructure assets acquired or that received significant improvements before June 15, 2003.
25. If a government elects the modified approach with regard to capitalization of infrastructure
- a) Costs to preserve infrastructure assets are expensed as incurred with no additional disclosure required.
 - b) Costs to preserve infrastructure assets are expensed as incurred and disclosure of assessed condition is required.
 - c) Costs to preserve infrastructure assets are capitalized as incurred and depreciated over the estimated useful with no additional disclosure required.
 - d) Costs to preserve infrastructure assets are capitalized as incurred and NOT depreciated over the estimated useful life with additional disclosure required.
26. A broker-dealer or other financial institution transfers cash to a government in exchange for securities and the government agrees to repay the cash plus interest in exchange for return of the same securities. From the government's point of view, this transaction is a
- a) Repurchase agreement.
 - b) Reverse repurchase agreement.
 - c) Derivative.
 - d) Option.

27. The risk that the other party to an investment will not fulfill its obligation is
- Market risk.
 - Credit risk.
 - Collateralized risk.
 - Legal risk.
28. The risk that there will a change in interest or market prices is
- Market risk.
 - Credit risk.
 - Collateralized risk.
 - Legal risk.
29. The risk that the transaction will be determined to be prohibited by law, regulation or contract is
- Market risk.
 - Credit risk.
 - Collateralized risk.
 - Legal risk.
30. Which of the following is NOT an example of a derivative?
- Stock options.
 - Interest-only strips.
 - Debt instruments backed by pools of mortgages.
 - Repurchase agreements.
31. Governments must disclose information about investment risks in which of the following categories?
- Credit risk.
 - Custodial credit risk.
 - Foreign currency risk.
 - All of the above.
32. Disclosures about investment risk apply
- To investments only.
 - To deposits, investments, and derivatives.
 - To deposits and investments.
 - Only to investments held by governmental and proprietary funds.
33. For governmental entities, a capital asset is considered impaired
- When its service capacity has declined significantly and unexpectedly.
 - When it is reported in a governmental fund.
 - When it no longer generates cash flows.
 - When it no longer generates the cash flows expected of it.

34. The “restoration cost” approach to determining the extent of an impairment
- a) First calculates the percentage decline in the number of service units caused by the impairment.
 - b) First determines the current cost of an asset that would provide the current (impaired) level of service.
 - c) Estimates the cost to restore the utility of an impaired asset.
 - d) Estimates the change in future cash flows generated by the impaired asset.
35. The government-wide financial statements report capital assets:
- a) At estimated fair value
 - b) At historical cost, including ancillary charges
 - c) In the general fixed assets account group
 - d) Only in the notes if they are donated
36. Fair value accounting is required for investments in:
- a) External investment pools
 - b) Open-end mutual funds
 - c) Participating, interest-earning investments contracts
 - d) All of the above
 - e) A & B only

PROBLEMS (CHAPTER 7)

1. The City of Brownsville engaged in the following transactions. REQUIRED: Assuming that the City maintains its books and records in a manner that facilitates the preparation of fund financial statements, prepare the appropriate journal entries in the General Fund. If no entry is required, write "No Entry Required."
 - a) The City purchased for cash three dump trucks at a unit cost of \$70,000 each.
 - b) The City sold for \$3,000, a police car that had been purchased four years ago at a cost of \$30,000. At the time of acquisition, the City estimated that the police car had a useful life of five years and a salvage value of \$5,000.
 - c) During the year, the City spent \$12 million to build a third lane on both sides of the major north-south highway through town.
 - d) The City traded in a pickup truck used in general government operations for a new pickup truck, paying a difference of \$16,000. The old pickup truck was purchased four years ago at a cost of \$21,000. At the time it had an estimated useful life of five years, and an estimated salvage value of \$6,000. At the time of the trade, the old truck had a fair value of \$10,000. The new truck has a sticker price of \$27,000.
 - e) During the year the City began construction of a new City Hall. By year-end, the City had made progress payments to the contractor of \$2 million.
 - f) The City received a gift of land from a citizen. The land is to be used to build a city park. The land had been in Mrs. Marshall's family since it was homesteaded. It had a fair value when contributed of \$2 million.

[**NOTE:** Guidance on the calculation of gain or loss in item d in the next question is not covered in this chapter but comes from APB Opinion 29. Students should be familiar with this pronouncement from their intermediate accounting classes.]

2. The City of Brownsville engaged in the following transactions. **REQUIRED:** Assuming that the City maintains its books and records in a manner that facilitates the preparation of the government-wide financial statements, prepare the appropriate journal entries. If no entry is required, write “No Entry Required.”
- a) The City purchased for cash three dump trucks at a unit cost of \$70,000 each.
 - b) The City sold for \$3,000, a police car that had been purchased four years ago at a cost of \$30,000. At the time of acquisition, the City estimated that the police car had a useful life of five years and a salvage value of \$5,000.
 - c) During the year, the City spent \$12 million to build a third lane on both sides of the major north-south highway through town.
 - d) The City traded in a pickup truck used in general government operations for a new pickup truck, paying a difference of \$16,000. The old pickup truck was purchased four years ago at a cost of \$21,000. At the time it had an estimated useful life of five years, and an estimated salvage value of \$6,000. At the time of the trade, the old truck had a fair value of \$10,000. The new truck has a sticker price of \$27,000.
 - e) During the year the City began construction of a new City Hall. By year-end, the City had made progress payments to the contractor of \$2 million.
 - f) The City received a gift of land from a citizen. The land is to be used to build a city park. The land had been in Mrs. Marshall’s family since it was homesteaded. It has a fair value when contributed of \$2 million.

3. A drunk driver crashed into a fully loaded gasoline truck while trying to pass on the City's Main Avenue bridge. The truck exploded and the heat of the fire caused a portion of the structure of the bridge to melt. The City did not use the modified approach to report the bridge. Rather, its historical cost of \$10 million was being depreciated over 20 years with no expected salvage value. The bridge was 10 years old. Its current replacement cost is \$20 million. The City's engineers estimate that it will take \$8 million to restore the bridge.

REQUIRED:

- a. What is the deflated restoration cost for the bridge, calculated as using the restoration approach?
- b. If an impairment loss is calculated by dividing the deflated restoration cost by the asset's original historical cost and then multiplying that percentage times the carrying amount of the bridge, what is the City's impairment loss?
- c. Assuming the City makes the \$8 million of repairs, how should the City report this cost?

4. In 1987, the City of Kayla constructed a new Fifth Avenue bridge. The City has no records of the cost of the bridge. The City must apply GASB Statement 34 retroactively to its infrastructure assets in 2007. The City's engineers estimate that the current replacement cost of the bridge is \$20 million. The construction price index in 1987 was 150 and is 200 in 2007. The engineers also estimate that the bridge has a total useful life of 30 years.

REQUIRED:

- a. What values should the City assign to the bridge for estimated historical cost and accumulated depreciation?
- b. Suppose the City decided to use the modified approach to report its bridges. What value would the City assign to the bridge?
- c. In your opinion, would a depreciation charge for the bridge add significant information to the City's financial statements? Why or why not?

5. The table below lists the types of investments reported by the City of Katerah in its General Fund. All of the investments of the General Fund will be needed to liquidate liabilities within the next 6 to 12 months. REQUIRED: What types of investment risks should the City disclose?

| <u>Type of Investment</u> | <u>Comments</u> |
|---|---|
| \$45 million Boeing short-term notes | The City's agent holds the securities |
| \$10 million 20-year Treasury bills | The federal government lists the City as owner of the bills |
| \$2 million in short-term junk bonds | The City's agent holds the securities. |
| \$1 million in overnight repurchase agreements | The broker-dealer holds the underlying securities. |
| \$2 million in collateralized mortgage obligations (CMOs) | The City is not authorized to invest in these securities. |
| Total Portfolio Value: \$60 million | |

6. The following pertain to a city's assets and liabilities.
- A. The city (1) purchased a 3-year, 7 percent U.S. Treasury note (2) used the note to enter into a 90-day "reverse-repo" transaction that incorporates an interest rate of 6 percent and (3) used the proceeds from the "reverse repo" transaction" to purchase another 3-year 7 percent U.S. Treasury note.
1. What is a "reverse-repo"?
 2. What are the benefits and risks of the city's investment practices?
- B. In 2007 the city constructed a new highway at a cost of \$120 million. Yet in the year's following 2003, it did not record a depreciation charge on the highway – not even in its government-wide statements. Can the omission of the depreciation charge be justified under GASB Statement No. 34? Explain.

ESSAYS (CHAPTER 7)

1. Governmental accounting does not permit depreciation to be charged on the operating statements of the governmental funds. Present arguments FOR reporting depreciation and present arguments AGAINST reporting depreciation.
2. What is "deferred maintenance?" What is its possible role in governmental financial reporting?
3. Recently, governmental investment policies have been sharply criticized because of some significant losses incurred by certain governments. What is the nature of the problem that is being criticized? What should be the role of accounting in determining and reporting investment strategies?
4. What are the differences between credit risk, concentrations of credit risk, market risk, and interest rate risk? Describe how each of these risks could affect a government's investment in a 20-year Treasury note.
5. GASB Statement 34 allows a major exception for reporting depreciation expense on certain capital assets. What is this exception? What is the notion behind the exception?

ANSWERS TO TRUE/FALSE (CHAPTER 7)

1. True
2. True
3. False
4. False
5. True
6. True
7. False
8. True
9. True
10. False

ANSWERS TO MULTIPLE CHOICE (CHAPTER 7)

1. D
2. B
3. A
4. C
5. C
6. D
7. C
8. C
9. D
10. A
11. B
12. D
13. A
14. A
15. A
16. C
17. C
18. C
19. C
20. D
21. B
22. A
23. B
24. D
25. B
26. B
27. B
28. A
29. D
30. D
31. D
32. B
33. A
34. C
35. B
36. D

ANSWERS TO PROBLEMS (CHAPTER 7)

Problem 1

| | | | |
|----|--|--------------|--------------|
| a. | Expenditure | \$210,000 | |
| | Cash | | \$210,000 |
| b. | Cash | \$ 3,000 | |
| | Other financing source—sale of capital assets | | \$ 3,000 |
| c. | Expenditure | \$12 million | |
| | Cash | | \$12 million |
| d. | Expenditure | \$ 16,000 | |
| | Cash | | \$ 16,000 |
| e. | Expenditure | \$2 million | |
| | Cash | | \$2 million |
| f. | No Entry Required | | |

Problem 2

| | | | |
|----|--------------------------|--------------|--------------|
| a. | Equipment | \$210,000 | |
| | Cash | | \$210,000 |
| b. | Cash | \$ 3,000 | |
| | Accumulated Depreciation | \$20,000 | |
| | Loss on Sale | \$ 7,000 | |
| | Old Equipment | | \$30,000 |
| c. | Infrastructure Assets | \$12 million | |
| | Cash | | \$12 million |
| d. | New Truck | \$25,000 | |
| | Accumulated Depreciation | \$12,000 | |
| | Old Truck | | \$21,000 |
| | Cash | | \$16,000 |
| e. | Construction in Progress | \$2 million | |
| | Cash | | \$2 million |
| f. | Land | \$2 million | |
| | Revenue | | \$2 million |

Problem 3

- a. Deflated restoration cost is \$4 million. [$\$8 \text{ million} \times (\$10 \text{ million} \div \$20 \text{ million})$].
- b. Impairment loss is \$2 million. [deflated restoration cost of \$4 million \div \$10 million historical cost \times (\$5 million carrying value of the bridge)].
- c. The repair would be treated as a separate event from the impairment. The \$8 million repair would be added to the new carrying value of the bridge [$\$5 \text{ million} \text{ less } \$2 \text{ million impairment loss}$] for a new carrying value of \$11 million.

Problem 4

- a. The estimated historical cost of the bridge using the deflated replacement cost method is \$15 million ($\$20 \text{ million} \times 150/200$). Accumulated depreciation would be \$10 million ($\$15 \text{ million} \times 20/30$). The net carrying value would be \$5 million.
- b. Using the modified approach, the bridge would be reported at \$15 million with \$0 accumulated depreciation.
- c. The depreciation charge would seem to be justified if, in fact, the bridge declines in utility and value with time. If, however, the bridge retains its usefulness because of preservation measures taken by the City, then the maintenance charge only (modified approach) would appear to be the preferred alternative.

Problem 5

The City should disclose concentration of credit risk related to its Boeing investments; they constitute 75 percent of the total portfolio value.

The City should disclose interest and market risk related to its investments in 20-year T bills and CMOs. These long-term investments are subject to large swings in values when interest rates change. These investments are especially inconsistent with the City's stated cash flow needs.

Credit risk disclosures are required for the City's investment in short-term junk bonds.

Custodial credit risks exist for the repurchase agreements when the underlying securities are held by the other party to the agreement and especially not held in the City's name. If the broker-dealer were to default on the transaction, there would be no record that the City owned the underlying collateral securities.

Legal risk exists for the investment in CMOs, which are not authorized for investment by the City.

Problem 6

A. 1) *A reverse repo is, in substance, a secured borrowing transaction. The borrower receives cash in exchange for marketable securities and agrees to buy back the securities at a specified date at a specified price.*

2). *The city's investment practices enable it to "leverage" its portfolio, thereby increasing its return. The main risk is the interest rates will rise. The city will be locked into its long-term investments, but will have to borrow at the new, higher, interest rates. Moreover, the value of its long-term investments will fall as the interest rates rise.*

B. Yes. *Cities are permitted to use an optional "modified" method to account for infrastructure assets. If certain conditions are met then the city need not record depreciation but rather expense all preservation costs.*

ANSWERS TO ESSAYS (CHAPTER 7)

1. Arguments against reporting depreciation in governmental funds are as follows:
 - Financial statement users are concerned primarily with the flow of financial resources. Depreciation-related information would do little to facilitate the decisions made by most users of financial statements.
 - Financial statement users place low priority on depreciation and accumulated depreciation information.
 - Because governments do not measure income, depreciation is unnecessary.
 - Depreciation is subjective. It is the allocation of an irrelevant historical cost to the current period.
 - Depreciation is based on historical cost, which, over time (through price level changes), results in comparing apples and oranges.

The primary argument in favor of reporting depreciation is that depreciation is a measure of the using up of assets. Its omission understates the cost of providing services during the current period.

2. Deferred maintenance costs are defined as delayed repair, or upkeep, measured by the outlay required to restore a plant or individual asset to full operating characteristics. Governmental entities do not currently record depreciation in the governmental funds. One criticism of governmental accounting is directly related to this omission. There is a cost associated with the consumption of fixed assets. Currently that cost appears in the operating statement in either the year of acquisition (if the asset is acquired with existing assets) or over the financing period (if the asset is financed). More importantly, fixed assets create a need for the government to maintain those assets. In 'budget crunches' it is easy for legislative bodies to delay scheduled maintenance. Fixed assets continue, at least in the short run, to perform and delay of maintenance appears to be an easy way to restore balance to the budget without reducing services delivered. In the long run, delay of scheduled maintenance is a way to pass on to future generations costs that should have been paid by taxpayers of the current period.

Presentation of deferred maintenance costs would help readers assess future cash outflows. Without necessary maintenance the assets will deteriorate more quickly than planned and will require higher cash outflows for their replacement.

3. Most of the recent losses (in particular, Orange County) came about because governmental financial managers invested in securities whose very nature they did not understand or whose nature they fully understood and chose to take the risks anyway. The use of historical cost to report investments compounded the problem but did not create the problem. It is not accounting that created the problems, it is the underlying investment strategy. The level of risk that should be assumed by governmental investment managers who invest tax dollars as stewards for taxpayers should be different from the level of risk that individual investors may choose for their own money.

Ideally, accounting should not drive transactions, it should reflect the transactions and events that occurred. Accounting should give readers sufficient information to determine the level of risk being assumed by financial managers and to make judgments about the appropriateness of that level of risk. Required disclosures about investment risk, required by GAAP, help financial statement users understand and make their own assessments about the level of risk assumed.

4. Market risk is the risk of changing prices. In the case of fixed income securities such as bonds, the market prices change mainly in response to increases or decreases in interest rates. For long-term Treasury bills, the market risk is substantial because the market value of long-term bonds is greatly affected by even small changes in prevailing interest rates. Credit risk is the risk of the other party defaulting. Absent failure of the federal government, there is no credit risk attached to Treasury bills. Concentrations of credit risk result when a government's investments in the securities of a particular issuer exceed 5 percent or more of the total investments or a particular fund or activity. Again, a concentration of investment in Treasury bills would not be an issue absent failure of the federal government. Interest rate risk is degree to which investments are sensitive to changes in interest rates. A government that invests in a long-term Treasury bill as a temporary investment has a high interest rate risk because their rate is fixed. A small change in interest rates will cause the fair value of the investment to increase or decrease dramatically. If the government planned to hold the Treasury bill to maturity, risk would be low.

5. If a government satisfies certain conditions, mainly that it preserves its infrastructure at a specified condition level, then it need not charge depreciation expense for those assets. The notion behind this exception is that if assets are maintained at a specified condition level, then they become more like inexhaustible assets, which are not depreciated. Only the cost of maintaining the assets is required to be reported as an expense.

Chapter 8

Long-term Obligations

TRUE/FALSE (CHAPTER 8)

1. Unlike individuals and businesses, governments cannot seek protection under the Federal Bankruptcy Code.
2. General obligation debt is the obligation of the government at large and is thereby backed by the government's general credit and revenue-raising powers.
3. Revenue debt is secured only by designated revenue streams.
4. When the proceeds of general long-term debt are received by a governmental fund, rather than reporting a liability on the balance sheet, the inflow of resources is treated as an other financing source on the operating statement.
5. Per GASB Statement No. 34, governments generally should report their bonds, notes, and comparable long-term obligations at present value.
6. A government is prohibited from ever recognizing bond anticipation notes (BANs) as long-term obligations.

7. Tax anticipation notes (TANs) must be reported as current liabilities of the governmental funds in which the related revenues will be reported, as well as in the government-wide statements.
8. Governments may enter into operating leases, but may not enter into capital leases.
9. In accounting for operating leases, the rental payments should be recognized as expenditures in a governmental fund and as expenses in the government-wide statement of activities in the periods in which they apply.
10. Because they are not obligations of the government at large, revenue bonds are usually not subject to voter approvals or other forms of voter oversight.
11. Although governments may elect to report conduit obligations in their government-wide and proprietary fund statements, the GASB has ruled that note disclosure is sufficient.

MULTIPLE CHOICE (CHAPTER 8)

1. A governmental entity that is unable to satisfy claims against it
 - a) Is prohibited from filing bankruptcy.
 - b) May seek protection under the federal Bankruptcy Code, using the same section that is used by businesses.
 - c) May seek protection under the federal Bankruptcy Code, using a special section directed to governments.
 - d) Is automatically placed under the jurisdiction of a higher level of government.

2. To seek protection under the federal Bankruptcy Code, a governmental entity must
 - a) Be unable to provide the level of services it has provided in the recent past.
 - b) Be unable to pay its debt in its current year.
 - c) Have budgeted expenditures in excess of revenues.
 - d) Both (b) and (c).

3. General long-term debt of a governmental entity includes
 - a) All future financial obligations.
 - b) All future financial obligations that result from past transactions.
 - c) All future financial obligations that result from past transactions for which the government has already received a benefit.
 - d) All future financial obligations that are backed by the government's general credit and revenue raising power and that result from past transactions for which the government has already received a benefit.

4. When the proceeds of long term debt are reported in governmental fund financial statements
 - a) They are reported only as an increase in liabilities in the funds.
 - b) They are reported only as revenues in the funds.
 - c) They are reported only as an other financing source—debt proceeds.
 - d) They are reported only as an other financing use—debt proceeds.

5. In governmental fund financial statements, the assets acquired under a capital lease would be reported at
 - a) They are not reported in the fund financial statements.
 - b) The present value of the required lease payments.
 - c) The undiscounted total of required lease payments.
 - d) The total of all payments required under the lease.

6. In the government-wide financial statements, the assets acquired under a capital lease would be reported at
 - a) They are not reported in the government-wide financial statements.
 - b) The present value of the required lease payments.
 - c) The undiscounted total of required lease payments.
 - d) The total of all payments required under the lease.

7. Salmon County issued \$20 million of 5% demand bonds for construction of a county maintenance building. The County has no take-out agreement related to the bonds. It estimates that 25% of the bonds would be demanded (called) by the buyers if interest rates increased at least 1%. At year-end rates on comparable debt were 7%. How should these demand bonds be reported in the **government-wide financial statements** at year-end?
- \$20 million in the Long-term Liability section of the governmental activities column.
 - \$5 million in the Current Liability section of the governmental activities column AND \$15 million in the Long-term Liabilities section of the governmental activities column.
 - \$5 million in the governmental activities column AND \$15 million would be reported in the Schedule of Changes in Long-Term Debt Obligations.
 - \$20 million in the Current Liability section of the governmental activities column.
8. Salmon County issued \$20 million of 5% demand bonds for construction of a county maintenance building. Before year-end the County entered into a two-year noncancellable take-out agreement with a local bank with a 10-year payback period. The County estimates that 25% of the bonds would be demanded (called) by the buyers if interest rates increased at least 1%. At year-end rates on comparable debt were 7%. How should these demand bonds be reported in the County's government-wide financial statements at year-end?
- \$20 million in the Long-term Liability section of the governmental activities column.
 - \$5 million in the Current Liabilities section of the governmental activities column AND \$15 million in the Long-term Liabilities section of the governmental activities column.
 - \$5 million in the governmental activities column AND \$15 million would be reported in the Schedule of Changes in Long-term Debt Obligations.
 - \$20 million in the Current Liabilities section of the governmental activities column.
9. Salmon County issued \$20 million of 5% demand bonds for construction of a county maintenance building. The County has no take-out agreement related to the debt. It estimates that 25% of the bonds would be demanded (called) by the buyers if interest rates increased at least 1%. At year-end rates on comparable debt were 7%. How should these demand bonds be reported in the **governmental fund financial statements** at year-end?
- \$20 million in the Capital Projects Fund.
 - \$5 million in the Capital Projects Fund AND \$15 million would be reported in the Schedule of Changes in Long-Term Debt Obligations.
 - \$15 million in the Capital Projects Fund AND \$5 million would be reported in the Schedule of Changes in Long-Term Obligations.
 - \$20 million in the Schedule of Changes in Long-Term Obligations.

10. Voters of Valley School District, a public school district, approved construction of a new high school at a cost not to exceed \$20 million. The District will finance the construction by issuing \$20 million of 6% term bonds payable in 20 years. Because the site had already been prepared, the School district began construction immediately but the bonds would not be issued for nearly a year. Shortly before the fiscal year-end, the School District borrowed \$5 million from a local bank due in one year with interest at 6.2%. The note will be repaid from bond proceeds. The School District secured a financing agreement with the bank to convert the debt to a 10-year debt if the School District is unable to sell the bonds by the due date. At year-end, how should the \$5 million note be displayed in the governmental fund financial statements?
- Capital Projects Fund—Notes Payable \$5 million; Nothing in the Schedule of Changes in Long-Term Obligations.
 - Capital Projects Fund—Notes Payable \$5 million; \$15 million in the Schedule of Changes in Long-Term Obligations.
 - Capital Projects Fund—Encumbrances of \$5 million; \$15 million in the Schedule of Changes in Long-Term Obligations.
 - Nothing in the Capital Projects Fund AND \$5 million notes payable in the Schedule of Long-Term Obligations.
11. Pulling County has a December 31 fiscal year-end. In November, the County borrowed \$8 million from a local bank, due in six months at 6% interest, to finance general government operations. The county pledges property tax revenues to secure the loan. At year-end, how should the bank note be displayed in the governmental fund financial statements?
- Nothing in the General Fund; Nothing in a Schedule of Changes in Long-Term Obligations.
 - General Fund--\$8 million in Other Financing Sources; Nothing in a Schedule of Changes in Long-Term Obligations.
 - General Fund--\$8 million in Other Financing Sources; \$8 million in a Schedule of Changes in Long-Term Obligations.
 - General Fund--\$8 million in Notes Payable; Nothing in a Schedule of Changes in Long-Term Obligations.
12. Governmental entities enter into capital leases, rather than conventional buy and borrow arrangements for which of the following reasons? Capital leases
- May be an effective means of circumventing debt limitations.
 - Are less expensive overall than buy and borrow arrangements.
 - Reduce the cash outflows related to the asset acquisition.
 - Have less effect on governmental fund balances than buy and borrow arrangements.
13. New City entered into a capital lease agreement for several new dump trucks to be used in general government activities. Assuming the City maintains its books and records in a manner that facilitates the preparation of the fund financial statements, acquisition of these dump trucks would require entries in which of the following funds and/or schedules?
- General Fund only.
 - General Fund AND Schedule of Changes in Long-Term Debt Obligations.
 - General Fund AND Schedule of General Fixed Assets.
 - General Fund, Schedule of General Fixed Assets AND Schedule of General Long-Term Debt Obligations.

14. Southwest City enters into a lease agreement that contains a nonappropriation clause. The clause
- Has been held by courts in 26 states to effectively cancel the lease.
 - Stipulates that the yearly lease payment must be appropriated by the City Council each year.
 - Prohibits the City from replacing leased property with similar property.
 - Permits the City to lease at lower rates than would be possible without the presence of the clause.
15. Why would a government issue revenue bonds (which generally are issued at a higher rate of interest than general obligation bonds) even though the government knows that if revenues from the project are not sufficient to cover principal and interest payments, the government will use resources from general government activities to fund the principal and interest payments?
- Revenue bonds may not require approval of the voters.
 - Revenue bonds may not be considered in legal debt limitations.
 - Revenue bonds may permit the interest costs to be passed on to the users of the services financed.
 - All of the above.
16. Which of the following funds is most likely to receive the proceeds of revenue bonds?
- General Fund.
 - Capital Project Fund.
 - City Utility Enterprise Fund.
 - Highway Department Special Revenue Fund.
17. Obligations of property owners within a particular government for their proportionate share of debts of other governments with whom they share boundaries are called
- Overlapping debts.
 - Conduit debts.
 - Committed debts.
 - Moral obligation debts.
18. Overlapping debt should be reported in which of the following ways?
- It should be reported in the Schedule of Changes in Long-term Obligations.
 - It should be disclosed as a note to the financial statements.
 - It should be reported in a schedule in the statistical section of the annual report.
 - It should not be reported in the financial statements of the reporting entity.
19. Obligations issued in the name of a government on behalf of a nongovernmental entity is called
- Overlapping debt.
 - Conduit debt.
 - Committed debt.
 - Moral obligation debt.

20. The City of Pocahontas issued \$20 million in bonds at par. The City loaned the proceeds to Domsee Fish Processors to expand the size of its facility, which would allow Domsee to hire additional workers. The loan payments from Domsee to the City are established to match the principal and interest payments on the bond issue. The bonds are payable exclusively from the loan repayments by Domsee. The bonds are secured by the additional plant facilities built by Domsee. Where should the City report the bonds in its annual financial report?
- In the government-wide financial statements.
 - In the notes to the financial statements.
 - In the proprietary fund financial statements.
 - In any of the above ways.
21. Industrial development bonds are issued in the name of a government with the proceeds used to attract private businesses to a community. Which of the following is a true statement about industrial development bonds?
- The proceeds are used by the private corporations and principal and interest payments are made by the private corporation. The government backs the bonds in the event of default by the private corporation.
 - The proceeds are used by the private corporations and principal and interest payments are made by the private corporation. The government does not back the bonds in the event of default by the private corporation.
 - The proceeds are used by the government to build infrastructure to service private corporations with principal and interest payments made by the government out of the additional tax revenues received from the private corporation.
 - The proceeds are used by the government to build infrastructure to service private corporations with principal and interest payments made by the private corporation in lieu of property taxes.
22. The Southside City has \$95 million of debt recorded in its Schedule of Changes in Long-term Obligations, made up of \$60 million of general obligation debt, \$2 million of compensated absences payable, \$8 million claims and judgments, and \$25 million of obligations under capital leases. The State limits the amount of general obligation debt that can be issued by a City to 20% of the assessed value of its taxable property. The assessed value of property in Southside City is \$500 million. The legal debt margin for Southside City is
- \$ 5 million.
 - \$ 40 million.
 - \$ 60 million.
 - \$100 million.
23. A state created a Housing Authority to provide financing for low-income housing. The Authority issues bonds and uses the proceeds for that purpose. Currently the Authority has outstanding \$200 million in bonds backed by the State's promise to cover debt service shortages should they arise. The State Constitution specifically limits the State to no more than \$2 million in general obligation debt. How can the state officials defend the \$200 million in debt outstanding?
- The debt is not general obligation debt.
 - The State is only morally obligated for the debt.
 - The debt is the debt of the Authority, not the State.
 - All of the above.

24. Debt that is issued by one entity but backed by the promise of another entity to make up any debt service deficiency is
- Committed debt.
 - Overlapping debt.
 - Conduit debt.
 - Moral obligation debt.
25. A City entered into a long-term capital lease for some office equipment. Assuming the city maintains its books and records in a manner to facilitate preparation of fund financial statements, what entry would be made in its General Fund to record this event?
- Debit Expenditures; Credit Other Financing Sources—Leases.
 - Debit Equipment; Credit Other Financing Sources—Leases.
 - Debit Equipment; Credit Leases Payable.
 - No entry because this event had no effect on financial resources.
26. A City Electric Utility Enterprise Fund made its annual interest payment on its outstanding \$20 million of 6% bonds, which were originally issued at a premium. Assuming the City maintains its books and records in a manner that facilitates preparation of its fund financial statements, the entry to record this would include a credit to cash for the amount of the interest checks written and debit(s) to
- Interest Expenditure AND Bond Premium.
 - Interest Expense AND Bond Premium.
 - Interest Expenditure only.
 - Interest Expense only.
27. Which of the following is likely to be used by a bond rating agency to rate the general obligations bonds of a governmental entity?
- A review of the Basic Financial Statements.
 - Consideration of economic statistics such as unemployment rates.
 - Consideration of legal debt margin.
 - All of the above.
28. In a bond covenant, a city agreed to create and maintain a \$2 million reserve. These funds can be used
- Only to make the final year's interest and principal payments on the bonds.
 - Only to make the interest and principal payments on the bonds in a year in which the city is unable to make the required debt service payments from other resources.
 - To make either the final year's interest and principal payments on the bonds or in the event that the city is unable to make the interest and principal payments on the bonds.
 - By the city as it chooses since it legally belongs to the city.
29. Bond insurance issued by credit enhancement agencies
- Insures the holder of the debt that all interest and principal payments will be made.
 - Insures that the bonds receive the highest possible rating.
 - May seem cost prohibitive to many governments.
 - All of the above.

30. The work of bond rating agencies is important because
- They insure that all principal and interest payments on bonds issued will be made.
 - The rating they assign proves the quality of a particular debt instrument.
 - They affect the debt's marketability and hence its interest rate.
 - Bonds cannot be issued without them.
31. A major exception to the general rule of expenditure accrual for governmental funds of a state or local government relates to unmatured

| | Interest on General Long-term debt | Principal of general Long-term debt |
|----|---|--|
| a) | Yes | No |
| b) | No | Yes |
| c) | Yes | Yes |
| d) | No | No |

32. Calhoun City is accumulating financial resources that are legally restricted to payments of general long-term debt principal and interest maturing in future years. At year-end, \$7,000,000 has been accumulated for principal payments, and \$2,200,000 has been accumulated for interest payments. These restricted funds should be accounted for in the

| | General Fund | Debt Service Fund |
|----|---------------------|--------------------------|
| a) | \$0 | \$9,200,000 |
| b) | \$9,200,000 | \$0 |
| c) | \$2,200,000 | \$7,000,000 |
| d) | \$7,000,000 | \$0 |

PROBLEMS (CHAPTER 8)

1. During the fiscal year ended 6/30/07, the City of Hartsville engaged in the following transactions. **REQUIRED:** Assuming the city maintains its books and records in a manner that facilitates the preparation of its governmental fund financial statements, prepare all necessary journal entries that the City should make for each transaction. Clearly indicate in which fund the entry is being made. If no entry is required, write “No Entry Required.”
 - a) In July 2006, the City issued \$20 million in 6% general obligation term bonds to finance construction of a new building to house City offices. The bonds were issued at a premium of \$200,000.
 - b) In September 2006, the City transferred \$1 million from the General Fund to cover the \$.6 million principal and \$.4 million interest payments due that month on debt issued in previous years.
 - c) In September 2006, the City paid the principal and interest due from (b).
 - d) In June 2007, the City transferred \$2 million from the General Fund to cover the \$1.2 million interest payment and the \$.8 million principal payment due in July 2007 on the bonds issued in (a).

2. Rutherford City entered into the following transactions during the current year. **REQUIRED:** Assuming that the City maintains its books and records in a manner that facilitates the preparation of its fund financial statements, prepare entries to record the following transactions. Indicate the fund in which the entry is being made.
 - a) The City issues \$5 million of tax anticipation notes, backed by property taxes that will be recorded in the General Fund.
 - b) The City issues \$2 million of 90-day bond anticipation notes that it expects to roll over into long-term bonds.
 - c) The City repays the \$5 million in (a) plus \$.125 million in interest.
 - d) The City successfully issues \$20 million in long-term bonds and repays the notes in (b).

3. Young County engaged in the following debt-related transactions during the year. REQUIRED: Assuming that Young County maintains its books and records in a manner that facilitates the preparation of its government-wide financial statements, prepare the necessary journal entries to record these transactions. Clearly indicate if debt is long-term or short-term (current). If no entry is required, write "No Entry Required."
- a) The County issued \$5 million in 6%, 20-year bonds for \$5,117,466 to yield 5.8 % (2.9% per semi-annual period) to the investor.
 - b) The County made the first semi-annual interest payment on the bonds in (a).
 - c) The County issues \$3 million in 6% demand bonds for which it does not enter into a take-out agreement.
 - d) In anticipation of finally issuing \$10 million in bonds that were approved by the voters several months ago, the County borrows \$10 million from a consortium of national banks due in six months. A financing agreement is also entered into with the consortium to convert the debt to 10-year debt if long-term bonds are not sold successfully.
 - e) In anticipation of property tax revenues to be received several months after its fiscal year-end, the County borrows \$2 million from a local bank payable in nine months.
 - f) The County leased a new machine for its County Highway Department in an arrangement that qualified as a capital lease. The present value of the minimum lease payments is \$150,000, which approximates the fair value of the machine.
4. Sun City is located in Hailey County. Sun Valley School District encompasses all of Sun City and some of Hailey County. Property in Sun City is assessed at \$400 million; property in Hailey County is assessed at \$800 million; property in Sun Valley School District is assessed at \$600 million. The total debt outstanding for Sun City is \$30 million; Hailey County is \$50 million; Sun Valley School District is \$45 million. REQUIRED: For Sun City, compute (a) the amount of direct debt and (b) the amount of overlapping debt.
5. In August 2007, the voters of Snow City approved construction of a new public library at the cost of \$20 million, to be financed by general obligation bonds. The City put the contracts out to bid and approved the bid of the lowest competent bidder. In September 2007, it began the long process of issuing the general obligation bonds. However, so that construction could begin immediately, the City also issued \$4 million in bond anticipation notes in September 2007, maturing in March 2008. In December 2007, one of the City's major manufacturers announced that it would be closing its plant in the City, eliminating over half of the jobs currently available in the City. REQUIRED: (a) Prepare journal entries to initially record the issuance of the BANs in the City's capital projects fund as well as in its government-wide financial statements. (b) Assuming that the City decided to reconsider the scope of the library project in light of the plant closure, prepare any entries necessary to change the reporting of the BANs assuming that the City negotiated an extension of the initial due date for the BANs by an additional 6 months and would not issue any general obligation bonds before it issued its June 30, 2008 financial statements.

6. Central City engaged in two types of debt transactions in its fiscal year ending December 31, 2006. The city issued its financial statements for 2006 on May 15, 2007.
- A. In November 2006, it issued \$4 million in bond anticipation notes (BANs) to finance construction of a new maintenance facility. The proceeds were placed in a capital projects fund and the city began construction immediately. Although the city intended to refinance the BANs with long-term bonds, interest rates were higher than anticipated and as of May 15, 2007 the city had neither issued the bonds nor entered into an agreement to do so. How, if at all, should the debt be reported in the capital projects fund and the government-wide statements. Be specific.
1. Capital project fund
 2. Government-wide statements
- B. In October 2006, the city issued \$1 million of industrial development bonds to finance the construction of a new fast-food restaurant. The city will construct the facility and lease it to a restaurant chain. The lease satisfies the criteria of a capital lease. The lease payments will be exactly equal to the debt service on the bonds. The bonds are payable exclusively from the lease payments. In the event the restaurant chain defaults on its lease payments, the bondholders have a claim only against the restaurant chain and the leased property, not against the city. In its December 31, 2006 government-wide statement of net assets, the city failed to report the debt as a liability. Assuming that the amount involved is material, would you as an auditor issue an unqualified opinion on the statements? Explain and justify your response.

ESSAYS (CHAPTER 8)

1. Identify and define "conduit debt." What are the current reporting standards for conduit debt issued by governmental entities? Do you agree or disagree with the use of conduit debt by governmental entities? Justify your answer. Do you agree or disagree with the current reporting standards related to conduit debt? Why?
2. Generally accepted accounting principles require many assets to be reported at market values. However, few liabilities are reported at market value. What are arguments for and against reporting liabilities at market value?
3. Why is information about long-term debt important to financial statement users?
4. What is the distinction between general obligation debt and revenue bond debt? Why might a government issue revenue bond debt instead of general obligation debt?
5. The City of Chessie is considering issuing \$50 million in debt to finance construction of a new sewer system. REQUIRED: Compare the possible financial effects of the City's decision to finance the new system with: (a) General obligation debt, (b) State-issued sewer revolving bond fund debt, which carries the moral obligation of the state in addition to being a primary obligation of the City through its loan payments to the State, (c) The City's own sewer revenue bonds, or (d) General obligation debt insured by the Municipal Bond Insurance Association (MBIA).
6. What is overlapping debt and why is it important to financial analysts and others who use governmental financial statements?
7. The city financed the construction of sidewalks in a newly annexed subdivision by issuing \$50 million in special assessment debt. The debt is to be serviced entirely by assessments against the subdivision's property owners. The government does not have any obligation for the debt and has not guaranteed it. Nevertheless, when the property owners in a nearby subdivision were unable to pay their required assessments, the city, fearful of damaging its own credit rating, serviced the debt out of its own general funds. Should the city report the \$50 million in special assessment debt on its government-wide balance sheet? Explain, citing specific GASB provisions.
8. On December 31, 2006 the city issued \$50 million of 8 percent, 20-year, demand bonds that give bondholders the opportunity to "put" (i.e. sell) the securities back to the issuer at face value, beginning on January 1, 2010. On December 31, 2009, prevailing interest rates on comparable bonds were 6.7 percent. Should the city report the bonds as a liability on its December 31, 2009 general fund financial statements? Explain, indicating any additional information you would need to make a determination.
9. In November 2006, the city issued \$3 million in 6 percent TANs, payable in April 2007. In what fund or fund type should the city report the TANs on its December 31, 2006 financial statements? Explain, indicating any additional information you would need.

ANSWERS TO TRUE/FALSE (CHAPTER 8)

1. False
2. True
3. True
4. True
5. True
6. False
7. True
8. False
9. True
10. True
11. True

ANSWERS TO MULTIPLE CHOICE (CHAPTER 8)

1. C
2. B
3. D
4. C
5. A
6. B
7. D
8. A
9. A
10. D
11. D
12. A
13. D
14. B
15. D
16. C
17. A
18. C
19. B
20. D
21. B
22. B
23. D
24. D
25. A
26. A
27. D
28. C
29. D
30. C
31. C
32. A

ANSWERS TO PROBLEMS (CHAPTER 8)

Problem 1

- a) CAPITAL PROJECTS FUND
- | | | |
|--------------------------------------|----------------|---------------|
| Cash | \$20.2 million | |
| Other Financing Source—Bond Proceeds | | \$20 million |
| Other Financing Source—Premium | | \$.2 million |
- [\$20 million should also be added to the Schedule of Changes in Long-term Obligations]
- b) GENERAL FUND
- | | | |
|-------------------------------|-------------|-------------|
| Other Financing Uses—Transfer | \$1 million | |
| Cash | | \$1 million |
- DEBT SERVICE FUND
- | | | |
|----------------------------------|-------------|-------------|
| Cash | \$1 million | |
| Other Financing Sources—Transfer | | \$1 million |
- c) DEBT SERVICE FUND
- | | | |
|--------------|-------------|-------------|
| Expenditures | \$1 million | |
| Cash | | \$1 million |
- [\$.6 also should be shown as a retirement in the Schedule of Changes in Long-term Obligations]
- d) GENERAL FUND
- | | | |
|-------------------------------|-------------|-------------|
| Other financing Uses—Transfer | \$2 million | |
| Cash | | \$2 million |
- DEBT SERVICE FUND
- | | | |
|----------------------------------|-------------|-------------|
| Cash | \$2 million | |
| Other Financing Sources—Transfer | | \$2 million |
- DEBT SERVICE FUND (optional entry)
- | | | |
|---------------------------|---------------|---------------|
| Expenditure—Principal | \$.8 million | |
| Expenditure—Interest | \$1.2 million | |
| Matured Principal Payable | | \$.8 million |
| Matured Interest Payable | | \$1.2 million |
- [If this optional entry is made \$.8 should be shown as a retirement in the Schedule of Changes in Long-term Obligations]

Problem 2

| | | |
|---|-----------------|-----------------|
| a) GENERAL FUND | | |
| Cash | \$5 million | |
| Tax Anticipation Notes Payable | | \$5 million |
| b) CAPITAL PROJECTS FUND | | |
| Cash | \$2 million | |
| Other Financing Sources—Proceeds of BANs | | \$5 million |
| [\$2 million should be shown as an addition to Schedule of Changes in Long-term Obligations] | | |
| c) GENERAL FUND | | |
| Tax Anticipation Notes Payable | \$5 million | |
| Debt service expenditure—interest | \$0.125 million | |
| Cash | | \$5.125 million |
| d) CAPITAL PROJECTS FUND | | |
| Cash | \$20 million | |
| Other Financing Sources—Bond Proceeds | | \$20 million |
| [\$20 million should be shown as an addition to Schedule of Changes in Long-term Obligations] | | |
| Other Financing Uses—Repay BANs | \$2 million | |
| Cash | | \$2 million |
| [\$2 million should be shown as a retirement in the Schedule of Changes in Long-term Obligations] | | |

Problem 3

| | | | |
|----|--------------------------|--------------|--------------|
| a) | | | |
| | Cash | \$ 5,117,466 | |
| | Premium | | \$ 117,466 |
| | Long-term Bonds Payable | | \$ 5,000,000 |
| b) | | | |
| | Interest Expense | \$ 148,406 | |
| | Premium on Bonds Payable | \$ 1,594 | |
| | Cash | | \$ 150,000 |
| c) | | | |
| | Cash | \$ 3 million | |
| | Short-term Notes Payable | | \$ 3 million |
| d) | | | |
| | Cash | \$10 million | |
| | Long-term BANs | | \$10 million |
| e) | | | |
| | Cash | \$ 2 million | |
| | Short-term TANs | | \$ 2 million |
| f) | | | |
| | Equipment | \$ 150,000 | |
| | Long-term Lease Payable | | \$ 150,000 |

Problem 4

- a. Direct debt is \$30 million.
- b. Overlapping debt is \$55 million, consisting of:
Hailey County debt \$50 million x (\$400 million/\$800 million) = \$25 million
Sun Valley School District debt \$45 million x (\$400 million/\$600 million) = \$30 million.

Problem 5

| | | | |
|--------------------------------------|--|-------------|-------------|
| a. CAPITAL PROJECTS FUND | | | |
| Cash | | \$4 million | |
| Other financing sources—BAN proceeds | | | \$4 million |

| | | | |
|--------------------------------------|--|-------------|-------------|
| GOVERNMENT-WIDE FINANCIAL STATEMENTS | | | |
| Cash | | \$4 million | |
| Long-term Liabilities—BANs | | | \$4 million |

| | | | |
|--------------------------------------|--|-------------|-------------|
| b. CAPITAL PROJECTS FUND | | | |
| Other financing sources—BAN proceeds | | \$4 million | |
| BANs payable | | | \$4 million |

[No entry would be needed to extend the due date if the original BANs by 6 months.]

| | | | |
|--------------------------------------|--|-------------|-------------|
| GOVERNMENT-WIDE FINANCIAL STATEMENTS | | | |
| Long-term liabilities—BANs | | \$4 million | |
| Short-term liabilities—BANs | | | \$4 million |

Problem 6

A..

1. Capital project fund

The debt would be reported as a fund liability

2. Government-wide statements

It would be reported as a **current** (short term) liability

B.

Yes. The IDBs are conduit bonds. They should only be reported in notes, not on the statement of net assets.

ANSWERS TO ESSAYS (CHAPTER 8)

1. Conduit debt refers to obligations issued in the name of government on behalf of a nongovernmental entity, such as a business or not-for-profit organization.

The current reporting standards require only that governments provide note disclosure about conduit debt. The note disclosure must provide the following information:

- A general description of the conduit debt transactions.
- The aggregate amount of all conduit debt obligations outstanding.
- A clear indication that the issuer has no obligation for the debt beyond the resources provided by related leases or loans.

The current reporting standards allow governments to report conduit obligations in their government-wide and proprietary fund statements, but only require note disclosures.

[There should be a variety of answers related to agree/disagree with the use of conduit debt. Those who agree will include benefits such as lower rates of interest for the beneficiaries, new jobs for the community. Those who disagree will be concerned that certain entities will benefit from the issuance of conduit debt while other entities must pay higher interest rates. It amounts to a subsidy for selected entities. Should governments be in the business of job development or should they be providing the infrastructure and atmosphere in which free enterprise creates job? Questions should arise about government's role in economic development. Some may say it is corporate welfare.]

[There should be a variety of answers to the question of the appropriateness of the reporting standards. Some may say that the debt will be repaid by the beneficiaries and to include that debt on the financial statements of the government will overstate their liabilities. Others may feel that not including it in the financial statements understates the government's liabilities because they feel certain the government will service the debt if the beneficiary ceases to make lease or loan payments sufficient to service the debt. The potential "drain" on the resources of the government should be displayed.]

2. Overall, if governments have long-term debt outstanding, and also hold long-term bonds as an investment it may appear inconsistent and misleading to show changes on one side of the balance sheet while ignoring those on the other side

The primary argument in favor of reporting long-term liabilities at historical, rather than market price, is that the market value information will not be used. Because most entities have no intention of retiring the debt until it matures, period-to-period fluctuations are irrelevant. This argument is supported by FASB's standard (applicable to for-profit entities) which permits investments that are to be held to maturity to be reported at amortized cost, while all other investments must be reported at market.

The primary arguments in favor of reporting long-term liabilities at market price would appear to be that it is consistent between assets and liabilities. Also, if an entity holds investments that are timed to mature to provide proceeds with which to liquidate outstanding liabilities, it seems misleading to value the assets at market and the liabilities at historical cost (or present value) because the liability will be liquidated with the proceeds from the sale of the related assets.

3. Information on long-term debt is especially important to financial statement users because an entity's failure to make timely payments of interest and principal can have profound repercussions, both for its creditors and for the government itself. Creditors will obviously incur losses. Governments that fail to meet their debt obligations will have difficulty issuing new debt in the future. Inability to issue debt can significantly affect a government's ability to provide infrastructure and other fixed assets. Many of a government's programs require the use of long-lived assets. For purposes of establishing interperiod equity, most governments finance long-lived capital assets over the life of those assets. Inability to issue new debt can hinder the ability of the government to provide the services expected of them. Because many governments have only a limited amount of legal borrowing power, taxpayers and bondholders also should be interested in the government's legal debt margin.
4. General obligation debt is an obligation of the government at-large and is thereby backed by the government's full faith and credit. Revenue debt, by contrast, is secured only by designated revenue streams, such as from the sale of electricity, highway tolls, rents, receipts from student loans or patient billings.

A government might issue revenue bond debt instead of general obligation debt because:

- Revenue bonds are usually not subject to voter approval or other forms of voter oversight.
 - Revenue bonds may not be considered in legal debt limitations.
 - Revenue bonds help governments readily incorporate the cost of debt service (interest) into user fees. This is particularly helpful when many of the users are outside the government's jurisdiction, for example, revenue bonds issued to finance a toll road.
5.
 - a) The City's general obligation debt would carry the full faith and credit of the City and, therefore, would likely carry a lower interest rate (financing cost) than the options contemplated in (b) and (c). However, GO debt would likely be considered in the calculation of the City's legal debt margin.
 - b) The State revolving fund debt is priced according to the State's credit quality. In addition, it would not likely be considered in the calculation of the City's legal debt margin. However, depending on how well the City manages its finances, this credit enhancement might not be as good as the City's own credit rating in (a).
 - c) City revenue bonds have the advantage of directly charging the users of the sewer system for the cost of the loan. If the users of the new sewer system are all City residents, however, this advantage would be overshadowed by the higher interest rates that revenue bonds usually carry. If many of the new users of the new system will be outside the City's jurisdiction, however, this would be an advantage. Revenue bonds are not usually considered in the calculation of the City's legal debt margin.
 - d) Bonds that are insured carry the highest rating, and therefore, the lowest possible interest rate for the City. However, the City would need to compare the cost of the insurance to the interest savings that would result.

6. *Overlapping debt* refers to the obligations of stakeholders within a particular government for their proportionate share of debts of other governments with overlapping geographic boundaries. It represents additional obligations that are supported from the same sources as the government's direct debt. Overlapping debt is significant because, like direct debt, it bears upon the government's fiscal capacity to meet its obligations as they come due.
7. Yes. As long as the city is "obligated in some manner" for the debt it must account for it as its own. The city is "obligated in some manner" unless it is legally prohibited from assuming the debt and makes no statement or gives no indication that it will or may honor the debt. By assuming the debt of a similar entity, the city clearly indicated that it may honor the debt in the event of default.
8. The city need not report the "put" bonds as a general fund obligation as long as it has a "take out agreement" which does not expire for at least a year, a written by a party with the financial wherewithal to honor it and has not been violated as of the balance sheet date.
9. Tax anticipation notes (TANs) are always considered short-term liabilities. Hence they should be reported in the city's general fund or some other governmental fund.

Chapter 9

Business-Type Activities

TRUE/FALSE (CHAPTER 9)

1. In both the fund statements and the government-wide statements, business-type activities and internal service funds are on a full accrual basis, and their measurement focus is on all economic resources.
2. The operating statement required as one of the three basic financial statements for proprietary funds is called the statement of revenues, expenditures, and changes in fund net assets.
3. The amounts reported in proprietary fund statements are generally the same as those reported in the government-wide statements because both sets of statements are on a full accrual basis of accounting.
4. Governments are required to prepare a statement of cash flows for proprietary funds, but not for governmental funds.
5. GASB Statement No. 34 mandates that governments report their cash flows from operations using the indirect method.

6. The FASB mandates entities report their cash flows from operations using the direct method.
7. Governments generally do not have to get formal legislative approval for enterprise fund budgets or incorporate them into their accounting systems.
8. In accounting for closure and postclosure landfill costs in an enterprise fund, a government does not necessarily have to “fund” the costs during the landfill’s useful life; it merely has to report both an expense and a liability for them.
9. The revenues of an internal service fund are the expenditures and expenses of other funds of that government.
10. The proprietary fund operating statement includes ALL changes in net assets including capital contributions.

MULTIPLE CHOICE (CHAPTER 9)

1. The appropriate measurement focus for the business-type activities of the City of Rockford is
 - a) Current financial resources.
 - b) Economic resources.
 - c) Both (a) and (b).
 - d) None of the above.

2. Which of the following is not a proprietary fund?
 - a) City Water Enterprise Fund.
 - b) City Motor Pool Internal Service Fund.
 - c) City Hall Capital Project Fund.
 - d) None of the above. They are all proprietary funds.

3. The appropriate basis of accounting for the proprietary funds of a governmental entity is
 - a) Cash basis.
 - b) Modified accrual.
 - c) Full accrual.
 - d) None of the above.

4. Which of the following is a valid reason for governmental entities to engage in business-type activities?
 - a) The entity does not want control over the activity.
 - b) The activity competes with general government activities.
 - c) The entity does not want to subsidize the activity.
 - d) The entity can provide the services more cheaply or efficiently than can a private firm.

5. Which of the following is a valid argument for separate accounting principles for proprietary activities?
 - a) Two separate measurement focuses and bases for accounting within the same set of financial statements are confusing.
 - b) There are no clear-cut distinctions between business and non-business activities.
 - c) The measurement focus on all economic resources is more consistent with the GASB's objectives that financial reporting should provide information to determine whether current-year revenues were sufficient to pay for current-year services.
 - d) Surveys of statement users indicate that information on depreciation is not of high priority to governmental decision makers.

6. Which of the following is a key reason for using business-type accounting to account for proprietary fund activities?
 - a) The modified accrual basis of accounting captures all the resources and obligations associated with an activity.
 - b) Depreciation is not recognized in business-type accounting in governments and surveys of statement users indicate that information on depreciation is not of high priority to governmental decision makers.
 - c) The measurement focus on all economic resources is more consistent with the GASB's objectives that financial reporting should provide information to determine whether current-year revenues were sufficient to pay for current-year services.
 - d) Business-type accounting facilitates comparisons with governmental activities.

7. Which of the following is NOT a budget typically prepared for an activity accounted for in a proprietary fund?
 - a) Appropriation budget.
 - b) Cash budget.
 - c) Capital budget.
 - d) Flexible budget.

8. A governmental entity reports its utility services provided to the citizens in a proprietary fund. Which of the following best represents an acceptable election of accounting standards for the proprietary fund? Unless the FASB pronouncement conflicts with or contradicts a GASB pronouncement, a propriety fund must adhere to
 - a) All FASB pronouncements.
 - b) All FASB pronouncements issued prior to November 30, 1989, as well as any post-November 30, 1989 pronouncements specifically adopted by GASB.
 - c) It must apply only GASB standards.
 - d) It may elect either (a) or (b).

9. A proprietary fund of a governmental entity has donor-restricted assets on its balance sheet. Which of the following best describes where and how those assets will generally be displayed?
 - a) In a separate restricted asset category on the statement of net assets.
 - b) Intermingled with other assets on the statement of net assets.
 - c) Intermingled with other assets on the statement of net assets but footnoted.
 - d) In a separate restricted fund.

Use the following information to answer #10 and #11.

The City of Brockton voted to establish an internal service fund to account for its printing services. The City transferred \$500,000 cash from the General Fund to the newly created internal service fund.

10. The appropriate entry in the general fund to account for this transfer would be a credit to cash for \$500,000 and a debit for \$500,000 to
 - a) Due from Internal Service Fund.
 - b) Transfer Out.
 - c) Expenditures.
 - d) Investment in Internal Service Fund.

11. The appropriate entry in the internal service fund is a debit to cash for \$500,000 and a credit for \$500,000 to
 - a) Due to General Fund.
 - b) Transfer In.
 - c) Capital Contribution (Revenues).
 - d) Investment provided by the General Fund.

12. The City issued \$2 million in general obligation bonds to acquire a fleet of vehicles for the Central Motor Pool Internal Service Fund. At the date of issue, the appropriate entry in the Internal Service Fund is a \$ 2 million debit to cash and a \$2 million credit to
- Bonds Payable.
 - Capital Contribution (Revenues).
 - Capital Contributed (Revenues) AND show \$2 million as an addition to the Schedule of Changes in Long-term Obligations.
 - No entry in the proprietary fund. Show \$2 million as an addition to the Schedule of Changes in Long-term Obligations.
13. Which of the following is the *best* rationale/justification for reporting the business-type activities of a government in a separate fund?
- Laws or regulations require that the activity's costs of providing services be recovered by fees and charges rather than general purpose taxes or similar charges.
 - Separate funds facilitate budgeting, planning, and controlling.
 - Separate funds facilitate the assessment of performance of the activity.
 - Separate funds facilitate the assessment of fiscal status of the activity.
14. Which of the following are required basic statements of a Proprietary Fund?
- Balance Sheet and Income Statement.
 - Balance Sheet; Statement of Revenues, Expenses, and Changes in Retained Earnings; and Statement of Cash Flows.
 - Statement of Net Assets and Statement of Revenues, Expenses, and Changes in Fund Net Assets.
 - Statement of Net Assets; Statement of Revenues, Expenses, and Changes in Fund Net Assets; and Statement of Cash Flows.
15. Burton County issued \$6 million of revenue bonds to finance construction of additional physical plant facilities for the City Sewer System that is accounted for in an enterprise fund. The bond agreement requires that \$.5 million of the proceeds be invested in U.S. Treasury securities to be used to service the debt if revenues in a particular year are insufficient to do so. At the time of the sale of the bonds, the County debited restricted cash and credited bonds payable. What additional entry, if any, would be needed?
- No additional entry would be needed at this time.
 - Restricted Net Assets \$.5 million; Unrestricted Net Assets \$.5 million.
 - Debit Unrestricted Net Assets \$.5 millions; Credit Restricted Net Assets \$.5 million.
 - Debit Unrestricted Retained Earnings \$.5 million; Credit Restricted Retained Earnings \$.5 million.
16. Franklin County operates a solid waste landfill that is accounted for in an enterprise fund. The County calculated this year's portion of the total closure and postclosure costs associated with the landfill to be \$300,000. The entry(ies) to record this cost should be
- Debit Landfill Expense \$300,000; Credit Liability for Landfill Costs \$300,000
 - Debit Landfill Expense \$300,000; Credit Liability for Landfill Costs \$300,000 AND Include an addition of \$300,000 on the Schedule of Changes in Long-term Obligations.
 - Show only an addition of \$300,000 on the Schedule of Changes in Long-term Obligations.

d) No entry in any fund; No entry in the Schedule of Changes in Long-term Liabilities.

17. Marsh Lake County operates a solid waste landfill that is accounted for in a governmental fund. The County calculated this year's portion of the total closure and postclosure costs associated with the landfill to be \$600,000. The entry to record this cost should be
- Debit Landfill Expenditure \$600,000; Credit Liability for Landfill Costs \$600,000
 - Debit Landfill Expenditure \$600,000; Credit Liability for Landfill Costs \$600,000 AND Include \$600,000 as an addition on the Schedule of Changes in Long-Term Obligations.
 - No entry in the fund; include \$600,000 on the Schedule of Changes in Long-Term Obligations.
 - No entry in any fund or Schedule.
18. During the current year, the Wilson County Landfill Enterprise Fund installed wells designed to assist in the ground water monitoring process after closure for their solid waste landfill. The landfill has reached 40% of its capacity and is expected to continue to accept waste until 2012. The costs of the wells were \$80,000. The appropriate entry to record this event is a credit to cash for \$80,000 and an \$80,000 debit to
- Fixed assets.
 - Landfill expenses.
 - Liability for landfill costs.
 - Deferred expenses.
19. Over the long run, governmental internal service funds are intended to
- Generate revenues sufficient to cover the full costs of providing services.
 - Generate revenues sufficient to cover the full costs of providing services and to earn a profit.
 - Generate revenues sufficient to cover the current operating costs of providing services.
 - Generate revenues sufficient to cover the current operating costs of providing services and to earn an operating profit.
20. Which of the following is **NOT** true about internal service funds as reported in the fund financial statements?
- Costs reported by internal service funds are reported twice within the same set of financial statements.
 - Billing rates must be set to cover the full cost of providing the goods or services.
 - Depreciation can be charged to governmental funds through the billing rates established by the internal service fund.
 - Deficits or surpluses in the general fund can be transferred to the internal service fund by adjusting the billing rates.
21. In the Statement of Net Assets, the net assets of a proprietary fund should be displayed in which of the following categories?
- Unrestricted Fund Balance; Restricted Fund Balance, Invested in Capital Assets, Net of Related Debt.
 - Unrestricted Net Assets; Restricted Net Assets; Invested in Capital Assets, Net of Related Debt.
 - Unrestricted Net Assets; Restricted Net Assets; Net Assets Available for Use.
 - Net Assets Available for Use.

22. A Statement of Revenues, Expenses, and Changes in Fund Net Assets should include which of the following in addition to operating revenues and operating expenses and ending Net Assets
- Nonoperating revenues and expenses.
 - Nonoperating revenues and expenses, and Other Changes in Net Assets.
 - Nonoperating revenues and expenses, Capital Contributions and Other Changes in Net Assets, Beginning Net Assets.
 - None of the above.
23. In which of the following circumstances must an enterprise fund be used to account for the activity?
- A newly created electric utility fund will finance its operations by a charge to users based on kilowatt hours used.
 - To finance the acquisition of plant facilities, a newly created electric utility issues general obligation debt.
 - To finance the acquisition of plant facilities, a newly created electric utility issues revenue bonds that will be repaid solely from operations of the electric utility.
 - To acquire needed plant facilities, a newly created electric utility enters into long-term lease agreements.
24. Washington County has designated the General Fund as the single fund to account for its self-insurance activities. What is the maximum amount that can be charged to expenditure in the General Fund related to the self-insurance activities?
- The amount of "premium" charged to the other funds.
 - The amount of actual claims expenditures.
 - The actuarially determined amount necessary to cover claims, expenditures, and catastrophic losses.
 - The amount transferred from other funds and activities to the general fund for self-insurance purposes.
25. Lehi City has designated an internal service fund as the single fund to account for its self-insurance activities. Most of the insured activities such as the police department, fire department, and general government functions are accounted for in the General Fund. What is the maximum amount that can be charged to expenditure in the General Fund related to the self-insurance activities?
- The amount of "premium" charged to the General Fund by the internal service fund.
 - The amount of actual losses incurred by the insurance activity.
 - The actuarially determined amount necessary to cover claims, expenditures, and catastrophic losses.
 - The amount transferred from the General Fund to the internal service fund for self-insurance purposes.
26. A governmental entity operates landfill. In the Landfill Enterprise Fund financial statements, which of the following would be reported as a restricted asset?
- Cash received from the sale of bonds that must, based on the debt covenant, be spent only on building a new landfill runoff treatment plant.
 - Cash that management has voted to use only for landfill expansion.

- c) Cash received from the General Fund that will be used only to expand the landfill.
- d) None of the above.

Use the following information to answer questions #27 and #28.

During the year the City's Self-Insurance Internal Service Fund billed the General Fund \$300,000 for "premiums," of which \$30,000 was for catastrophic losses and the balance was the premium computed on an actuarially determined basis. During the year the City incurred \$250,000 in claims losses. The total amount transferred to the Self-Insurance Fund by the General Fund was \$310,000.

27. The amount the City Self-Insurance Fund can recognize as revenue is
- a) \$310,000
 - b) \$300,000.
 - c) \$270,000.
 - d) \$250,000.
28. The amount the City General Fund can recognize as an expenditure is
- a) \$310,000.
 - b) \$300,000.
 - c) \$270,000.
 - d) \$250,000.
29. When a governmental enterprise fund has restricted assets on its balance sheet, which of the following is a true statement?
- a) The total of the restricted assets in the asset section will be equal to the "Restricted Net Assets" amount in the equity section.
 - b) The total of the restricted assets will be offset by a liability of an equal amount.
 - c) The total of the restricted assets less related liabilities will be equal to the "Restricted Net Assets" amount in the equity section.
 - d) None of the above statements is true.
30. Any internal service fund balances that are not eliminated in the consolidation process should generally be presented on the government-wide financial statements
- a) In the business-type activities column.
 - b) In the internal service fund column.
 - c) In the governmental activities column.
 - d) These balances should not be presented on the government-wide financial statements.
31. On the fund financial statements, internal service activities should be presented
- a) In the Proprietary Fund statements, net of interfund eliminations.
 - b) In the Governmental Fund statements, net of interfund eliminations.
 - c) In the Proprietary fund statements, without any interfund eliminations.
 - d) In the Governmental Fund statements, without any interfund eliminations.
32. Cash flows from Investing Activities include which of the following as cash inflows
- a) Cash collection of receivable for sale of services.
 - b) Grants for operating activities.
 - c) Interest and dividends received.
 - d) Purchases of investments.

33. Cash flows from Capital and Related Financing Activities include which of the following as cash outflows
- a) Grants to other governments for operating activities.
 - b) Grants to other governments for capital asset acquisitions.
 - c) Payments for services performed by other funds.
 - d) Purchases of capital assets.
34. Cash flows from Operating Activities include which of the following as inflows
- a) Proceeds from short-term borrowing to finance operations.
 - b) Receipts from property taxes levied to support operations of the activity.
 - c) Grants from other governments to finance an operating deficit.
 - d) Any cash receipt that does not meet the definition of investing, capital and related financing, or noncapital financing activities.
35. Cash flows from Investing Activities include which of the following as outflows
- a) Repayments of short-term borrowing to finance operations.
 - b) Interest received on investments.
 - c) Cash transfers to other funds.
 - d) Purchase of short-term investments.
36. Cash flows from Capital and Related Financing Activities include which of the following as inflows
- a) Repayment of bonds issued to construct a new city hall building.
 - b) Interest received on investments.
 - c) Grant from the state to subsidize the mass transit system.
 - d) Receipts from the sale of an old backhoe that had been used in general government activities.
37. Cash flows from Investing Activities do NOT include which of the following as inflows
- a) Receipts from the sale of marketable securities.
 - b) Interest received on bonds held as short-term investments.
 - c) Interest received on bonds held as long-term investments.
 - d) Transfers to other funds.
38. Cash flows from Noncapital Financing Activities include which of the following as outflows
- a) Repayment of bonds issued to finance construction of City Hall.
 - b) Deposits into investment pools.
 - c) Loans to another fund of the entity.
 - d) Grants made to other governments to support operating activities.
39. Which of the following entities is required to use the direct method to report its cash flows?
- a) City of Gaston Utility Fund.
 - b) United Way.
 - c) General Motors.
 - d) Oak Grove Water Users Association.

40. Which of the following factors are considered by rating agencies when considering revenue bond debt?

- a) Tax base.
- b) Assessed valuation of property in jurisdiction.
- c) History of rates and rate increases.
- d) Demographics.

41. The reporting of activities by an Enterprise Fund is most likely optional if:

- a) Fees are charged to external users for goods or services.
- b) The entity's pricing policies set fees and charges to recover costs.
- c) The entity is financed with debt, and the only security is a pledge of the activity's net revenues from fees and charges.
- d) The entity's costs are legally required to be recovered from fees and charges.

42. The Financial Statements of a Proprietary fund are prepared using the

| | <u>Full Accrual Basis</u> | <u>Modified Accrual Basis</u> | <u>Economic Resources Measurement Focus</u> | <u>Current Financial Resources Measurement Focus</u> |
|----|---------------------------|-------------------------------|---|--|
| a) | No | Yes | Yes | No |
| b) | Yes | No | No | Yes |
| c) | No | Yes | No | Yes |
| d) | Yes | No | Yes | No |

43. The following transactions were among those reported by Madison City's water utility enterprise fund for the current year:

| | |
|--|-------------|
| Proceeds from sales of revenue bonds | \$3,900,000 |
| Cash received from customer households | \$1,600,000 |
| Capital Contributed by subdivisions | \$700,000 |

In the water utility enterprise fund's statement of cash flows for the current year, what amount should be reported as cash flows from capital and related financing activities?

- b) \$3,900,000
- c) \$6,200,000
- d) \$5,500,000
- e) \$4,600,000

PROBLEMS (CHAPTER 9)

1. Benton County voted to establish an internal service fund to account for printing and copying for all its departments and agencies. The County engaged in the following activities related to the new fund. REQUIRED: Prepare transactions to record these events in the internal service fund. If no entry is required, write "No Entry Required."
 - a) The County Commission voted to transfer \$200,000 from the General Fund to the internal service fund to establish the new fund.
 - b) The fund entered into a capital lease for equipment to be used in printing activities. The total present value of the lease obligation is \$600,000.
 - c) Issued \$1 million in general obligation bonds at 101. The bonds were issued to acquire additional equipment. The bonds are to be serviced from the internal service fund.
 - d) Purchased equipment at a cost of \$980,000. The equipment has an estimated useful life of nine years and an estimated salvage value of \$80,000.
 - e) Billed the General Fund for copying and printing charges, \$70,000.
 - f) Paid salaries to printing employees, \$50,000.

2. The City of Petersburg has operated a City Utility Enterprise Fund for a number of years. The fund accounts for the activities of the City-owned electric, water and sewer systems. During the current year, the City engaged in the following transactions related to the City Utility Fund. REQUIRED: Prepare the appropriate journal entries. If none is required, write "No Entry Required."
 - a) The City billed its customers \$1 million for services provided during the year.
 - b) The City received \$260,000 from a developer to connect new houses to the existing utility lines.
 - c) Depreciation on existing physical plant was \$700,000.
 - d) Revenue bonds in the amount of \$2 million were issued at par to finance new construction. The bond agreement requires that the City retain \$200,000 of the bond proceeds for purposes of servicing the debt if revenues are not sufficient to do so.

3. The City of San Dominguez received a \$500,000 federal grant to acquire several buses to be used in its public transit system. The City paid \$400,000 to acquire several buses. At year-end, \$100,000 of the grant had not yet been used. During the year total depreciation on the buses was \$40,000. Revenues for the public system were \$600,000; operating expenses (other than depreciation) were \$470,000. REQUIRED: Assuming the Public Transit Enterprise Fund began the year with unrestricted net assets of \$420,000, prepare the following for the Public Transit Enterprise Fund.
- Statement of Revenues, Expenses, and Changes in Fund Net Assets.
 - Net Assets section of the Statement of Net Assets.
4. Greene County operates a solid waste landfill that is accounted for as an enterprise fund. At the end of 2005, the Landfill Enterprise Fund had a Liability for landfill closure care costs of \$50,000. The County estimated the total costs associated with closing and monitoring the landfill as listed below. REQUIRED: (a) Calculate the estimated total current cost of postclosure care as of year-ends 2006 and 2007. (b) Calculate current period expenses for year-ends 2006 and 2007. (c) Prepare the required journal entries at year-ends 2006 and 2007 to recognize the current period expenses. Be sure to show all of your work.

| | <u>2006</u> | <u>2007</u> |
|----------------------------|---------------|---------------|
| Costs | | |
| Equipment to be installed | \$2.5 million | \$3.0 million |
| Final cover | \$.5 million | \$1.0 million |
| Monitoring and maintaining | \$4.0 million | \$4.0 million |
| Capacity used in total | 30,000 | 58,000 |
| Estimated total capacity | 600,000 | 580,000 |

5. Johnson City opened a landfill that it elects to account for in an enterprise fund.
- At the time the landfill was opened the government estimated total capacity of the landfill to be 5 million cubic feet, useful life to be 20 years, and total closure and postclosure costs to be \$15 million.
 - At the end of Year 1, the government reestimated total closure costs to be \$15.2 million and estimated capacity to be same as the original estimate.
 - At the end of Year 2, the government reestimated total capacity to be 4.8 million cubic feet and total closure costs to be \$15.4 million.
 - At the end of Year 3, the government reestimated useful life to be 17 years but capacity remained unchanged from the preceding year and closure and postclosure costs were estimated to be \$15.3 million.

REQUIRED: Prepare entries in the enterprise fund to record the following events

- a) During Year 1, the city estimates 300,000 cubic feet of capacity were used. Record the landfill expense.
 - b) During Year 2, the city estimates that an additional 350,000 cubic feet of capacity were used. Record the landfill expense.
 - c) During Year 3 the City installed equipment at a cost of \$130,000. The equipment will be used in monitoring the landfill when it is closed.
 - d) During Year 3 the city estimates that an additional 400,000 cubic feet of capacity were used. Record the landfill expense.
6. When insurance premiums went through the roof, Hat City decided to “self insure.” It established an internal service fund (ISF), setting aside resources of potential claims in that new fund. During the year, the following transactions were recorded in the ISF:
- The ISF recognized \$1.5 million in claims expense/liabilities based on GASB Statement 10 and paid \$1.3 million of those claims.
 - Based on an actuarial calculation, the ISF billed the other funds of the City for \$2.0 million. Of this, \$1.2 million was billed to the City’s general fund and \$0.8 million was billed to the City’s water and sewer enterprise fund. The actuarial valuation included a reasonable provision for future catastrophe losses of \$0.3 million.

REQUIRED:

- a) Prepare journal entries to record these transactions in the City’s self-insurance ISF.
- b) Suppose, instead, that the City reported its self-insurance activities in its general fund. Prepare journal entries to record these transactions in the City’s general fund. Assume any excess was allocated ratably (proportionately) between the general fund and the water and sewer fund.

7. The following list of cash flows was taken from the Clark City airport fund's statement of cash flows. All amounts are in thousands.

| | |
|---|--------|
| Cash on hand, beginning of year | \$ 122 |
| Operating lease receipts | 2,350 |
| Interest received from investments | 25 |
| Wages and salaries paid | 815 |
| Purchases of supplies | 1,025 |
| Collections (for services) from other funds of the City | 290 |
| Interest paid on long-term capital debt | 175 |
| Purchases of capital assets | 1,625 |
| Proceeds of revenue bonds to acquire capital assets | 1,200 |
| Purchases of investments | 725 |
| Proceeds from sale of capital assets | 55 |
| Proceeds from sales of investments | 830 |
| Capital lease payments | 100 |
| Operating grants received | 500 |
| Proceeds from line of credit (used for operations) | 325 |
| Capital contribution from airline | 75 |
| Interest paid on line of credit | 5 |

REQUIRED: Put these cash flow amounts in the form of a cash flows statement for the airport. Calculate and include a line for cash on hand at the end of the period.

ESSAYS (CHAPTER 9)

1. Internal service funds are used by many governmental entities to account for activities that provide services to the entity itself. What are the ramifications of such an accounting arrangement? What are the effects on the entity's financial statements?
2. Governmental entities may elect to account for their landfill activities in either a governmental or enterprise fund. Explain the differences that would result if one government elected to account for its landfill activities in its general fund and another government elected to account for its landfill activities in an enterprise fund.
3. Because of the rising cost of commercial insurance, many governments have elected to be "self-insured." Explain what being "self-insured" means. Explain the difference in the accounting for self-insurance activities between a governmental fund and a proprietary fund.
4. An electric utility reports both restricted assets and restricted net assets, but the amounts are different from each other. What could account for this difference?
5. What are the differences between a cash flows statement prepared for a governmental electric utility versus one prepared for an investor-owned utility?
6. How the activities of an internal service fund are usually reported in the government-wide financial statements?
7. A city's comptroller is distraught because depreciation cannot be recorded in a general fund. Moreover, for political reasons the city council never permits the general fund to have a substantial surplus balance. As a consequence the city is unable to "save" resources to replace aging fixed assets. The comptroller has heard that it is possible indirectly to charge depreciation in a general fund by transferring fixed assets to an internal service fund and correspondingly to build up a cash reserve to replace the fixed assets. Is the comptroller correct? If so, explain how an internal service fund can be used to charge depreciation in the general fund and thereby create a cash reserve of what would otherwise be general fund assets.

ANSWERS TO TRUE/FALSE (CHAPTER 9)

1. True
2. False
3. True
4. True
5. False
6. False
7. True
8. True
9. True
10. True

ANSWERS TO MULTIPLE CHOICE (CHAPTER 9)

1. B
2. C
3. C
4. D
5. C
6. C
7. A
8. D
9. A
10. B
11. B
12. A
13. A
14. D
15. A
16. A
17. C
18. C
19. A
20. B
21. B
22. C
23. C
24. B
25. C
26. A
27. B
28. B
29. C
30. C
31. C
32. C
33. D
34. D
35. D
36. D
37. D
38. C
39. A
40. C
41. A
42. D
43. D

ANSWERS TO PROBLEMS (CHAPTER 9)

Problem 1

| | | |
|--------------------------|-------------|-------------|
| a) Cash | \$200,000 | |
| Transfer In | | \$200,000 |
| b) Equipment | \$600,000 | |
| Lease Obligations | | \$600,000 |
| c) Cash | \$1,010,000 | |
| Deferred Bond Premium | | 10,000 |
| Bonds Payable | | \$1,000,000 |
| d) Equipment | \$980,000 | |
| Cash | | \$980,000 |
| e) Due from General Fund | \$70,000 | |
| Revenues [or Billings] | | \$70,000 |
| f) Salary Expense | \$50,000 | |
| Cash | | \$50,000 |

Problem 2

| | | |
|----------------------------------|-------------|-------------|
| a) Accounts receivable | \$1 million | |
| Revenue | | \$1 million |
| b) Cash | \$260,000 | |
| Capital contributions (revenues) | | \$260,000 |
| c) Depreciation expense | \$700,000 | |
| Accumulated depreciation | | \$700,000 |

| | | |
|-----------------------|-------------|-------------|
| d) Un-Restricted cash | \$1,800,000 | |
| Restricted cash | \$ 200,000 | |
| Bonds payable | | \$2,000,000 |

Problem 3

Statement of Revenues, Expenses, and Changes in Fund Net Assets

| | | |
|-------------------------------|------------------|--------------------|
| Operating Revenues | | \$ 600,000 |
| Operating Expenses | \$470,000 | |
| Depreciation Expense | <u>\$ 40,000</u> | <u>\$ 510,000</u> |
| Income before contributions | | \$ 90,000 |
| Capital Contributions | | <u>500,000</u> |
| Change in Net Assets | | \$ 590,000 |
| Net Assets, Beginning of Year | | <u>\$ 420,000</u> |
| Net Assets, End of Year | | <u>\$1,010,000</u> |

Net Assets Section of the Statement of Net Assets

| | | |
|---------------------------------|--------------------|------------------------|
| Invested in capital assets, net | | |
| of related debt | \$ 360,000 | (\$400,000 – \$40,000) |
| Restricted | 100,000 | |
| Unrestricted | <u>550,000</u> | |
| Total net assets | <u>\$1,010,000</u> | |

Problem 4

- (a) Estimated Total Current Cost of Closure and Postclosure Care

| <u>For 2006:</u> | | <u>For 2007:</u> |
|------------------|--------------------|--------------------|
| Equipment | \$2.5 million | \$3.0 million |
| Final cover | .5 million | 1.0 million |
| Monitoring | <u>4.0 million</u> | <u>4.0 million</u> |
| Total | \$7.0 million | \$8.0 million |

- (b) Current Period Expense

For 2006:

$\$ 30,000 \times \$7 \text{ million} = \$350,000$ less $\$50,000$ previously recognized = $\$300,000$.
 $\$600,000$

For 2007:

$\$ 58,000 \times \$8 \text{ million} = \$800,000$ less $\$350,000$ previously recognized = $\$450,000$.
 $\$580,000$

(c) Journal Entries

2006

| | | |
|--------------------------------------|-----------|-----------|
| Landfill closure expense | \$300,000 | |
| Liability for landfill closure costs | | \$300,000 |

2007

| | | |
|--------------------------------------|-----------|-----------|
| Landfill closure expense | \$450,000 | |
| Liability for landfill closure costs | | \$450,000 |

Problem 5

| | | |
|--------------------------------------|-----------|-----------|
| a) Landfill closure expense | \$912,000 | |
| Liability for landfill closure costs | | \$912,000 |

$(300,000/5,000,000) \times \15.2 million

| | | |
|--------------------------------------|-------------|-------------|
| b) Landfill closure expense | \$1,173,417 | |
| Liability for landfill closure costs | | \$1,173,417 |

$(650,000/4,800,000) \times \$15.4 \text{ million less amounts previously recognized } (\$912,000)$

| | | |
|---|-----------|--|
| c) Liability for landfill closure costs | \$130,000 | |
| Cash | \$130,000 | |

| | | |
|--------------------------------------|-------------|-------------|
| d) Landfill closure expense | \$1,261,458 | |
| Liability for landfill closure costs | | \$1,261,458 |

$(1,050,000/4,800,000) \times \$15.3 \text{ million less amounts previously recognized } (\$912,000 + \$1,173,417)$

Problem 6

a) Entries in ISF

| | | |
|--|-------|-------|
| Expense—claims | \$1.5 | |
| Cash | | \$1.3 |
| Claims liability | | 0.2 |
| <i>To record losses incurred and claims paid</i> | | |

| | | |
|----------------------------------|-------|-------|
| Cash | \$2.0 | |
| Revenues—insurance premiums | | \$2.0 |
| <i>To record premium revenue</i> | | |

b) Entries in General Fund

| | | |
|--|-------|-------|
| Expenditure—claims | \$1.5 | |
| Cash | | \$1.3 |
| Claims liability | | 0.2 |
| <i>To record losses incurred and claims paid</i> | | |

| | | |
|--|-------|-------|
| Cash | \$0.8 | |
| Interfund reimbursements—insurance premiums | | \$0.6 |
| Other financing source—transfer from water and sewer fund | | 0.2 |
| <i>To record premium revenue and a transfer-in from water and sewer fund</i> | | |

Problem 7

| Clark City Airport | |
|---|----------------|
| Statement of Cash Flows | |
| Cash flows from operating activities: | |
| Operating lease receipts | \$ 2,350 |
| Operating grants received | 500 |
| Charges to other funds of the City | 290 |
| Wages and salaries paid to employees | (815) |
| Purchases of supplies | <u>(1,025)</u> |
| Total cash flows from operating activities | 1,300 |
| Cash flows from capital financing activities | |
| Capital contributions | \$ 75 |
| Sale of capital asset | 55 |
| Capital debt proceeds | 1,200 |
| Capital lease payments | (100) |
| Purchase of capital assets | (1,625) |
| Interest paid on long-term capital debt | <u>(175)</u> |
| Total cash flows from capital financing activities | (570) |
| Cash flows from noncapital financing activities | |
| Proceeds from line of credit | \$ 325 |
| Interest paid on line of credit | <u>(5)</u> |
| Total cash flows from noncapital financing activities | 320 |
| Cash flows from investing activities | |
| Proceeds from sale of investments | \$ 830 |
| Interest received from investments | 25 |
| Purchases of investments | <u>(725)</u> |
| Total cash flows from investing activities | <u>130</u> |

| | |
|---|-----------------|
| Total increase (decrease) in cash flows | <u>\$ 1,180</u> |
| | |
| Cash on hand, beginning of year | \$122 |
| Cash on hand, end of year | \$1,302 |
| | |

ANSWERS TO ESSAYS (CHAPTER 9)

1. Governments commonly use internal service funds (ISF) as cost centers. They permit a government to accumulate all costs (including depreciation) of providing a specific service to other activities or functions of the government. Use of the ISF in external financial reporting overstates the expenditure/expense of the combined entity by the amount of billings to the various departments. The costs of providing the services are accumulated in the ISF. When the ISF bills the departments, the amounts billed are reported as expenditures/expenses in the various funds. Because there are no eliminations in the fund financial statements, the costs of providing service are counted twice. Duplications are removed in the government-wide financial statements.

Governments that wish to include a depreciation charge in a governmental fund can do so by accounting for an activity in an ISF, billing the governmental fund an amount that reimburses the ISF for all costs, including depreciation.

The billing rates used by an ISF are supposed to cover costs. Management of the government has the power to set the rates and can set them at any amount they choose. The billings are arbitrary and may make the fund financial statements less than objective.

If the general fund is prohibited from operating at a deficit and it accounts for an activity that can be transferred to an internal service fund, management could hide any deficit by transferring that activity to an ISF. That is, management could set an ISF billing rate arbitrarily low and avoid displaying the deficit in the general fund.

2. Landfill expenditures/expenses that may appear on the operating statement depend on the measurement focus and basis of accounting used by the fund. If the landfill were accounted for as an enterprise fund, the entire amount of landfill expense and resulting liability for closure and postclosure care (based on capacity used to date, as required by GASB standards) would appear on the fund operating statement and balance sheet. If the landfill were accounted for in the general fund, only the portion (expenditure) that is due and payable with available financial resources will appear on the operating statement (modified accrual basis). The full accrual basis liability will appear only in the governmental activities column in the government-wide statement of net assets and in the Schedule of Long-Term Debt.

3. Being self-insured means being without insurance. The concept of insurance is spreading the risk among a number of entities or individuals. Some governmental entities are sufficiently large to be able to spread the risk among their various funds and activities. By simply providing a mechanism for setting aside an amount each year (probably comparable to the total premiums that would have been paid to a commercial insurance company), they can enjoy the benefits of insurance and save the ‘profits’ that would have been part of a billing from a commercial insurance carrier.

GASB allows the “premiums” transferred from the paying funds to the self-insurance internal service fund to be treated as expenses/expenditures on the paying funds’ financial statements (within certain parameters) and as revenues by the receiving fund. The “premiums” billed can be based on actuarial amounts rather than current period actual amounts and can include an amount for future catastrophic losses.

If the self-insurance fund is the general fund, the amount that can be charged to other funds of the entity is limited to the amount that will be recognized in the general fund as an expenditure using the modified accrual basis of accounting. Amounts billed are not reported as revenues in the general fund but as reductions of claims expenditures. Any amounts billed by the general fund in excess of actual expenditures must be reported as transfers between the funds.

4. The difference between reported restricted assets and reported restricted net assets usually arises when restricted cash and investments include unspent proceeds of long-term debt. These restricted assets would be offset by bonds payable, resulting in a zero net asset balance. Particularly for utilities, a difference may also arise from reporting cash and investments arising from customer deposits, which are offset by deposit liabilities payable to the customer.
5. First, the statement of cash flows for a governmental enterprise must be prepared using the direct method. Governments, unlike businesses, cannot use the indirect method. Second, the statement of cash flows must classify transactions into four categories rather than the three required of businesses. These are:
 - Cash flows from operating activities,
 - Cash flows from noncapital financing activities,
 - Cash flows from capital and related financing activities, and
 - Cash flows from investing activities.

Finally, interest receipts are reported as investing cash flows while interest payments are reported as either cash flows from noncapital financing or capital financing. Neither are reported as *operating* cash flows, unlike the FASBS 95 requirements for businesses.

6. Unless an internal service fund provides services primarily to a government’s enterprise fund activities, the residual net assets of an internal service fund would be included in the governmental activities column of the government-wide statement of net assets. Residual means all assets and liabilities remaining after elimination of internal balances. In the government-wide statement of activities, the *net income (loss)* of internal service funds is allocated back to the activities that participated in the ISF. In this way, individual revenues

and expenses of ISFs arising from internal activity are excluded from the program expense, program revenues, and general revenues columns of the statement of activities.

7. The city can establish an internal service fund (ISF) and then incorporate depreciation on the assets in the rates that the ISF bills the general fund. The difference between the ISF's cash received and the total reported expenses (including the noncash expense for depreciation) can then be retained in the ISF.

Chapter 10

Fiduciary Funds and Permanent Funds

TRUE/FALSE (CHAPTER 10)

1. Per GASB Statement No. 34, permanent funds are classified as fiduciary funds.
2. In accounting for permanent funds only the income can be spent; the principal must be preserved intact.
3. Fiduciary funds focus on current financial resources and use the full accrual basis of accounting.
4. Fiduciary funds are excluded from the government-wide financial statements.
5. The concept of major versus nonmajor funds does not apply to permanent funds, as it does to governmental and proprietary funds.
6. Accounting for the employer's contribution to a defined contribution pension plan is straight forward, because the employer is obligated only to make annual contributions in the amount specified in the plan terms.
7. Accounting for the employer's contribution to a defined benefit pension plan is straight forward, because the employer is obligated only to make annual contributions in the amount specified in the plan terms.
8. Not-for-profits report all investment gains and losses on endowments as additions to temporarily restricted net assets, regardless of donor-imposed restrictions.
9. An employer may have a liability to a defined benefit pension plan other than for its annual required contributions, depending on the future financial health of the plan.
10. In an agency fund, assets always equal fund balances because there are no liabilities.

MULTIPLE CHOICE (CHAPTER 10)

1. A governmental entity receives a gift of cash and investments with a fair value of \$200,000. The donor specified that the earnings from the gift must be used to beautify city-owned parks and the principal must be re-invested. The \$200,000 gift should be accounted for in which of the following funds?
 - a) General fund.
 - b) Private-purpose trust fund.
 - c) Agency fund.
 - d) Permanent fund.

2. In previous years, Center City had received a \$400,000 gift of cash and investments. The donor had specified that the earnings from the gift must be used to beautify city-owned parks and the principal must be re-invested. During the current year, the earnings from this gift were \$24,000. The earnings from this gift should generally be considered revenue to which of the following funds?
 - a) Special revenue fund.
 - b) Private-purpose trust fund.
 - c) Agency fund.
 - d) Permanent fund.

Use the following information to answer Questions #3-4

The City received \$200,000 to help maintain a local art museum that is owned and operated by a not-for-profit organization. During the year the City transferred net earnings of \$20,000 to the appropriate entity/fund.

3. The \$200,000 gift would be reported in a (an):
 - a) Special revenue fund.
 - b) Private-purpose trust fund.
 - c) Agency fund.
 - d) Permanent fund.

4. The \$20,000 transfer would be reported by the fund that made the transfer as a (an)
 - a) Transfer out.
 - b) Expenditure.
 - c) Deduction from Net Assets—Benefits.
 - d) Expense.

Use the following information to answer Questions #5-6.

In the current year, the City of Katerah earned \$24,000 on the principal of a private-purpose trust fund but disbursed only \$20,000.

5. During the current year the private-purpose trust fund will recognize, related to earnings:
 - a) \$24,000 revenues.
 - b) \$20,000 revenues.
 - c) \$24,000 addition to net assets.
 - d) \$20,000 addition to net assets.

6. During the current year the private-purpose trust fund will recognize, related to the cash outflow:
 - a) \$20,000 transfer out.
 - b) \$20,000 expenses.
 - c) \$24,000 deduction from net assets.
 - d) \$20,000 deduction from net assets.

7. Which of the following activities of a governmental entity should be accounted for in a fiduciary fund?
 - a) Funds received from the federal government to support public transportation activities.
 - b) Funds received from an individual who specified that the principal must be kept intact but the income can be used to support families of police officers killed in the line of duty.
 - c) Funds received from the state government that must be used to purchase capital assets.
 - d) Funds received from a contractor to assist with the development of utility infrastructure.

8. What basis of accounting is used to account for transactions of a governmental private-purpose trust fund?
 - a) Full accrual basis of accounting.
 - b) Modified accrual basis of accounting.
 - c) Cash basis of accounting.
 - d) Budgetary basis of accounting.

9. In which of the following funds would a government report depreciation expense?
 - a) Private-purpose trust fund.
 - b) Agency fund.
 - c) Permanent fund.
 - d) None of the above

10. Which of the following would **NOT** be accounted for in a fiduciary fund of a governmental entity?
 - a) Nonexpendable resources held for the benefit of other governmental units.
 - b) Nonexpendable resources held for the benefit of the government holding the resources.
 - c) Expendable resources held for the benefit of other governmental units.
 - d) Funds held as an agent for other entities.

11. Permanent funds are classified as
 - a) Governmental funds.
 - b) Proprietary funds.
 - c) Fiduciary funds.
 - d) Trust funds.

12. Which of the following is **NOT** a fiduciary fund?
 - a) Pension trust fund.
 - b) Investment trust fund.
 - c) Permanent fund.
 - d) Private purpose trust fund.

13. What basis of accounting is used to account for the transactions of a government's permanent fund?
- a) Full accrual basis of accounting.
 - b) Modified accrual basis of accounting.
 - c) Cash basis of accounting.
 - d) Budgetary basis of accounting.

Use the following information to answer Questions #14-16

Previously a local charity received a \$1 million gift, the income from which was restricted to support activities for senior citizens. During the current year the endowment earned \$70,000 of interest revenues, of which the charity designated \$50,000 to support senior citizen activities.

14. On its year-end statement of activities, the charity would report interest revenues of:
- a) \$0
 - b) \$50,000
 - c) \$70,000
 - d) None of the above.
15. On its year-end statement of financial position, the charity would report **temporarily restricted** net assets of:
- a) \$70,000.
 - b) \$ 0.
 - c) \$50,000.
 - d) \$1.07 million.
16. On its year-end statement of financial position, the charity would report **permanently restricted** net assets of:
- a) \$1 million.
 - b) \$1.07 million.
 - c) \$1.05 million.
 - d) \$1.02 million.
17. Cedar City has a permanent fund that reported current year investment earnings (realized and unrealized) of \$80,000. The endowment principal is \$800,000 and the city council has adopted a policy of considering only the inflation-adjusted rate of return to be available for transfer to the recipient fund. During the current year the Council declared the inflation-adjusted rate of return to be 8%. How much **revenue** would be recognized in the permanent fund?
- a) \$ 0.
 - b) \$ 64,000.
 - c) \$ 80,000.
 - d) Unable to determine.

18. During the year, a state-owned university received a \$5 million gift. The donor specified that the principal of the gift must be held intact for 3 years, but the earnings from the gift can be used to support technology improvements in the College of Business. At the end of the 3 years, the donor together with the University President and the College Dean will decide how the \$5 million gift can be used. The University will report the gift in what type of fund?
- Permanent fund.
 - Private-purpose trust fund.
 - Special revenue fund
 - Plant fund.
19. A wealthy citizen provided in her will for a gift of cash and other assets to the City. Her will specified that the gift was to be kept intact and that the earnings from the gift were to be used to support public parks. At the time of the donation, the gift had a book value in the hands of the donor of \$250,000 and a fair value of \$400,000. When recording this gift the City would credit
- Contributions revenues \$400,000.
 - Other Financing Sources—Contributions \$400,000.
 - Contributions revenues \$250,000.
 - Other Financing Sources—Contributions \$250,000.
20. At the beginning of the year, the **permanent fund** of Rapid City had an investment portfolio with a historical cost of \$200,000 and a fair value of \$220,000. There were no purchases or sales of securities during the year. At year end the portfolio had a fair value of \$240,000. At the end of the year Rapid City will account for this increase in fair value in which of the following ways?
- Credit Investment Income, \$20,000.
 - Credit Investment Income, \$40,000.
 - Credit Fund Balance, \$20,000.
 - No entry is made to recognize increase in fair value.
21. Several years ago, a donor gave \$5 million to the City and specified that the principal was to be kept intact but the earnings were to be used to support operations of the city parks. During the current year, the City earned \$300,000 on the gift. To what type of fund, should the City transfer the \$300,000 earnings?
- It should not make any transfers. The \$300,000 should remain in the City's permanent fund.
 - A special revenue fund.
 - The general fund.
 - An enterprise fund.

22. A defined contribution pension plan is one in which the employer agrees to which of the following?

- a) The employer agrees to make payments to a specified pension plan with no guarantee of a specific pension amount to be paid to the employee.
- b) The employer agrees to make actuarially determined payments to a pension plan AND guarantees that the employee will receive a specified pension benefit (usually determined by length of service and salary).
- c) The employer agrees to make actuarially determined payments to a pension plan that guarantees that the employee will receive a specified pension (usually determined by length of service and salary).
- c) The employer agrees to pay specified amounts (usually determined by length of service and salary) to the employee upon retirement.

23. Hill City Light & Water (a proprietary fund) contributes to a defined benefit plan for its employees. During 2007, Hill City contributed \$27 million to its pension plan. The City also made an additional \$3 million contribution related to 2006. The actuarially determined contribution requirement for 2007 was \$32 million. The amount of pension expense recognized by Hill City Light & Water for 2007 should be:

- a) \$ 0
- b) \$ 27 million
- c) \$ 30 million
- d) \$ 32 million

24. During the fiscal year ended December 31, 2006, the Highland City General Fund contributed \$48 million to a defined benefit pension plan for its employees. On February 27, 2007, Highland made an additional \$2 million contribution related to the 2006 pension contribution requirements. The actuarially determined contribution requirement for 2006 is \$52 million. The amount of pension expenditure recognized by Highland City General Fund for 2006 should be:

- a) \$ 0
- b) \$ 48 million
- c) \$ 50 million
- d) \$ 52 million

25. In which of the following funds would Net Pension Obligation be most likely to appear?

- a) General fund.
- b) Enterprise fund.
- c) Private-purpose trust fund.
- d) Agency fund.

26. The Schedule of Changes in Long-Term Obligations contains an account Net Pension Obligation. Which of the following describes the event that gave rise to this account?

- a) The actual contribution by a proprietary fund was less than the actuarially required contribution.
- b) The actual contribution by a governmental fund was less than the actuarially required contribution.
- c) The actuarially computed pension liability exceeded the pension plan assets.
- d) The actuarially computed pension liability exceeded pension plan assets.

27. Required disclosure by a government General Fund related to its pension plan does **NOT** include which of the following?
- The employer's funding policy.
 - The components of the pension cost.
 - The key assumptions used in determining the pension costs.
 - The present value of the future benefits to be paid.
28. The primary financial statements for a government-sponsored pension plan are:
- Balance Sheet and Statement of Activities.
 - Balance Sheet, Statement of Activities, and Cash Flows Statement.
 - Statement of Fiduciary Net Assets and a Statement of Changes in Fiduciary Net Assets
 - Balance Sheet, Statement of Activities, Cash Flows Statement, and Statement of Funding Progress.
29. Which of the following is **NOT** a criterion that an employer's annual required contribution must satisfy to be considered acceptable?
- It must consist of the employer's normal cost plus a provision for amortizing the plan's unfunded actuarially accrued liability.
 - Actual assumptions must be in accordance with standards of the Actuarial Standards Board.
 - Actuarial value of pension plan assets must be based on market values on the financial statement date.
 - Assumptions as to investment earnings should be based on long-term projections.
30. A plan's unfunded actuarially accrued liability is the excess of the:
- Actuarially determined plan cost over the actual contribution.
 - Actuarially determined plan cost over the plan assets.
 - Actuarially determined pension liability over the plan assets.
 - Actuarially determined pension liability over the total contributions
31. Citizens within a defined geographic area of Hill City created a special assessment district to facilitate the construction of sidewalks. Hill City was responsible for overseeing the entire construction project. Hill City issued bonds in its own name to pay the contractor for the construction. However, Hill City was not responsible in any manner for the bonds. The bonds were secured by the special assessments that are levied against properties within the special assessment district. Collections of special assessments would be recorded in which of the following funds of Hill City?
- Special assessment fund.
 - Agency fund.
 - Special revenue fund.
 - Debt service fund.
32. The City of Highland Hills receives a federal grant to assist in nutrition programs for its senior citizens. The City will select the contractors that will provide meals and approve the participants in the program. The proceeds of this grant should be accounted for in which of the following funds of the City?
- A governmental fund.
 - An enterprise fund.
 - An agency fund.
 - A private-purpose trust fund.

33. The City of Highland Hills receives a federal grant to assist in nutrition programs for its senior citizens. Senior citizens whose income is below a specified amount (the amount was specified by the Federal government) are eligible to participate in the program. Monthly checks of \$100 (this amount was specified by the Federal government) will be mailed to eligible senior citizens. The proceeds of this grant should be accounted for in which of the following funds of the City?
- The general fund.
 - A special revenue fund.
 - An agency fund.
 - Private-purpose trust fund.
34. Financial assets reported by most governmental investment trust funds should be reported at
- Cost
 - Amortized historical cost.
 - Fair value on the date of the financial statements.
 - Fair value computed by a weighted-average approach.
35. Assets reported in a government's investment trust fund should include:
- Only investments owned by external participants in the investment pool.
 - Investments of both the sponsoring government and of external participants in the investment pool.
 - Investments related to the sponsoring government's governmental funds and of external participants in the investment pool.
 - Investments related to the sponsoring government's other fiduciary funds and of external participants in the investment pool.
- 36. Financial assets reported by 2a7-like investment pools should be reported at**
- Fair value at the date of the financial statements.
 - Amortized historical cost.
 - Fair value computed using a weighted-average approach.
 - Cost.
37. Under proposed GASB standards, accounting for other postemployment benefits (OPEB) would
- Continue to permit governments to fund OPEB benefits on a pay-as-you-go basis.
 - Require governments to report actuarially required contributions as OPEB expense, regardless of whether these contributions are actually made by the government.
 - Require governments to report OPEB costs based on FASB Statement No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions."
 - Require disclosure only of estimated OPEB liabilities.
38. Liabilities reported in pension trust funds consist of
- Liabilities accrued using the accrual basis of accounting, including the actuarial accrued liability for the plan.
 - Liabilities accrued using the modified accrual basis of accounting, excluding the actuarial accrued liability for the plan.
 - Liabilities accrued using the accrual basis of accounting, excluding the actuarial accrued liability for the plan.
 - Liabilities accrued using the modified accrual basis of accounting, including the plan benefits that will be paid with measurable and available financial resources.

39. The following financial statements must be reported for fiduciary funds.

- a) Statement of cash flows
- b) Statement of changes in fiduciary net assets
- c) Statement of fiduciary net assets
- d) All of the above
- e) b & c only

40. The fiduciary fund financial statements report contain

- a) No separate statements for individual pension plans
- b) A separate column for each fund type
- c) Three components of net assets
- d) Information by major fund

41. The liabilities relating to benefits and refunds of a Defined Benefit Pension Plan are reported in a governmental entity's fiduciary fund financial statements using the

| | <u>Full Accrual Basis</u> | <u>Modified Accrual Basis</u> | <u>Economic Resources Measurement Focus</u> | <u>Current Financial Resources Measurement Focus</u> |
|----|---------------------------|-------------------------------|---|--|
| a) | No | Yes | Yes | No |
| b) | Yes | No | No | Yes |
| c) | No | Yes | No | Yes |
| d) | Yes | No | Yes | No |

PROBLEMS (CHAPTER 10)

1. The City of Bancroft received a donation from the estate of the late Kathy Smith to be used to support the City Public Library. The gift consisted of \$200,000 cash and a portfolio of securities with a market value of \$300,000. The securities have a book value of \$250,000. The donor stipulated that the principal of the gift, including investment gains (realized and unrealized) but excluding investment losses, must be kept intact. The income must be used to care for and maintain the book collection at the Smith Public Library. All appropriate costs, including investment losses, may be charged against the revenues yearly to determine the amount available for the specified purposes. During the year, the City engaged in the following transactions on behalf of the Library. Prepare the appropriate entries in the City's permanent fund.
 - a) Accepted the donation.
 - b) Received dividends and interest of \$18,000.
 - c) Purchased securities for \$200,000.
 - d) Sold securities that were part of the original gift (market value at date of gift \$72,000; book value in hands of donor \$68,000) for \$75,000.
 - e) Sold some of the securities that were acquired in transaction (c) for \$51,000. They were acquired at a price of \$55,000.
 - f) The portfolio of securities at year-end had a market value of \$377,000.
 - g) Closed the fund's revenue and expense accounts and transferred the amount available for expenditure to the appropriate fund. Close the transfer account.

2. The City of Shane received a cash gift of \$125,000 from a citizen who specified that the gift must be used to support recreational activities for youth of the City. The City accounted for this gift in the appropriate fund. During the year the City engaged in the following activities. Prepare the appropriate journal entries. Be sure to indicate in which fund the entries should be recorded.
 - a) The City accepted the donation.
 - b) The City engaged in a fund-raising effort to provide additional funds to support youth recreational activities. The City raised \$6,000 in pledges. The City collected \$2,000 in cash with the remaining pledges collectible shortly after the end of the year.
 - c) The City temporarily invested \$50,000 of the gift in marketable securities.
 - d) The City spent \$26,000 on goal posts, nets, etc., for a soccer field.
 - e) The City received \$2,000 in dividends and interest earned on the temporary investment.
 - f) At year-end the temporary investments had a market value of \$51,000.
 - g) The City closed the revenue and expense accounts.

3. Penn County provides a defined benefit pension plan for its employees. The County accounts for the pension plan in a Pension Trust Fund in the County's basic financial statements. The County engaged in the following transactions related to the Pension Trust Fund. Prepare all necessary entries. Clearly indicate the fund in which the entry is being made. If no entry is needed, please write "No Entry Required."
 - a) In Year 1, the Pension Trust Fund sent billings to the General Fund and the City Utility Enterprise Fund for the actuarially determined amount of required contributions. The General Fund was billed \$200,000 but paid only \$150,000 during the year. The Enterprise Fund was billed \$300,000 and paid \$350,000.
 - b) In Year 2, the Pension Trust Fund sent billings to the General Fund and the City Utility Fund for the actuarially determined amount of required contributions. The General Fund was billed \$210,000 and paid the entire amount plus \$20,000 on last year's underpayment. The Enterprise Fund was billed \$320,000 and paid only \$250,000.

4. State University maintains accounts for each of its student groups. The monies collected by the Accounting Fraternity are deposited with the University. As the Fraternity authorizes disbursements of its funds, the University disburses the monies. During the year, the Fraternity engaged in the following transactions. Prepare the appropriate entries *on the books of the University*. Be sure to indicate in which fund the entries would be recorded.
- a) The Fraternity deposited \$400 in student dues.
 - b) The Fraternity authorized payment to Delta Airlines for an airline ticket for a member to fly to the National meeting, \$350, and to the National Accounting Fraternity, \$100 for registration.
 - c) The Fraternity received a contribution from a major accounting firm to be used by the Fraternity to offset the cost of attending the national meeting, \$500.
 - d) The Fraternity operated a book exchange on a consignment basis and collected revenues of \$10,000. It authorized the University to write \$9,000 of checks to the students whose books they had sold. The Fraternity was pleased with the \$1,000 profit.
 - e) The Fraternity received a reimbursement from their National Office to offset their costs of attending the National meeting, \$150.
5. At the end of 2004, The Learning Tree, a not-for-profit organization, received a \$5 million contribution (fair value), consisting entirely of investment securities. The contribution is required to be used to establish a permanent endowment, the income from which must be used exclusively to provide free “chapter books” to elementary school children. The endowment specifies that both realized and unrealized gains may be used for this purpose in addition to investment income. Learning Tree follows FASB not-for-profit accounting.

At the start of 2005, The Learning Tree had \$600,000 in unrestricted net assets.

During 2005, the endowment earns \$100,000 in dividends and interest. The Learning Tree spends the entire amount on books and distribution costs. At year-end, the value of the endowment portfolio is \$5.5 million.

During 2006, the endowment earns \$100,000 in dividends and interest. The entire amount is spent on books. At year-end, the fair value of the endowment portfolio has decreased by \$1 million to \$4.5 million.

During 2007, the endowment earns \$100,000 in dividends and interest. The entire amount is spent on books. At year-end, the fair value of the endowment portfolio has gone back up by \$0.4 million to \$4.9 million.

REQUIRED:

- a) Assuming no other transactions, prepare a schedule showing the balances in unrestricted, temporarily restricted, and permanently restricted net assets for the years ending in 2005, 2006, and 2007.
- b) What effect would there be on these three balances of net assets if the donor specified that all gains (realized and unrealized) must be reinvested?

6. The City of Chessie provides a defined benefit pension plan for its full-time employees. The City includes the plan as a pension trust fund in its fund financial statements.
REQUIRED: Using the information below, prepare a Statement of Plan Net Assets and a Statement of Changes in Plan Net Assets for the Chessie Pension Trust Fund.

| | |
|---|-----------------|
| Cash at year-end | \$1.5 million |
| Investments at year-end | \$3.5 million |
| Actuarial value of plan assets at year-end | \$20.95 million |
| Accounts payable | \$0.04 million |
| Actuarial accrued liability | \$29.9 million |
| Refunds payable | \$0.09 million |
| Employer contributions | \$1.2 million |
| Employee contributions | \$0.4 million |
| Investment earnings | \$3.2 million |
| Benefits paid | \$0.8 million |
| Administrative expenses | \$0.5 million |
| Net assets held for pension benefits at beginning of year | \$21.37 million |

7. The Statement of Plan Net Assets for a school district's pension fund shows the following (in condensed form and in thousands)

| | |
|--|--------------------|
| <u>Assets</u> | |
| Cash and short-term investments | \$ 66,129 |
| Receivables | 49,946 |
| Investments at fair value | <u>3,565,931</u> |
| Total assets | <u>\$3,682,006</u> |
| <u>Liabilities</u> | |
| Amount payable to current employees and retirees | <u>\$ 4,212</u> |
| Net assets | <u>\$3,677,794</u> |

- C. The plan has been in operation for over 20 years and covers all school district employees. What is the most reasonable explanation as to why the amount payable to current employees and retirees is so small relative to plan assets?
- D. Suppose that in the current year the school district's annual required contribution was \$6,300,000. However, the district budgeted, and paid, into the pension fund only \$5,000,000. Prepare the appropriate journal entries that the district (not the plan) should make to record the year's pension activity. You need not make budgetary or closing entries. The plan is accounted for in a governmental fund.
- E. The annual report of district indicated that its "normal cost" was \$530,000 and that the "amortization of unfunded actuarial accrued liability" was \$100,000."
1. What is meant by "normal cost?"
 2. What is meant by "unfunded actuarial accrued liability"? What are its main components? Why must it be amortized?

ESSAY QUESTIONS (CHAPTER 10)

1. Current GASB standards for Public Employer Pension Plans require that the primary financial statements, a Statement of Fiduciary Net Assets and a Statement of Changes in Fiduciary Net Assets, report only on net plan assets, excluding actuarially determined benefits to current and future retirees. Do you think the requirements are appropriate? Why or why not? If you do not believe they are appropriate what reporting standards would you prefer? How do you think stewardship and accountability are enhanced by the GASB reporting requirements?
2. A donor gives your City \$100,000 to be used to support youth recreational programs. In what type of fund should this gift be accounted for? How or why did you select this fund? What other funds could be used to account for this gift? What are the criteria required to determine which type of fund is the most suitable for reporting this type of gift?
3. Agency funds are excluded from the face of the government-wide financial statements for governmental entities. What are agency funds? Should they be presented in the government-wide statements? Could, or should, they be presented elsewhere?
4. Governments report four types of fiduciary funds—pension (and other employee benefit) trusts, private-purpose trusts, investment trusts, and agency funds. What is the purpose of investment trust funds? What is the nature of the assets and liabilities that they report?
5. You are asked by a wealthy businesswoman to help construct a permanent endowment for a local university. She asks you whether you believe the university should be required to add investment gains to the principal of the endowment. Or, she asks, would it be preferable for gains to be available for spending? How would you respond, and why?

ANSWERS TO TRUE/FALSE (CHAPTER 10)

1. False
2. True
3. False
4. True
5. False
6. True
7. False
8. False
9. True
10. False

ANSWERS TO MULTIPLE CHOICE (CHAPTER 10)

1. D
2. D
3. B
4. C
5. C
6. D
7. B
8. A
9. A
10. B
11. A
12. C
13. B
14. C
15. A
16. A
17. C
18. A
19. A
20. A
21. B
22. A
23. D
24. C
25. B
26. B
27. D
28. C
29. C
30. C
31. B
32. A
33. C
34. C
35. A
36. B
37. B
38. C
39. E
40. B
41. D

ANSWERS TO PROBLEMS (CHAPTER 10)

Problem 1

| | | |
|---|------------|------------|
| a) Cash | \$200,000 | |
| Investments | \$300,000 | |
| Contributions(Revenue) | | \$500,000 |
| b) Cash | \$ 18,000 | |
| Revenue | | \$ 18,000 |
| c) Investments | \$200,000 | |
| Cash | | \$200,000 |
| d) Cash | \$ 75,000 | |
| Gain (not available to beneficiary) | | \$ 3,000 |
| Investments | | \$ 72,000 |
| e) Cash | \$ 51,000 | |
| Loss on Sale (available to beneficiary) | \$ 4,000 | |
| Investments | | \$ 55,000 |
| f) Investments | \$ 4,000 | |
| Unrealized Gain (not available to beneficiary) | | \$ 4,000 |
| [(300,000 + 200,000 – 72,000 – 55,000) – 377,000] | | |
| g) Contributions (revenue) | \$ 500,000 | |
| Gain/Revenue (not available to beneficiary) | \$ 7,000 | |
| Fund Balance | | \$ 507,000 |
| Revenue (available to Beneficiary) | \$ 18,000 | |
| Income available to Beneficiary | | \$ 14,000 |
| Loss (available to Beneficiary) | | \$ 4,000 |
| Transfer | \$ 14,000 | |
| Cash | | \$ 14,000 |
| Income available to beneficiary | \$ 14,000 | |
| Transfer | | \$ 14,000 |

Problem 2

These entries are recorded in a Special Revenue Fund.

[**Note:** Because all assets are indeed restricted by outside parties, some students might record the assets as restricted cash and investments.]

| | | | |
|----|----------------------------|-----------|-----------|
| a) | Cash | \$125,000 | |
| | Contributions (revenue) | | \$125,000 |
| b) | Cash | \$ 2,000 | |
| | Pledges receivable | \$ 4,000 | |
| | Contributions (revenue) | | \$ 6,000 |
| c) | Investments | \$ 50,000 | |
| | Cash | | \$ 50,000 |
| d) | Expenditures | \$ 26,000 | |
| | Cash | | \$ 26,000 |
| e) | Cash | \$ 2,000 | |
| | Revenues | | \$ 2,000 |
| f) | Investments | \$ 1,000 | |
| | Revenues (unrealized gain) | | \$ 1,000 |
| g) | Contribution (revenue) | \$131,000 | |
| | Revenue | \$ 3,000 | |
| | Fund balance | | \$108,000 |
| | Expenditures | | \$ 26,000 |

Problem 3

| | | | |
|---------------------------|------------|------------|------------|
| a) PENSION TRUST FUND | | | |
| Due from General Fund | \$ 200,000 | | |
| Due from Enterprise Fund | \$ 300,000 | | |
| Revenue | | | \$ 500,000 |
| Cash | \$ 500,000 | | |
| Due from General Fund | | \$ 150,000 | |
| Due from Enterprise Fund | | \$ 300,000 | |
| Transfer | | \$ 50,000 | |
| GENERAL FUND* | | | |
| Pension Expenditure | \$ 150,000 | | |
| Cash | | | \$ 150,000 |
| ENTERPRISE FUND | | | |
| Pension Expense | \$ 300,000 | | |
| Transfer | \$ 50,000 | | |
| Cash | | | \$ 350,000 |
| b) PENSION TRUST FUND | | | |
| Due from General Fund | \$ 210,000 | | |
| Due from Enterprise Fund | \$ 320,000 | | |
| Revenue | | | \$530,000 |
| Cash | \$ 480,000 | | |
| Due from General Fund | | \$ 230,000 | |
| Due from Enterprise Fund | | \$ 250,000 | |
| GENERAL FUND | | | |
| Pension expenditure | \$ 230,000 | | |
| Cash | | | \$ 230,000 |
| ENTERPRISE FUND | | | |
| Pension Expense | \$ 320,000 | | |
| Due to Pension Trust Fund | | \$ 320,000 | |
| Due to Pension Trust Fund | \$ 250,000 | | |
| Cash | | | \$ 250,000 |

*[**Note:** Students may record a due to Pension Trust Fund here. In the case of pension contributions, however, GAAP require the Pension Trust Fund to adjust its receivable and contribution revenue to the amount that will actually be paid by the governmental fund (GASB Comprehensive Implementation Guide—2003, Question 5.55). In this way, the governmental fund does not report a fund liability and expenditure for unpaid pension contributions—that is, a “due to pension trust fund.”]

Problem 4

All journal entries are recorded in an agency fund.

- a) Cash \$ 400
 Due to Fraternity \$ 400
- b) Due to Fraternity \$ 450
 Cash or Accounts Payable \$ 450
- c) Cash \$ 500
 Due to Fraternity \$ 500
- d) Cash \$ 10,000
 Due to Fraternity \$ 10,000
- Due to Fraternity \$ 9,000
 Cash \$ 9,000
- e) Cash \$ 150
 Due to Fraternity \$ 150

Problem 5

a)

| | <u>Net Assets Related to Investments — 2005</u> | | | |
|------------------------|---|-----------------------------------|---------------------|--------------------|
| | <u>Permanently Restricted</u> | <u>Temporarily Restricted</u> | <u>Unrestricted</u> | <u>Total</u> |
| Beginning of year | \$5,000,000 | \$ 0 | \$600,000 | \$5,600,000 |
| Interest and dividends | | 100,000 | | 100,000 |
| Distributions | | (100,000) | | (100,000) |
| Investment gains | | <u>500,000</u> | <u>0</u> | <u>500,000</u> |
| End of year | <u>\$5,000,000</u> | <u>\$500,000</u> | <u>\$600,000</u> | <u>\$6,100,000</u> |

| | <u>Net Assets Related to Investments — 2006</u> | | | |
|------------------------|---|-----------------------------------|---------------------|--------------------|
| | <u>Permanently Restricted</u> | <u>Temporarily Restricted</u> | <u>Unrestricted</u> | <u>Total</u> |
| Beginning of year | \$5,000,000 | \$500,000 | \$600,000 | \$6,100,000 |
| Interest and dividends | | 100,000 | | 100,000 |
| Distributions | | (100,000) | | (100,000) |
| Investment losses | | <u>(500,000)</u> | <u>(500,000)</u> | <u>(1,000,000)</u> |
| End of year | <u>\$5,000,000</u> | <u>\$ 0</u> | <u>\$100,000</u> | <u>\$5,100,000</u> |

Net Assets Related to Investments — 2007

| | <u>Permanently Restricted</u> | <u>Temporarily Restricted</u> | <u>Unrestricted</u> | <u>Total</u> |
|------------------------|-----------------------------------|-----------------------------------|---------------------|--------------------|
| Beginning of year | \$5,000,000 | \$ 0 | \$100,000 | \$5,100,000 |
| Interest and dividends | | 100,000 | | 100,000 |
| Distributions | | (100,000) | | (100,000) |
| Investment gains | | <u>0</u> | <u>400,000</u> | <u>400,000</u> |
| End of year | <u>\$5,000,000</u> | <u>\$0</u> | <u>\$500,000</u> | <u>\$5,500,000</u> |

b) The gains would be added to the principal of the endowment, but losses would be reported first as a reduction of temporarily restricted net assets and, when temporarily restricted net assets equaled zero, as a reduction of unrestricted net assets. The treatment of losses is the same as above.

Problem 6

| CHESSIE CITY | |
|-------------------------------------|----------------------|
| CHESSIE PENSION TRUST FUND | |
| STATEMENT OF PLAN NET ASSETS | |
| ASSETS | |
| Cash | \$ 1.50 million |
| Investments | <u>23.50 million</u> |
| Total assets | 25.00 million |
| LIABILITIES | |
| Accounts payable | 0.04 million |
| Benefits payable | <u>0.09 million</u> |
| Total liabilities | 0.13 million |
| NET ASSETS | |
| Held in trust for pension benefits | \$24.87 million |

| CHESSIE CITY | |
|--|---------------------|
| CHESSIE PENSION TRUST FUND | |
| STATEMENT OF CHANGES IN PLAN NET ASSETS | |
| ADDITIONS | |
| Employer contributions | \$ 1.20 million |
| Employee contributions | 0.40 million |
| Investment earnings | <u>3.20 million</u> |
| Total additions | 4.80 million |
| DEDUCTIONS | |
| Administrative expenses | 0.50 million |
| Benefits paid | <u>0.80 million</u> |
| Total deductions | <u>1.30 million</u> |
| Change in net assets | 3.5 million |
| <u>Net assets—beginning of year</u> | 21.37 million |
| <u>Net assets—end of year</u> | \$24.87 million |

Problem 7

A. The statement of net plan assets reports only obligations as due. It does not report actuarial obligations.

| | |
|-------------------------------|-------------|
| <u>B.</u> Pension expenditure | \$5,000,000 |
| Cash | 5,000,000 |

C.

1. Normal cost is the portion of the present value of pension plan benefits that is allocated to a particular year by an actuarial cost method.

2. This is the excess of the actuarially computed pension liability over the pension plan's assets. It can result from (1) transition losses (2) actuarial losses (3) improvements in pension benefits (3) special termination benefits

ANSWERS TO ESSAY QUESTIONS (CHAPTER 10)

1. GASB reporting standards are different from FASB reporting standards for pension plans. Governments, unlike businesses, tend to be on-going organizations that will be around to honor their pension commitments. FASB was concerned about valuation of the liabilities incurred in relation to pension benefits and the assets available to fund those benefits. There are many examples of businesses liquidating and being unable or unwilling to meet their pension obligations.

GASB determined that the main objectives of reporting for governmental pension plans should be to provide information useful for assessing

- The stewardship of plan resources and the ongoing ability of the plan to pay benefits.
- The effect of plan operations and benefit commitments on the contributions required of both employers and employees.

The primary financial statements exclude actuarial liabilities and match current period contributions received with current period benefits paid. All actuarial liabilities are presented in supplementary schedules and notes. The information is available to those who search for the information.

[Students will have a variety of opinions on suitability of the required reporting. They will probably find it unsuitable because it is not like FASB.]

Stewardship and accountability are enhanced by the GASB standards only if one is concerned with the short-term. The excess of available resources to pay required benefits is measured. If one believes that governments have the right to tax and will, therefore, be able to raise sufficient revenues to meet their obligations, then one can conclude that stewardship and accountability are demonstrated through the required reporting model.

2. The gift should be reported in a special revenue fund. The problem does not state that only the earnings can be spent, so it is not appropriate to account for this gift in a permanent fund. A fiduciary fund should not be used because the gift is to benefit all youth in the City, not a narrow segment of the population (for example, when contributions are received to benefit the child of a slain police officer). Fiduciary funds are used only when the assets are held for the benefit of individuals, private organizations or other governments.
3. Agency funds account for resources held by one entity in a capacity as an agent of another. In a true agent relationship, the holder of the resources has no decision-making authority. The holder of the resources is a steward and accounting for his/her stewardship should be the primary concern. Agency funds do not carry out operations, therefore, they have no operating accounts.

Like all other fiduciary funds, agency funds are NOT presented on the face of the government-wide financial statements. The resources they report are not available to support the government's programs. By presenting separate fiduciary fund statements, the government demonstrates its stewardship. Governments could also demonstrate stewardship by presenting information in the notes to the financial statements.

4. Investment trust funds are used by governments that sponsor an external investment pool as a service to other governments within their jurisdiction. Investment pools are like mutual funds without all the related fees. Sometimes the sponsoring government invests its own money in the pool. However, the only assets that should be reported in an investment trust fund are the assets held for other governments. Investment of the sponsoring government is required to be reported in the fund that “owns” the investments in the fund financial statements as well as in the government-wide financial statements. Liabilities reported in an investment trust fund are amounts due to other governments.
5. By making the investment gains nonexpendable (adding them to principal), you will help protect the endowment from inflation. Assuming that at least a portion of net investment gains can be attributable to changes in the value of the monetary unit, the policy will help assure that the endowment principal retains its initial earning (and hence) purchasing power. The disadvantage of this policy, however, is that it assumes a direct relationship between the rate of inflation and investment gains. It uses investment gains as a surrogate for inflation, rather than taking inflation into account directly. Moreover, it may encourage the foundation, if in need of immediate income, to adopt investment strategies that will maximize current interest and dividends at the expense of overall return on investment.

On the other hand, if gains are available for spending, it is likely the principal of the endowment will eventually be decreased. In fact, even if the dollar amount of an endowment is the same as it was 20 years ago, adjusted for inflation, you can expect that it represents much less purchasing power. Although some may argue that reinvesting investment gains is a poor measure of inflation, it would be better than no measure at all.

Chapter 11

Issues of Reporting, Disclosure, and Financial Analysis

TRUE/FALSE (CHAPTER 11)

1. Governments must combine their blended component units into both the fund and government-wide statements.
2. Governments must combine their discretely presented component units into both the fund and the government-wide statements.
3. A related organization is a contractual arrangement whereby two or more participants agree to carry out a common activity and share its risks and rewards.
4. A primary government can impose its will on a potential component unit if it has the authority to modify or approve the unit’s budget.
5. The comprehensive annual financial report (CAFR) is divided into three main sections: the table of contents section, the auditors’ report section, and the financial section.
6. The typical audit is designed to cover all information included in the CAFR.

7. There are only two government-wide statements: the statement of net assets and the statement of activities.
8. Required notes are an essential element of the basic financial statements.
9. Required supplementary information (RSI) is considered part of the basic financial statements.
10. Public colleges and universities must adhere to the same GASB pronouncements as other types of governments.

MULTIPLE CHOICE (CHAPTER 11)

1. The financial reporting entity is composed of
 - a) The primary government.
 - b) The primary government and all legally separate governments for which the primary government is financial accountable.
 - c) The primary government and all legally separate organizations for which the primary government is financially accountable.
 - d) The primary government, all legally separate organizations for which the primary government is financially accountable and any organizations whose omission would cause the primary governments financial statements to be misleading or incomplete.

2. Which of the following is NOT a primary government?
 - a) A state government.
 - b) A general purpose local government with the ability to determine its own budget.
 - c) A general purpose local government whose tax levies must be approved by the state.
 - d) A special purpose local government whose tax levies must be approved by the state.

3. Which of the following is necessary for a special purpose local government to be considered a primary government?
 - a) It must operate for a single purpose.
 - b) It must have a separately elected governing body.
 - c) It must tax its citizens with ad valorem taxes.
 - d) It must be fiscally dependent on another government.

4. Which of the following is necessary for a governmental entity to be considered fiscally independent?
 - a) It must be able to hire its own management.
 - b) It must be able to issue bonds that are tax-exempt.
 - c) It must not be subsidized by another governmental entity.
 - d) It must be able to levy taxes and/or set rates for its services.

5. Which of the following is a necessary characteristic of a component unit?
 - a) It is fiscally dependent on a primary government.
 - b) The primary government provides services that are used by both organizations.
 - c) The primary government can impose its will on the unit or the unit has the potential to provide a financial benefit to or impose a financial burden on the primary government.
 - d) The primary government appoints a voting majority of the component unit's governing body or a voting majority of the unit's governing body is composed of officials of the primary government.

6. The Marsh River School District, a legally separate school district that has a separately elected governing body, cannot enter into any debt agreements without the approval of the County Commission. Marsh River School District would be considered a(n):
 - a) Primary government.
 - b) Component unit.

- c) Related organization.
- d) Affiliated organization.

7. The County Commission appoints a voting majority of the members of the Board of a particular organization. The County Commission cannot impose its will upon the organization. There is no potential for the organization to provide any financial benefit to the County nor is there any potential for the organization to impose any financial burden on the county. The organization is an example of a(n):
- Primary government.
 - Component unit.
 - Related organization.
 - Affiliated organization.
8. The State University Foundation is a legally separate, tax-exempt 501(c)(3) entity organized for the purpose of raising funds to provide scholarships only to academically qualified students at the State University. The existing University Foundation board members elect new members of the board. The Foundation provides scholarships to students of the State University, but the Foundation receives no financial support from the University. The Foundation is an example of:
- Primary government.
 - Related organization.
 - Affiliated organization.
 - None of the above.
9. The governor of the state appoints the members of the Game and Fish Commission. The members of the Commission serve ten-year terms and can be removed only for cause. State law prohibits the reappointment of a Commissioner. The Commission receives no tax dollars. It is supported entirely by licenses and fees paid by hunters and anglers. The only bonds that can legally be issued by the Commission are revenue bonds backed by the licenses and fees paid by the sportsmen. The Game and Fish Commission is not a 501(c)(3) organization and does not have separate legal status. The Game and Fish Commission is an example of a:
- Primary government.
 - Component unit.
 - Related Organization.
 - None of the above.
10. Of the following powers possessed by Government A, which is an indication that Government A can impose its will on Government B? Government A:
- Can dismiss Government B's chief operating officer.
 - Can review Government B's budget.
 - Can remove appointed members of Government B's governing board only for cause.
 - Issues debt on behalf of Government B.

11. Of the following powers possessed by Government A, which is NOT an indication that Government B should be included as a component unit of Government A?
- a) The governing documents state that, if dissolved, the assets of Government B will become the property of Government A.
 - b) Government A issues revenue bonds in its name backed by the revenues of a project to be undertaken by Government B. Government A is neither legally nor morally liable for repayment.
 - c) Government A has agreed to provide financial support to Government B if Government B operates at a deficit but in the entire 75 years that Government B has operated, it has never operated at a loss.
 - d) The governing documents state that once Government B has equity in excess of a certain amount, 50% of all future operating profits will be used to reduce bonded debt of Government A.

12. The State has a legally separate State Building Authority which has a board appointed by the Governor. The Authority issues debt in its own name, holds title to buildings in its own name, and leases its building exclusively to the State. The Authority would be considered a(n)
- a) Primary government.
 - b) Component unit.
 - c) Related organization.
 - d) Affiliated organization.

13. The State has a legally separate State Building Authority which has a board appointed by the Governor. The Authority issues debt in its own name, holds title to buildings in its own name, and leases its building exclusively to the State. In what manner would the Authority be included in the State's Basic Financial Statements?
- a) Blended.
 - b) Discretely presented.
 - c) Note disclosure only.
 - d) Not included in any manner.

14. The City created a legally separate Housing Authority to provide low-income housing to residents of the City. The City issues debt for the Housing Authority in the name of the City, but the Housing Authority is responsible for repayment of the debt. The Housing Authority is governed by a board composed of all 5 members of the City Council. Actions can be taken by the Authority upon receiving an affirmative vote by a simple majority of the board. The Housing Authority would be considered a(n):
- a) Primary Government.
 - b) Component Unit.
 - c) Related Organization.
 - d) Affiliated Organization.

15. The City created a legally separate Housing Authority to provide low-income housing to residents of the City. The City issues debt for the Housing Authority in the name of the City, but the Housing Authority is responsible for repayment of the debt. The Housing Authority is governed by a board composed of all 5 members of the City Council. The Authority can take action based on the affirmative vote of a simple majority of the board. In what manner would the Authority be included in the City's Basic Financial Statements?
- a) Blended.
 - b) Discretely presented.
 - c) Note disclosure only.
 - d) Not included in any manner.
16. The County created a legally separate County Hospital authority. Members of the board of the County Hospital are elected in county-wide elections. The County must approve the budget of the Hospital, but the hospital receives no financial support from the County, except that the County pays the hospital bills for county indigents. All revenues of the Hospital are user fees. The County Hospital would be considered a(n)
- a) Primary government.
 - b) Component unit.
 - c) Related organization.
 - d) Affiliated organization.
17. The County created a legally separate County Hospital authority. Members of the board of the County Hospital are elected in county-wide elections. The County must approve the budget of the Hospital, but the hospital receives no financial support from the County, except that the County pays the hospital bills for county indigents. All revenues of the Hospital are user fees. In what manner would the Hospital be included in the County's Basic Financial Statements?
- a) Blended.
 - b) Discretely presented.
 - c) Note disclosure only.
 - d) Not included in any manner.
18. The County created a legally separate County Hospital authority. Members of the board of the County Hospital are elected in county-wide elections. The hospital receives no financial support from the County, except that the County pays the hospital bills for county indigents. All revenues of the Hospital are user fees. The County Hospital would be considered a(n)
- a) Primary government.
 - b) Component unit.
 - c) Related organization.
 - d) Affiliated organization.
19. The County created a legally separate County Hospital authority. Members of the board of the County Hospital are elected in county-wide elections. The hospital receives no financial support from the County, except that the County pays the hospital bills for county indigents. All revenues of the Hospital are user fees. In what manner would the Hospital be included in the County's Basic Financial Statements?
- a) Blended.
 - b) Discretely presented.
 - c) Note disclosure only.

d) Not included in any manner.

20. The City created a legally separate Port Authority. Members of the board of the Port Authority are elected in general city elections. The Port Authority receives no tax dollars; it is supported entirely by user fees. The Port Authority determines its budget, sets user fees, and has the power to issue bonded debt. The Authority would be considered a(n)
- a) Primary government.
 - b) Component unit.
 - c) Related organization.
 - d) Affiliated organization.
21. The City created a legally separate Port Authority. Members of the board of the Port Authority are elected in general city elections. The Port Authority receives no tax dollars; it is supported entirely by user fees. The Port Authority determines its budget, sets user fees, and has the power to issue bonded debt. In what manner would the Port Authority be included in the City's Basic Financial Statements?
- a) Blended.
 - b) Discretely presented.
 - c) Note disclosure only.
 - d) Not included in any manner.
22. Two cities entered into a contractual agreement to operate a landfill. The cities each contributed the necessary assets to operate the landfill in proportion to their populations. First City has the ability to appoint five members of the seven-person governing body of the landfill. The appointees serve for six-year terms, cannot be reappointed, and can be removed only for cause. First City has no obligation to contribute to the landfill if the landfill revenues are insufficient to cover current operating costs. The landfill would be considered a(n)
- a) Primary government.
 - b) Component unit.
 - c) Related organization.
 - d) Affiliated organization.
23. Two cities entered into a contractual agreement to operate a landfill. The cities each contributed the necessary assets to operate the landfill in proportion to their populations. Each city has the ability to appoint two members of the governing body of the landfill, and each has an equity interest in the arrangement. The assets contributed by First City were primarily in the form of property and equipment that had been used in general government activities. In what manner would the landfill be included in First City's government-wide financial statements?
- a) As an investment.
 - b) Discretely presented.
 - c) Note disclosure only.
 - d) Not included in any manner.

24. Two cities entered into a contractual agreement to operate a landfill. The cities each contributed the necessary assets to operate the landfill in proportion to their populations. Each city has the ability to appoint two members of the governing body of the landfill. The assets contributed by First City were primarily in the form of property and equipment that had been used in general government activities. In what manner would the landfill be included in First City's fund financial statements?

- a) In a governmental fund only.
- b) In the schedule of capital assets only.
- c) In a proprietary fund only.
- d) Not be recognized in the financial statements.

25. The City created a legally separate entity to operate a County Hospital. The City Council appoints a voting majority of the board of the Hospital. The City cannot impose its will on the Hospital and there is no potential for a financial benefit or financial burden to the City. The County Hospital would be a(n)

- a) Primary government.
- b) Component unit.
- c) Related organization.
- d) Affiliated organization.

26. The City created a legally separate entity to operate a County Hospital. The City Council appoints a voting majority of the board of the Hospital. The City cannot impose its will on the Hospital and there is no potential for a financial benefit or financial burden to the City. In what manner would the Hospital be included in the City's Basic Financial Statements?

- a) Blended.
- b) Discretely presented.
- c) Only by note disclosure of the relationship.
- d) Not included in any manner.

27. The Friends of the City Public Library Foundation is a legally separate, tax-exempt 501(c)(3) entity organized for the purpose of raising funds to provide financial assistance to the Library. Members of the board of the Foundation are elected by the existing Foundation board members. The Foundation provides financial assistance to the Library, but the Foundation receives no financial support from the Library. If dissolved, all of the Foundation assets would revert to the Library. The Foundation would be considered a(n)

- a) Primary government.
- b) Component unit.
- c) Related organization.
- d) Affiliated organization.

28. The Friends of the City Public Library Foundation is a legally separate, tax-exempt 501(c)(3) entity organized for the purpose of raising funds to provide financial assistance to the Library. Members of the board of the Foundation are elected by the existing Foundation board members. The Foundation provides financial assistance to the Library, but the Foundation receives no financial support from the Library. If dissolved, all of the Foundation assets would revert to the Library. In what manner should the Foundation be presented in the financial statements of the Library?

- a) Blended.
- b) Discretely presented.

- c) Note disclosure only.
- d) Not included in any manner.

29. The University Foundation is a legally separate, tax-exempt 501(c)(3) entity organized for the purpose of raising funds to provide scholarships only to academically qualified students at State University. Members of the board of the University Foundation are elected by the existing Board of Trustees. The Foundation provides scholarships to students of State University, but the Foundation receives no financial support from the University. The Foundation would be considered a(n)

- a) Primary government.
- b) Component unit.
- c) Related organization.
- d) Affiliated organization.

30. The University Foundation is a legally separate, tax-exempt 501(c)(3) entity organized for the purpose of raising funds to provide scholarships only to academically qualified students at State University. Members of the board of the University Foundation are elected by the existing Board of Trustees. The Foundation provides scholarships to students of State University, but the Foundation receives no financial support from the University. In what manner would State University include the Foundation in its financial statements?

- a) Blended.
- b) Discretely presented.
- c) Consolidated.
- d) Note disclosure only.

31. A Comprehensive Annual Financial Report for the City of Highland Hills need not include which of the following sections?

- a) Condensed summary data.
- b) Introductory section.
- c) Financial section.
- d) Statistical section.

32. The introductory section of a CAFR includes which of the following?

- a) Auditor's opinion on the basic financial statements.
- b) Basic financial statements.
- c) Letter of Transmittal.
- d) MD&A and other RSI.

33. The financial section of a CAFR includes:

- a) MD&A and other RSI.
- b) Statistical section.
- c) Letter of Transmittal.
- d) GFOA certificate of achievement.

34. Which of the following statements is not a required part of the basic financial statements of the City of Highland Hills?

- a) Government-wide Statement of Net Assets.
- b) Statement of Revenues, Expenditures, and Changes in Fund Balances for all governmental funds.
- c) Statement of Revenues, Expenses, and Changes in Net Assets for all fiduciary funds.
- d) Statement of Cash Flows for all proprietary funds.

35. The auditor's report generally includes an opinion on which of the following sections of the CAFR?
- The introductory section, the financial section, and the statistical section.
 - The introductory and the financial sections only.
 - The statistical and the financial sections only.
 - The financial section only.
36. Government-wide financial statements include which of the following?
- Balance Sheet and Income Statement.
 - Balance Sheet, Income Statement, and Statement of Cash Flows.
 - Statement of Net Assets and Statement of Activities.
 - Statement of Net Assets, Statement of Activities, and Statement of Cash Flows.
37. Fund financial statements include which of the following for a governmental fund?
- Statement of Net Assets and Statement of Changes in Net Assets.
 - Statement of Net Assets, Statement of Changes in Net Assets, and Statement of Cash Flows.
 - Balance Sheet; Statement of Revenue, Expenditures, and Changes in Fund Balance; and Statement of Cash Flows.
 - Balance Sheet; and Statement of Revenue, Expenses, and Changes in Fund Balance.
38. Fund financial statements for fiduciary funds include which of the following?
- Balance Sheet and Income Statement.
 - Balance Sheet, Income Statement, and a Statement of Cash Flows.
 - Statement of Fiduciary Net Assets and a Statement of Changes in Fiduciary Net Assets.
 - Statement of Fiduciary Net Assets, Statement of Changes in Fiduciary Net Assets, and Statement of Cash Flows.
39. For a government that elects to capitalize infrastructure, RSI does not include which of the following?
- MD&A.
 - Actual to budget comparison.
 - Information about infrastructure condition.
 - Details of pension actuarial valuations.
40. With regard to combining statements, which of the following statements is true?
- Combining statements for nonmajor governmental funds are optional.
 - Combining statements for nonmajor governmental funds are required.
 - Combining statements for nonmajor internal service funds are optional.
 - Combining statements for all internal service funds is optional.

41. The city council of the City of Highland Hills has adopted a policy of aggressively pursuing grants and other resource inflows from other levels of government. Over the past several years, the proportion of total City revenues that comes from other levels of government has been steadily increasing. As a consequence of these increased revenues, the City has begun offering a number of new services to the citizens of the City. In assessing the financial condition of the City of Highland Hills, an analyst would conclude which of the following?

- a) The increasing reliance on intergovernmental revenues has increased the financial viability of the City.
- b) The increasing reliance on intergovernmental revenues can be a negative fiscal characteristic.
- c) The increasing reliance on intergovernmental revenues is irrelevant in assessing the financial condition of the City.
- d) The increasing reliance on intergovernmental revenues is a sign of poor management on the part of the City Council.

42. Which of the following is generally considered to be a positive fiscal characteristic for a City?

- a) A high, or increasing, ratio of intergovernmental revenues to total revenues.
- b) A low percentage of restricted revenues to total revenues.
- c) A high proportion of one-time revenues to total revenues.
- d) A low ratio of property tax revenues to total revenues.

43. Which of the following is generally considered to be a positive fiscal characteristic for a City?

- a) An increasing amount of payroll costs.
- b) An increasing amount of expenditures for specific functions.
- c) An increasing percentage of nondiscretionary expenditures.
- d) An increasing percentage of discretionary expenditures.

44. Which of the following would generally be considered an indication of future economic concern for a City?

- a) A decreasing percentage of revenue raised by the City as a proportion of total appraised value of property.
- b) A decreasing percentage of revenue raised by the City as a proportion of median family income.
- c) An increasing population base.
- d) An increasing industrial base in a variety of industries.

PROBLEMS (CHAPTER 11)

The City of Fannin joined with two other cities to create a Regional Landfill Authority. The initial cash investment by each community was as follows:

- City of Fannin \$10 million
- City of Shelley \$15 million
- City of Firth \$ 5 million

The Landfill will be governed by a Board composed of seven members—two chosen by each mayor and one chosen by majority vote of the six mayoral appointees. During the first year of operation the Landfill, which receives no tax dollars, generated an excess of revenues over expenses of \$150,000. Please record the City of Fannin's appropriate entries under each of the mutually exclusive situations, assuming all participants have an equity interest in the Authority. Please indicate clearly in which fund the entry is being made.

- a) Assume that the City of Fannin appropriates the \$10 million contribution from its general fund resources.
- b) Assume that the City of Fannin uses the resources available in its City Utility Enterprise Fund to make the contribution.

For each of the following independent cases state whether or not the entity described should be included in the financial statements of the primary government and if so, how? Be concise but adequately defend your answer using GASB criteria.

- a) The Planning and Development Authority is a separate legal entity with a five-member board appointed as follows: one member appointed by the School District, one member appointed by the City, one member appointed by the County, and two members elected by the three appointed members. The Planning and Development Authority received a \$50,000 grant from the State. The money was used to make loans to businesses agreeing to relocate to the immediate area. Repayments of the principal and interest by borrowers are available for lending to new entities.
- b) The State created a Public Building Authority, a separate legal entity. The Governor appoints a voting majority of the board of the Authority. The Authority issues bonds, backed by the buildings financed with the proceeds. The Authority leases the buildings to the State and uses the proceeds of those leases to service the debt on the bonds.
- c) Bane County Hospital is built on land donated to the hospital by the US Bureau of Land Management (a federal agency). The hospital board members elect replacements to the Board without outside nominations. The hospital is a separate legal entity and is entirely supported by revenues generated by the hospital. The County Commission must approve the budget each year, but the County Commission has never questioned any item in the budget.
- d) Members of the State University Board of Trustees are elected in a statewide general election. The State provides approximately half of the operating revenues necessary to finance the University's programs. The University is a separate legal entity, and state laws apply to the conduct of its business.

3. Based on the data from the General Fund presented below, assess (as best you can) the financial/fiscal condition of the City of Katerah. As much as possible, justify your answer with quantitative data.

(000's omitted)

| | |
|---|------------|
| Population (increasing slowly) | 86 |
| Value of taxable property | \$123,000 |
| Total general fund revenues | \$ 23,000 |
| General Fund property tax revenue | \$ 11,000 |
| Intergovernmental revenues | \$ 4,000 |
| Miscellaneous revenues | \$ 8,000 |
| Total General Fund expenditures (including debt service) | \$ 22,000 |
| Current expenditures | \$ 21,300 |
| Capital outlay | \$ 1,600 |
| Debt service expenditures | \$ 100 |
| Operating transfer in | \$ 600 |
| Operating transfer out | \$ (4,600) |
| Unreserved fund balance | \$ 13,000 |
| Cash and investments | \$ 15,000 |
| Current liabilities | \$ 1,400 |

4. The data below were taken from the CAFRs of two cities.

| | <u>City of Kayla</u> | <u>City of Katerah</u> |
|-----------------------------|----------------------|------------------------|
| Population | 17,000 | 105,000 |
| Value of taxable property | \$860,678,900 | \$1,075,890,100 |
| Annual property tax levy | \$16,787,068 | \$54,991,385 |
| Total general fund revenues | \$62,166,696 | \$82,171,776 |
| General fund tax revenues | \$43,977,949 | \$54,991,385 |
| Intergovernmental revenues | \$6,188,029 | \$17,293,415 |

REQUIRED: Based on this limited information

- a. Which City has the greater resources?
- b. Which City imposes a greater tax burden on its citizens based on
 - Per capita total general fund revenues?
 - Per capital property taxes?
 - Property taxes as a percentage of property values?
- c. Which City receives more assistance from other governments?

5. Geneva City has prepared all of the elements of its CAFR. **REQUIRED:** Numbering from one to ten, indicate the order in which each of these elements should appear in the City's CAFR.

- _____ Auditor's report
- _____ Letter of transmittal
- _____ Required supplementary information other than MD&A
- _____ Government-wide financial statements
- _____ Notes to financial statements
- _____ Combining statements for nonmajor funds
- _____ Combining statements for major discretely presented component units
- _____ Management's Discussion and Analysis (MD&A)
- _____ Statistical tables
- _____ Governmental fund statements

6. Chessie County has two component units—an Electric Utility and a Housing Authority. In its separate financial statements, the Electric Utility reports using a single enterprise fund. The Housing Authority reports using a general fund, a special revenue fund, and a debt service fund.

- a. Assuming that both component units meet the criteria for presentation as discretely presented component units

- Where should their financial information be presented in the County's report?
- How would the Housing Authority's general fund be reported?

- b. Assuming that the Electric Utility meets the criteria for reporting as a major component unit, what is the most likely way in which the City would meet the additional disclosure requirement for the Utility? What are two other ways that the disclosure requirements could be met?

- c. Assuming that the Housing Authority meets the criteria for presentation as a blended component unit**

Where should the Authority's financial information be presented?

- How would the Authority's general fund be reported?

7. A city established an airport authority as a municipal corporation under state law for the purpose of acquiring, maintaining, operating, and financing airports. The authority's governing board consists of five members, four appointed by the mayor of the city and one appointed by the board of county commissioners. The board members may not be removed by the appointing officials, except for cause through an impeachment process.

The authority is authorized to issue bonds, to levy taxes, to own property in its own name, to determine its budget, and to establish rates. All debt issued is payable from revenues derived solely from the operation of the authority. The city has no obligation for the debt of the authority. The authority's board controls the day-to-day operations of the organization. The authority has sole responsibility for financing its deficits and has sole control of its surplus funds.

Should the city include the authority in its financial statements as a component unit? How, if at all, should it report the authority. Explain and justify *citing the specific criteria* that you used to make your determination.

ESSAYS (CHAPTER 11)

1. The state established the State Housing Authority to finance construction of low-income housing. The Authority, a state corporation, is governed by an independent board of directors, the members of which are appointed by the governor. They can be removed only for cause. The board of directors has complete control over the Authority's operations. The Director is hired by the Board and reports to the Board; the Director cannot be removed by the Governor. Although the State Constitution limits the State to \$2 million of bonds outstanding, the Authority issued \$970 million in bonds to finance construction projects. In earlier years, the Authority issued debt that was backed by the taxing power of the State (moral obligation debt). The newer bonds are revenue bonds only.

The Authority uses the proceeds of its debt to make loans to finance housing construction. Debt is serviced from monies received in repayment of loans made by the Authority.

Do you believe the State should include the Authority in its reporting entity? If so, how? Justify your answer using the GASB Financial Reporting Entity criteria.

2. A Comprehensive Annual Financial Report includes a Statistical Section. What kinds of information are found in the statistical section? To what use would a reader put the information found in the statistical section? In your opinion, is the statistical section worth the effort put into its preparation?
3. GASB reporting standards require that legally separate component units be included on the face of the financial statements of the primary government. Small City created a legally separate City Utility Service. The Small City Council appoints the Utility board members, authorizes the bonds of the Utility, and approves its budget. Small City's general fund revenues are \$58 million; the revenues of the Public Utility are \$100 million (the Public Utility owns a generating plant and sells its excess power to other communities). Discuss the appropriate reporting for the City Utility Service. Do you think that this presentation is meaningful? Why or why not?
4. What are four types of information must be presented in Management's Discussion and Analysis (MD&A)? Which financial statement is each type of information derived from, if any?
5. Governmental colleges and universities have several reporting options under GAAP. What are they? What financial statements would be presented under each? What basis of accounting would be used?

ANSWERS TO TRUE/FALSE (CHAPTER 11)

1. True
2. False
3. False
4. True
5. False
6. False
7. True
8. True
9. False
10. True

ANSWERS TO MULTIPLE CHOICE (CHAPTER 11)

1. D
2. D
3. B
4. D
5. D
6. B
7. C
8. C
9. D
10. A
11. B
12. B
13. A
14. B
15. A
16. B
17. B
18. A
19. D
20. A
21. D
22. C
23. A
24. B
25. C
26. C
27. D
28. B
29. D
30. B
31. A
32. C
33. A
34. C
35. D
36. C
37. D
38. C
39. C
40. A
41. B
42. B
43. D
44. A

ANSWERS TO PROBLEMS (CHAPTER 11)

Problem 1

a) GENERAL FUND

| | | |
|---|--------------|--------------|
| Capital expenditure—investment in joint venture | \$10 million | |
| Cash | | \$10 million |

[Note: The investment is a long term investment and is, therefore, not recorded in the General Fund as an investment.]

b) ENTERPRISE FUND

| | | |
|--|--------------|--------------|
| Investment in landfill joint venture | \$10 million | |
| Cash (to record initial investment) | | \$10 million |

| | | |
|---|-----------|-----------|
| Investment in landfill joint venture | \$ 50,000 | |
| Earnings (to record one third share of joint venture net income) | | \$ 50,000 |

Problem 2

- a) The Planning and Development Authority should not be reported on the financial statements of any of the supporting organizations. It is a special purpose government that qualifies as a primary government. The entity is legally separate and no one entity appoints a voting majority. The fiscal dependency criterion is not met, and it appears that its omission from any of the supporting organizations' financial statements would not render them misleading.
- b) The Authority is a component unit that should be blended with the funds of the primary government—the state. The entity is legally separate and the Governor appoints a voting majority of the board of the Authority. There appears to be a potential financial burden to the state. The Authority provides its services entirely to the State.
- c) Because the County does not appoint a voting majority of the Hospital's Board, it would only be included as a component unit if the Hospital is fiscally dependent on the County or if it would be misleading for the County to exclude the Hospital. The fact that the County must approve the Hospital's budget, even though it has never questioned the budget, indicates that the Hospital is fiscally dependent on the County and should be included as a discretely presented component unit in the County's government-wide financial statements.
- d) Because the University's trustees are elected in a statewide general election, this special purpose government should not be included as a component unit of another government unless it is fiscally dependent on another government. The fact that the University receives a substantial amount of support from the State does not indicate fiscal dependency. Entities are fiscally independent if they can determine their budget, levy taxes or set rates, and issue bonds without the approval of another government. With no detail to the contrary, the University appears to be a fiscally independent primary government.

Problem 3

Students may calculate a number of ratios. Among them should be a liquidity measure, a measure of fiscal efforts, a measure of the adequacy of fund balance, and a measure of the tax burden imposed on the citizens.

$$\text{Adequacy of fund balance} = \frac{\text{Unreserved fund balance}}{\text{Total General Fund revenues}} = \frac{\$13,000}{\$23,000} = 56.52\%$$

$$\text{Liquidity measure} = \frac{\text{Cash and investments}}{\text{Current liabilities}} = \frac{\$15,000}{\$1,400} = 10.71 \text{ times}$$

$$\text{Fiscal effort measure} = \frac{\text{Revenue from own sources}^*}{\text{Total appraised value}} = \frac{\$19,000}{\$123,000} = 15.45\%$$

*[**Note:** Some students may include in the numerator only the property tax revenue.
 $\frac{\$11,000}{\$123,000} = 8.94\%$]

$$\text{Property taxes as a percentage of total revenues} = \frac{\$11,000}{\$23,000} = 47.83\%$$

$$\text{Tax burden per capita} = \frac{\$11,000}{86} = \$127.91 \text{ per person}$$

$$\begin{aligned} &\text{Debt service as a percentage} \\ &\text{of total General Fund expenditures} = \frac{\$100}{\$22,000} = .45\% \end{aligned}$$

A decline in the adequacy of fund balance ratio would be viewed as negative. This particular percentage implies that there can be as much as a 50% decline in operating revenues in a particular year and the City will still be able to operate on existing reserves and current revenues. This seems healthy.

Liquidity measures are valid for business entities and for governments. This particular ratio implies that there are almost \$11 to satisfy each \$1 of liabilities. That seems to be a very healthy position.

The fiscal effort measure is used to determine how sensitive the entity will be to changes in revenues that are outside of its control. Also, the ratio measures the level of taxation on the citizens. As this ratio increases, the margin between revenues and potential revenues decreases and governments become more vulnerable if expenditures increase significantly.

Property tax revenues as a percentage of total revenues is a measure of fiscal effort. Property tax revenues are under the control of the local City Council, and can be controlled (within existing laws) by the City Council. Total revenues from own sources is 15% of total assessed value of property. Total revenues from property taxes is 9% of total assessed value of property. These both seem to be reasonable numbers. External revenues are less dependable and cause the entity to be more vulnerable to changes in those revenue sources. In this particular situation property taxes are approximately 48% of the total revenues. The City has control over nearly one-half of its revenue sources. This seems to be good.

Property taxes per capita are a good measure of the tax burden on local citizens. The amount of revenue per person is approximately \$128. This seems to be a small number. Comparison with other entities would be important.

Debt service as a percentage of total expenditures is less than 1%. This is very good. Most of the revenues raised can be used to provide current period expenditures.

Overall, the entity seems to be very healthy.

Problem 4

a. Per capita value of taxable property

| | <u>Kayla</u> | <u>Katerah</u> |
|--------------------------------------|---------------|-----------------|
| Value of taxable property | \$860,678,900 | \$1,075,890,100 |
| Population | 17,000 | 105,000 |
| Per capita value of taxable property | \$ 50,628 | \$ 10,247 |

Based on property value, Kayla has the greater resources per capita upon which to draw.

b.

Per capita general fund taxes

| | <u>Kayla</u> | <u>Katerah</u> |
|-------------------------------|--------------|----------------|
| General fund tax revenues | \$43,977,949 | \$54,991,385 |
| Population | 17,000 | 105,000 |
| Per capita general fund taxes | \$ 2,587 | \$ 524 |

Per capita property taxes

| | <u>Kayla</u> | <u>Katerah</u> |
|---------------------------|--------------|----------------|
| Property tax levy | \$16,787,068 | \$54,991,385 |
| Population | 17,000 | 105,000 |
| Per capita property taxes | \$ 987 | \$ 524 |

Property taxes as a percent of property values

| | <u>Kayla</u> | <u>Katerah</u> |
|---------------------------|---------------|----------------|
| Property tax levy | \$ 16,787,068 | \$ 54,991,385 |
| Value of taxable property | 860,678,900 | 1,075,890,100 |
| Percent (tax rate) | 1.95% | 5.11% |

Kayla residents pay more in taxes on a per capita basis, but not as a percentage of their wealth (as measured by property values).

c.

Percentage of total general fund revenues from other governments

| | <u>Kayla</u> | <u>Katerah</u> |
|------------------------------------|--------------|----------------|
| Intergovernmental revenues | \$ 6,188,029 | \$ 17,293,415 |
| Total general fund revenues | 62,166,696 | 82,171,776 |
| Percent intergovernmental revenues | 9.95% | 21.05% |

Per capita intergovernmental revenues

| | <u>Kayla</u> | <u>Katerah</u> |
|---------------------------------------|--------------|----------------|
| Intergovernmental revenues | \$ 6,188,029 | \$ 17,293,415 |
| Population | 17,000 | 105,000 |
| Per capita intergovernmental revenues | \$ 364 | \$ 165 |

Despite being the wealthier community, Kayla receives a greater amount of intergovernmental revenues per capita. However, Katerah receives a higher percentage of its general fund revenues from other governments.

Problem 5

| | |
|-----------|---|
| <u>2</u> | Auditor's report |
| <u>1</u> | Letter of transmittal |
| <u>8</u> | Required supplementary information other than MD&A |
| <u>4</u> | Government-wide financial statements |
| <u>7</u> | Notes to financial statements |
| <u>9</u> | Combining statements for nonmajor funds |
| <u>6</u> | Combining statements for major discretely presented component units |
| <u>3</u> | Management's Discussion and Analysis (MD&A) |
| <u>10</u> | Statistical tables |
| <u>5</u> | Governmental fund statements. |

Problem 6

a.

- Discretely presented component units should be reported only in the government-wide financial statements in a column(s) to the right of the total primary government column.
- The Housing Authority's general fund should be included in the component unit column(s). The component unit data presented in the reporting entity's financial statements should be based on the component unit's government-wide information. No fund data should be presented.

b. The City would most likely meet the major component unit disclosure requirement by presenting the Utility in a separate column on the face of the government-wide financial statements. Alternatively, the City could disclose summary financial statements in the notes to its financial statements or present a combining statement of major discretely presented component units.

c.

- Blended component units should be presented with the other funds of the primary government. Therefore, the Authority should be reported both in the City's fund financial statements and its government-wide statements (in its governmental activities column).
- The Authority's general fund should be reported as a special revenue fund. If it meets the definition of a major fund, it should be presented as a separate column in the fund financial statements. Governments are prohibited from presenting more than one general fund.

Problem 7

Is the authority a legally separate entity? Yes

Does the city appoint a majority of its governing board? Yes

Can the city impose its will in the authority? No

Is there a financial benefit/burden relationship? No

Therefore the authority is related organization, not a component unit

ANSWERS TO ESSAY (CHAPTER 11)

1. The Authority is a separate legal entity but it does not have a popularly elected governing body. Since the Governor appoints the Board, the Authority is a potential component unit. Because the State backs the older bond issues, there is a potential for a financial burden. Therefore, the Authority is a component unit. Because the board of the primary government and the component unit are not substantially the same and because the component unit does not provide its service almost entirely to the primary government, this is a component unit that should be discretely presented.
2. The statistical section is considered supplementary disclosure. This section is of value for several reasons. Governmental entities have the power to tax, a characteristic not shared with other types of entities. Because the government has the power to command resources, information regarding the resources available to the government, but not yet under its direct control, is important.

Much of the information in the statistical section simply expands on the information already available in the financial statements—for example, 10 years' worth of property tax revenue. The demographic data, however, is not available in the financial statements. The statistical section provides information about the total amount of debt imposed on property subject to taxation by the government. It lists the largest taxpayers. This type of information is useful in projecting the ability of the government to sustain or increase the current levels of property tax revenues. Property taxes by multiple layers of governments may soon be 'overtaxed.' If the government is dependent on one or two major employers or business entities, the economic outlook for those entities is extremely important when forecasting the economic outlook for the government.

[Note: Students may have differing opinions on the usefulness of the statistical section.] The statistical data should be very useful to those forecasting the financial capacity of the entity in the future. Some users find the statistical data as useful, or more useful, than the financial statements because of the trend information it provides. Taken together with some financial data, the statistical section aids in assessing overall financial condition.

3. Despite the fact that the revenues of Public Utility far exceed the revenues of the General Fund, the City Utility Service is a component unit of Small City because Small City is financially accountable for Public Utility. Small City is financially accountable for Public Utility because the Small City Council appoints the board members for the Public Utility and the Public Utility is not fiscally independent. That is, Small City must authorize any bonds issued by the Utility and also approves its budget. City Utility Service should be presented as a discretely presented component unit to the right of the totals for Small City on the government-wide financial statements. This appears to be more appropriate than blending the two together (because of the size difference) or omitting the utility's operations from the financial statements.

GASB Statement No. 14 was controversial. The example of a component unit with assets and net assets in excess of those of the primary government has frequently been part of the argument against GASB Statement No. 14. According to GASB, accountability is the cornerstone of financial reporting. The only elected officials to which the public can look if they are unhappy with the management of City Utility Service are the elected officials of Small City. Holding elected officials financially accountable for entities over which they have effective control was a guiding premise for the GASB when they developed Statement No. 14.

4. Examples of items that must be addressed in the MD&A include:

[Note: Students must name four.]

- A brief description of the required financial statements—not derived from the financial statements.
- Condensed financial information—derived from government-wide statement of net assets and statement of activities.
- An analysis of the government's overall financial position and results of operations, including impact of important economic factors—based in part on information provided in the government-wide financial statements.
- An analysis of balances and transactions of individual funds—based on major funds in the governmental and proprietary fund financial statements.
- An analysis of differences between original and final budget amounts and between actual and budgeted amounts for the general fund—based on the budgetary comparison statement or the budgetary comparison schedule (if included as RSI).
- A description of changes in capital assets and long-term debt during the year—based principally on the required schedules of changes in capital assets and in long-term liabilities, required to be presented in the notes to financial statements.
- A discussion of the condition of infrastructure assets—required only if the government uses the modified approach, derived from RSI.
- A description of currently known facts, decisions or conditions that have, or are expected to have, a material effect on the financial position or results of operations—not necessarily derived from the financial statements.

5. Colleges and universities can elect to report as special purpose governments that engage (1) only in business-type activities (2) only in governmental activities, or (3) in both. If they report as entities that engage only in business-type activities then they will present a statement of net assets and a statement of revenues, expenses, and changes in net assets—both prepared using the full accrual basis of accounting. They will also need to present a statement of cash flows. Colleges that elect to report only governmental activities would present government-wide statements (prepared using the full accrual basis of accounting) and governmental fund financial statements (prepared using the modified accrual basis of accounting). If needed, they may also present fiduciary fund statements. Colleges that elect to present both governmental and business-type activities would present all of the above financial statements.

Chapter 12

Not-for-Profit Organizations

TRUE/FALSE (CHAPTER 12)

1. FASB Statement No. 117 directs that revenues and expenses be reported in a statement of financial position.
2. In the statement of activities, FASB Statement No. 117 requires revenues to be reported as increases in one of the three categories of net assets, depending on donor-imposed restrictions; however, all expenses should be reported as decreases in unrestricted net assets.
3. Restricted contributions may be reported as unrestricted if the restriction has been met in the same period as the contribution is made.
4. FASB Statement No. 95 requires not-for-profits to use the direct method in their statements of cash flows.
5. In accounting for investments, not-for-profits, like businesses, must report their investments at fair value and classify the investments as either trading, available-for-sale, or held-to-maturity.
6. FASB Statement No. 93 makes the recognition of depreciation on plant and equipment assets optional at the discretion of the not-for-profit.
7. Temporarily restricted funds related to plant and equipment generally account only for resources restricted to their purchase or construction, not for the plant and equipment itself, which are typically reported in the unrestricted fund.

MULTIPLE CHOICE (CHAPTER 12)

1. The basis of accounting used by not-for-profit organizations in their external financial reports is
 - a) Industry-specific basis of accounting.
 - b) Cash basis of accounting.
 - c) Modified accrual basis of accounting.
 - d) Accrual basis of accounting.

2. FASB require the balance sheets of not-for-profits to display
 - a) Net assets in four separate categories—unrestricted, temporarily restricted, permanently restricted, and restricted by creditors.
 - b) Three separate funds—unrestricted, temporarily restricted, and permanently restricted net assets.
 - c) Six totals—total assets, total liabilities, total net assets, total unrestricted net assets, total temporarily restricted net assets, and total permanently restricted net assets.
 - d) Unrestricted, temporarily restricted, and permanently restricted retained earnings.

3. FASB requires external financial reports to provide information about
 - a) Donor-imposed restrictions on resources.
 - b) All restrictions on resources.
 - c) Donor and creditor restrictions on resources.
 - d) None of the above.

4. Expenses incurred by not-for-profit organizations should be reported as
 - a) Decreases in one of the three categories of net assets.
 - b) Decreases in unrestricted net assets.
 - c) Decreases in temporarily restricted net assets.
 - d) Decreases in permanently restricted net assets.

5. Revenues of a not-for-profit organization should be reported as
 - a) Increases in one of the three categories of net assets.
 - b) Increases in unrestricted net assets.
 - c) Increases in temporarily restricted net assets.
 - d) Increases in permanently restricted net assets.

6. Restricted gifts to not-for-profit organizations
 - a) Must always be shown as an increase in restricted net assets.
 - b) Must always be shown as an increase in unrestricted net assets.
 - c) May be shown as an increase in unrestricted net assets if the restriction is met in the same period.
 - d) May be shown as an increase in unrestricted net assets at the discretion of management.

7. The account title “Resources Released from Restriction” is reported by a ‘restricted fund’ as a
 - a) Revenue account.
 - b) Contra-revenue account.
 - c) Expense account.
 - d) Contra-expense account.

8. The account title "Resources Released from Restriction" is reported by an unrestricted "fund" as a
- Revenue account.
 - Contra-revenue account.
 - Expense account.
 - Contra-expense account.
9. FASB requires that all not-for-profit organizations report expenses
- By object.
 - By function.
 - By natural classification.
 - By budget code.
10. The National Association for the Preservation of Wildlife received \$10,000 from a benefactor to support the overall objective of the organization. This amount will be recognized as revenue
- In the period received.
 - In the period spent.
 - Never, because it is not earned.
 - In the period it becomes susceptible to accrual.
11. Not-for-profit organizations report their cash flows in which of the following categories?
- Operating, noncapital financing, capital financing, investing.
 - Operating, noncapital financing, investing.
 - Operating, capital financing, investing.
 - Operating, financing, investing.
12. Not-for-profit organizations should report contributions restricted for long-term purposes in which of the following cash flows categories?
- Operating
 - Financing.
 - Capital financing.
 - Investing.
13. Not-for-profit organizations should report interest and dividends earned and restricted for long-term purposes in which of the following cash flows categories?
- Operating
 - Financing.
 - Capital financing.
 - Investing.
14. The characteristic that most clearly distinguishes a contribution from an exchange transaction is which of the following?
- Cash is always received.
 - An exchange transaction is a reciprocal transfer of resources.
 - An exchange transaction is a nonreciprocal transfer of assets.
 - There are always restrictions attached to use of the assets received as a result of a contribution.

15. Revenue from an exchange transaction may be classified as an increase in which class of net assets?
- a) Unrestricted net assets.
 - b) Temporarily restricted net assets.
 - c) Permanently restricted net assets.
 - d) Any of the above.
16. During the annual fundraising drive, the Cancer Society raised \$900,000 in pledges of financial support for their general operations. By the fiscal year-end, the Society had collected \$600,000 of the pledges. The Society estimates that 10% of the remaining pledges will be uncollectible. The NET amount of revenue the Society should recognize during the current year from this pledge drive is
- a) \$900,000.
 - b) \$870,000.
 - c) \$810,000.
 - d) \$600,000.

Use the following information to answer Questions 17 through 20.

United Charities' annual fund raising drive in 2006 raised pledges of \$600,000 of which \$400,000 were collected in 2006 and \$100,000 were collected in 2007. United Charities estimates \$75,000 of the remaining pledges will never be collected.

17. The increase in unrestricted net assets in 2006 as a result of the fund raising drive is
- a) \$600,000.
 - b) \$525,000.
 - c) \$400,000.
 - d) \$125,000.
18. The increase in temporarily restricted net assets in 2006 as a result of the fundraising drive is
- a) \$600,000.
 - b) \$525,000.
 - c) \$400,000.
 - d) \$125,000.
19. In 2007, the change in temporarily restricted net assets is
- a) \$0
 - b) \$100,000 decrease.
 - c) \$100,000 increase.
 - d) \$500,000 decrease.
20. In 2007, the change in unrestricted net assets is
- a) \$0
 - b) \$100,000 increase.
 - c) \$100,000 decrease.
 - d) \$500,000 increase.

24. Grace Church, a not-for-profit entity, operates a school in connection with the Church. This year members of the Church decided to construct a new wing on the school with six classrooms. The Church hired an architect and a construction supervisor. The bulk of the labor for construction was donated by Church members who were willing workers but not necessarily skilled carpenters. Materials for the construction cost \$300,000 and the paid labor was \$100,000. The fair value of the completed building is \$1 million. When the building is completed what should be the balance in the asset account "Building" and the account "Contributed Revenue"?
- a) Building \$400,000; Contributed Revenue \$0.
 - b) Building \$400,000; Contributed Revenue \$600,000.
 - c) Building \$1 million; Contributed Revenue \$600,000.
 - d) Building \$1 million; Contributed Revenue \$0.
25. Mary's Extended Care Center, a not-for-profit entity, enjoys the services of a group of high school age people who each agree to work three afternoons a week for three hours each afternoon performing a variety of patient-related services such as writing letters for those who are unable to do so, delivering mail to the patient rooms, and pushing wheel-chair patients across the grounds. The services rendered by these young people enhance the quality of life for the residents. They could not be provided if they were not donated because there are not enough resources to do so. The past year the young people donated 5000 hours in total. The services would have cost \$6.00 per hour if they had been purchased but they were worth \$10 an hour to St. Mary's. What is the amount of contributed revenue that should be recognized by St. Mary's related to these services?
- a) \$50,000.
 - b) \$30,000
 - c) \$0.
 - d) Cannot determine.
26. Simplex Games, a not-for-profit entity organized to provide athletic competition opportunities for high school students, utilizes a number of volunteers in carrying out its mission. At the 2007 Games 50 volunteers provided a total of 1000 hours of service performing tasks such as picking up litter and delivering water to the athletes. A local CPA firm donates its services to prepare the annual tax return and other federal and state required paperwork which must be filed to maintain its status as a tax-exempt organization. During 2007 the CPA firm provided 50 hours of service. If purchased, the CPA services would have cost \$50 per hour and the game workers would have cost \$5 per hour. How much contributed service revenue should Simplex Games recognize in 2007?
- a) \$7,500.
 - b) \$5,000.
 - c) \$2,500.
 - d) \$0.
27. A not-for-profit Art Museum that has elected not to capitalize its art collection receives a donation of a rare piece of Tlinket Indian art. The donor paid \$8,000 for the piece several years ago. Today the piece has an estimated fair value of \$50,000. What entry should the Art Museum make upon receipt of this donation?
- a) Debit Collection Items \$50,000; Credit Donated Revenue \$50,000.
 - b) Debit Collection Items \$8,000; Credit Donated Revenue \$8,000.
 - c) Debit Collection Items \$50,000; Credit Unrestricted net assets \$50,000.
 - d) No entry required.

28. Greene County Historical museum, a not-for-profit entity that capitalizes its collection items, received a gift of several Civil War artifacts to be used for display and research. The donor found these items while cleaning out the closet of an old house. The fair value is hard to estimate but a dealer in these types of artifacts estimates their value at \$2,000. The entry to record this donation is
- Debit Collection Expense, \$2,000; Credit Contributions Revenue \$2,000.
 - Debit Collection Items \$2,000; Credit Contributions Revenue \$2,000.
 - No entry is required because the cost to the donor was \$0.
 - No entry required because the value of the items is estimated.
29. Native Art Museum, a not-for-profit entity that elects not to capitalize its collection items, purchased for \$10,000 a wonderful totem pole for display near the door of the Museum. As a result of this transaction, which of the following entries should be made?
- Debit Collection Items \$10,000; Credit Cash \$10,000.
 - Debit Collection Expense \$10,000; Credit Cash \$10,000.
 - Debit Unrestricted Net Assets \$10,000; Credit Cash \$10,000.
 - No entry is required.
30. The Nature Conservatory, a not-for-profit entity, engaged in a fundraising drive to raise money to buy land to provide a habitat for the endangered Sleepy Eagle. A donor pledged \$1 million to the project provided that the Nature Conservatory was able to raise an additional \$1.5 million from other sources. What entry should the Nature Conservatory make at the time of the \$1 million pledge?
- Debit Pledge Receivable \$1 million; Credit Unrestricted Revenue \$1 million.
 - Debit Pledges Receivable \$1 million; Credit Temporarily Restricted Revenue \$1 million.
 - Debit Pledges Receivable \$1 million; Credit Temporarily Restricted Net Assets \$1 million.
 - No entry is made at the time of the pledge.
31. When should a not-for-profit entity recognize pledge revenue that is contingent upon raising a matching amount?
- When the pledge is made.
 - When the cash is received.
 - When the matching funds have been raised.
 - When the project is completed.
32. A donor pledges \$100,000 to the Shakespeare Foundation to be used only to support the summer Shakespeare Theater—an event that has been held every summer for 38 years. This is an example of a
- Conditional Contribution.
 - Unconditional contribution.
 - Restricted contribution.
 - Unrestricted contribution.
33. United Charities accepted a contribution from a donor and agreed to transfer the assets to Aid for Friends, a not-for-profit that provides temporary shelter to the homeless. United Charities should debit cash or other assets and credit
- Unrestricted revenue.
 - Temporarily restricted revenue.
 - Liability to Aid for Friends.

d) United Charities should not make an entry.

34. Music Lovers Foundation, a not-for-profit governed by an independent board, was founded to support the Northern State University Choir until such time as the state legislature shall adequately fund the choir. When the Choir is adequately funded by appropriation the Foundation may direct resources to other music projects that it deems acceptable. When Music Lovers accepts a contribution from a donor it should debit cash and/or other assets and credit

- a) Unrestricted revenue.
- b) Temporarily restricted revenue.
- c) Liability.
- d) It should not make an entry.

35. The Save the Animals Foundation received a gift of \$500,000 from a donor who wanted the gift used to acquire habitat for endangered snails. The money may be invested but all earnings are restricted to habitat acquisition. During the year the entire gift was invested in corporate securities. At year-end, the securities had a value of \$501,000. The appropriate way to recognize the change in fair value is

- a) Debit Investment \$1,000; Credit Unrestricted Revenue \$1,000.
- b) Debit Investment \$1,000; Credit Temporarily Restricted Revenue \$1,000.
- c) Debit Investment \$1,000; Credit Permanently Restricted Revenue \$1,000.
- d) No entry should be made until the securities are sold.

36. During the year, a not-for-profit entity received \$15,000 in dividends and \$12,000 in interest on its investment portfolio. The entity also accrued \$3,000 in interest on the portfolio. The increase in fair value of the portfolio during the year was \$4,000. How much should the entity report for investment earnings during the year?

- a) \$31,000.
- b) \$27,000.
- c) \$4,000.
- d) \$0.

37. The Friends of the Library (FOL), a not-for-profit entity, received a gift restricted to acquisition of a special piece of the equipment used to restore books. Late last year FOL acquired the machine at a total cost of \$19,000. The machine is estimated to have a useful life of eight years and a salvage value of \$3,000. In what fund should FOL make the entry to record the depreciation for the current year?

- a) Unrestricted fund.
- b) Temporarily restricted fund.
- c) Permanently restricted fund.
- d) FOL should not recognize depreciation.

38. Which of the following entities should recognize depreciation expense on its operating statement?

- a) Not-for-profit university.
- b) Not-for-profit foundation.
- c) Not-for-profit hospital.
- d) All of the above.

39. A not-for-profit would include which of the following financial statements in its Basic Financial Statements?
- a) Statement of Financial Position and Statement of Activities.
 - b) Statement of Financial Position, Statement of Activities, and Cash Flow Statement.
 - c) Statement of Financial Position, Statement of Activities, Cash Flow Statement, and a Statement of Functional Expenses.
 - d) Statement of Financial Position, Statement of Activities, and a Statement of Functional Expenses.

PROBLEMS (CHAPTER 12)

1. United Charities, a not-for-profit entity, supports activities for lower-income families. They have regularly engaged in activities such as providing transportation for physically challenged individuals, providing shelters for the temporarily homeless, providing congregate meals for the homeless, and providing shelters for abused women and children. Record the following transactions. Your account titles should clearly indicate to which class of net assets the entry will be closed or the fund in which the entry is being made. If no entry is required, write "No entry required."

- a. United Charities engaged in a fund-raising campaign that resulted in pledges of \$600,000 to support activities of the current year. During the year, United collected \$500,000 on these pledges.
- b. A local citizen pledged \$50,000 to purchase and equip a van to provide transportation for physically challenged individuals. This citizen has donated regularly and there is no reason to believe that this pledge will not be collectible.
- c. In prior years, an advocacy group for abused women donated \$10,000 to be used to furnish a "safe-house" for abused women and children. During the current year renovation of the safe house was completed and furniture was acquired at a total cost of \$15,000.
- d. A wealthy benefactor pledged \$100,000 to United if United successfully raises a matching amount in a capital asset fund-raising drive being conducted over a 12-month period.
- e. \$60,000 cash is received from a donor who specifies that the money must be spent to provide educational activities for children who will be living in the "safe-house." It will be next year before the "safe-house" has its first residents.
- f. A local attorney has agreed to provide legal services to United on a pro bona basis. During the current period the attorney provided services for which she would have billed \$1,500.
- g. Several older housewives provide services at the United Charities congregate meal setting facility. These women work in the kitchen serving meals and cleaning up the kitchen. If these services were not donated they would have had to purchase them. The value of these services at the prevailing wage rate for similar employees would have amounted to \$50,000 for the current year.
- h. Fixed assets belonging to United Charities had an original cost of \$270,000, an estimated salvage value of \$70,000, and an estimated useful life of 20 years. Record depreciation if applicable.
- i. \$75,000 is received from a donor who specifies that \$25,000 is for use by United Charities and \$50,000 is to be used by Zimbabwe Charities, United's sister organization in Africa.

2. The Heritage Art Museum, a not-for-profit entity specializing in art items created by natives of the Pacific Northwest, has a December 31 fiscal year-end. The Museum has a policy of NOT capitalizing collection items. Your entry should clearly indicate to which class of net assets the account would be closed, or in which fund the entry is being made. If no entry is required, write “No entry required.”
- a) During the current year the Museum received admissions fees in cash \$500,000.
 - b) Citizens of the local community are encouraged to participate in a program called “Friends of the Museum.” For a yearly contribution of \$25 per family, a family is entitled to free admission to the Museum during the calendar year. A “Friend of the Museum” also receives a monthly one-page newsletter announcing upcoming events. At year-end, there were 1000 members in the “Friends of the Museum.”
 - c) During the current year the Museum incurred salary expense of \$1 million of which \$60,000 remains unpaid at year-end.
 - d) During the year the Museum incurred operating expenses of \$400,000 of which \$30,000 remains unpaid at year-end. Of the \$400,000, \$50,000 was used to buy supplies of which \$20,000 remains on hand at year-end.
 - e) Office equipment owned by the Museum has a historical cost of \$100,000, salvage value of \$20,000 and can be depreciated over 8 years on the straight-line basis.
 - f) During the year the Museum conducted a fund-raising drive to raise money to acquire new art items for the Museum. The Museum received pledges of \$200,000 of which the Museum had collected \$150,000 by year-end and expected to ultimately collect another \$20,000.
 - g) The Museum had a small portfolio of investments in equity securities.. At the beginning of the year the portfolio had a fair value of \$60,000. During the year the Museum collected \$3,000 in dividends on the securities. At year-end the portfolio had a market value of \$61,000.
 - h) During the year a citizen died and willed his wonderful collection of native art to the Museum. The appraised value of the collection was \$600,000.
 - i) To balance its collection, the Museum sold two of its collection items for \$250,000, which approximates fair value. These items had a historical cost to the Museum of \$10,000.
 - j) The proceeds of the sale were used to acquire two new items at a cost of \$310,000.

3. Save the Children Foundation has the following types of cash receipts and disbursements during its current fiscal year. Indicate in which categories each of these flows would be reported in the Foundation's statement of cash flows.
- a. Unrestricted contributions
 - b. Sales of handmade crafts
 - c. Contributions restricted to capital asset acquisition
 - d. Contributions to endowments
 - e. Investment earnings on endowments, not required to be added to the endowment
 - f. Salaries
 - g. Interest paid on short-term loan
 - h. Capital asset purchases
 - i. Investments sold
 - j. Short-term loan proceeds
 - k. Contributions made to other organizations
 - l. Capital lease payments.

4. In June 2006, the wealthy parents of a college sophomore pledge to donate \$3 million to the college she attends, making payments of \$1 million at the end of each of her remaining years at the school until her expected graduation in 2009. Assuming the college does not use separate funds to track restricted resources, prepare the entries required, if any, to recognize the pledge in 2006. The college applies a discount rate of 3%. Based on that rate, the present value of \$1 for three periods is \$2.82861. What entries, if any, would be required to record the receipt of the first \$1 million at the end of year 1?
5. In December 2006, Technology University received a \$2 million grant from the National Hockey Association to develop an effective neck brace to prevent injuries in its non-goalie hockey players. The NHA grant was intended to cover \$1.5 million of direct costs and \$0.5 million in overhead costs. The grant stipulated that the NHA would be the sole beneficiary of the research. Technology carried out the research in 2007. As estimated, direct costs were \$1.5 million.

REQUIRED:

- a. What accounting entries, if any, should Technology make when notified of the grant?
- b. What accounting entries, if any, should Technology make in 2007? (Be sure to indicate in which funds the entries would be recorded.)
- c. Would your answer be different if the research were made available to the general public, and not just the NHA? Explain.
- d. Would your answer be different if the NHA indicated it would not make any payments on the research until Technology delivers the final research product?

ESSAYS (CHAPTER 12)

1. For each of the cases below state whether the contributed services would be recognized, how much would be recognized, and how it would be recognized. Explain your answer in terms of the existing standard. Also explain why, in your opinion, the standard permits/prohibits recognition of this particular type of contribution.

- a. A church votes to construct a new educational wing on its existing facility. The church will hire an architect to design the new wing and a construction supervisor to oversee the construction. Church members will provide most of the labor for the construction. Labor donated by members who have construction experience or who are considered professional craftsmen at the prevailing wage for their trade or craft is \$500,000. Labor donated by persons possessing non-building specialized skills (doctors, teachers, lawyers, etc.) at their prevailing wage rates is \$700,000. Labor donated by non-professionals measured at the minimum wage is \$300,000. The appraised value of the building when completed is \$3 million. The architect was paid \$700,000, the construction supervisor was paid \$50,000 and the materials purchased for use in the building cost \$1 million.
- b. An investment advisor, a member of the Board of a not-for-profit entity, provides pro bona investment advice to the NFP. The NFP does not have a particularly large investment portfolio and without the advice of the Board member the NFP would probably invest its idle cash in certificates of deposits at an insured commercial bank to protect itself against loss of its principal. If the investment advisor had provided similar services to his customers he would have charged \$2,000.
- b. Members of a religious order provide professional nursing services for a healthcare facility that is run by their order. The members are not compensated but their order provides lodging, food, and other necessities. The cost of the lodging, food, etc., is paid by the healthcare entity and classified as Nursing Service Expense. At the end of the year the balance in the Nursing Service Expense account is \$3 million. The value of the nursing services provided, measured at the prevailing wage for nurses, is \$5 million.

2. A generous benefactor pledges \$1 million to The R. J. Smith Foundation, a not-for-profit entity that promotes the arts. The gift is to be used to provide scholarships for talented musicians at a music camp operated by the Foundation. The gift was given in August 2006 to support the Summer 2007 music program. The Foundation Director argues that the gift is a conditional restricted gift and therefore cannot be recognized as revenue in 2006. The accountant argues that the gift is an unconditional restricted gift and must be recognized in the current year. What is the basis for the Director's argument? What is the basis for the accountant's argument? In your answer provide an explanation of the terms conditional, unconditional, restricted and unrestricted.

3. Alpha Hospital is a recipient of Hill-Burton funds and must provide some hospital care for which it will not be compensated. During the current year, Alpha Hospital provided \$1 million in charity care. What is the current financial reporting requirement for charity care? Do you agree or disagree with the current financial reporting requirement? Why or why not? If you do not agree, how do you think charity care should be reported? If you agree with the current standards, what alternative reporting requirements do you believe would be proposed by those who do not agree with the current standards?

ANSWERS TO TRUE/FALSE (CHAPTER 12)

1. T
2. T
3. T
4. F
5. F
6. F
7. T

ANSWERS TO MULTIPLE CHOICE (CHAPTER 12)

1. D
2. C
3. A
4. B
5. A
6. C
7. B
8. A
9. B
10. A
11. D
12. B
13. B
14. B
15. A
16. B
17. C
18. D
19. B
20. B
21. B
22. A
23. B
24. C
25. C
26. C
27. D
28. B
29. B
30. D
31. C
32. C
33. C
34. A
35. B
36. A
37. A
38. D
39. B

ANSWERS TO PROBLEMS (CHAPTER 12)

Problem 1

There are two approaches to the entries. The textbook assumes that all assets received with restrictions are recorded in a restricted fund. FASB SFAS No. 117 illustrations show all assets in the unrestricted fund with the only identification of restrictions being the balance in restricted (temporarily or permanently) net assets. Solution #1A presents the textbook solutions. Solution #1B presents entries that would be used if the FASB illustration were used.

Solution #1A

a) TEMPORARILY RESTRICTED FUND

| | | |
|--------------------|-----------|-----------|
| Pledges Receivable | \$100,000 | |
| Revenue | | \$100,000 |

UNRESTRICTED FUND

| | | |
|---------|-----------|-----------|
| Cash | \$500,000 | |
| Revenue | | \$500,000 |

b) TEMPORARILY RESTRICTED FUND

| | | |
|--------------------------------|-----------|-----------|
| Pledge Receivable | \$ 50,000 | |
| Temporarily Restricted Revenue | | \$ 50,000 |

c) TEMPORARILY RESTRICTED FUND

| | | |
|-------------------------------------|-----------|-----------|
| Resources Released from Restriction | \$ 10,000 | |
| Cash | | \$ 10,000 |

UNRESTRICTED FUND

| | | |
|-------------------------------------|-----------|-----------|
| Fixed Assets | \$ 15,000 | |
| Resources released from Restriction | | \$ 10,000 |
| Cash | | \$ 5,000 |

d) No entry required.

e) TEMPORARILY RESTRICTED FUND

| | | |
|---------|-----------|-----------|
| Cash | \$ 60,000 | |
| Revenue | | \$ 60,000 |

f) UNRESTRICTED FUND

| | | |
|----------------|----------|----------|
| Legal Expenses | \$ 1,500 | |
| Revenue | | \$ 1,500 |

g) No entry required.

h) UNRESTRICTED FUND

| | | |
|--------------------------|-----------|-----------|
| Depreciation Expense | \$ 10,000 | |
| Accumulated Depreciation | | \$ 10,000 |

| | | |
|-----------------------------|-----------|-----------|
| i) UNRESTRICTED FUND | | |
| Cash | \$ 75,000 | |
| Revenue | | \$ 25,000 |
| Payable to Zimbabwe Charity | | \$ 50,000 |

Solution #1B (An Alternative)

| | | | |
|----|-----------------------------------|-----------|-----------|
| a. | Cash | \$500,000 | |
| | Pledge Receivable | \$100,000 | |
| | Unrestricted Revenue | | \$500,000 |
| | Temporarily Restricted Revenue | | \$100,000 |
| b. | Pledges Receivable | \$ 50,000 | |
| | Temporarily Restricted Revenue | | \$ 50,000 |
| c. | Fixed Assets | \$ 15,000 | |
| | Cash | | \$ 15,000 |
| | Temporarily Restricted Net Assets | \$ 10,000 | |
| | Unrestricted Net Assets | | \$ 10,000 |
| d. | No entry required. | | |
| e. | Cash | \$ 60,000 | |
| | Temporarily Restricted Revenue | | \$ 60,000 |
| f. | Legal Expenses | \$ 1,500 | |
| | Revenue | | \$ 1,500 |
| g. | No entry required. | | |
| h. | Depreciation Expense | \$ 10,000 | |
| | Accumulated Depreciation | | \$ 10,000 |
| i. | Cash | \$ 75,000 | |
| | Revenue | | \$ 25,000 |
| | Payable to Zimbabwe Charity | | \$ 50,000 |

Problem 2

There are two approaches to the entries. The textbook assumes that all assets received with restrictions are recorded in a restricted fund. FASB SFAS No. 117 illustrations show all assets in the unrestricted fund with the only identification of restrictions being the balance in restricted (temporarily or permanently) net assets. Solution #2A presents the textbook solutions. Solution #2B presents entries that would be used if the FASB illustration were used.

Solution #2A

| | | | |
|--|-------------|------------|--|
| a) UNRESTRICTED FUND | | | |
| Cash | \$ 500,000 | | |
| Revenue | | \$ 500,000 | |
| b) UNRESTRICTED FUND | | | |
| Cash | \$ 25,000 | | |
| Revenue | | \$ 25,000 | |
| c) UNRESTRICTED FUND | | | |
| Salary Expense | \$1,000,000 | | |
| Cash | | \$ 940,000 | |
| Wages Payable | | \$ 60,000 | |
| d) UNRESTRICTED FUND | | | |
| Operating Expenses | \$ 380,000 | | |
| Supplies | \$ 20,000 | | |
| Cash | | \$ 370,000 | |
| Accounts Payable | | \$ 30,000 | |
| e) UNRESTRICTED FUND | | | |
| Depreciation Expense | \$ 10,000 | | |
| Accumulated Depreciation | | \$ 10,000 | |
| f) TEMPORARILY RESTRICTED FUND | | | |
| Cash | \$ 150,000 | | |
| Pledges Receivable | \$ 50,000 | | |
| Allowance for Uncollectible Accounts | | \$ 30,000 | |
| Revenue | | \$ 170,000 | |
| g) UNRESTRICTED FUND | | | |
| Cash | \$ 3,000 | | |
| Investment | \$ 1,000 | | |
| Investment Revenue | | \$ 4,000 | |
| h) No entry required. Note disclosure is required. | | | |
| i) UNRESTRICTED FUND | | | |
| Cash | \$ 250,000 | | |
| Revenue | | \$ 250,000 | |

| | | |
|----------------------------|------------|------------|
| j) UNRESTRICTED FUND | | |
| Acquisition Expense | \$ 310,000 | |
| Cash | | \$ 310,000 |
| (Note disclosure required) | | |

Solution #2B

| | | |
|--|-------------|------------|
| a) Cash | \$ 500,000 | |
| Unrestricted Revenue | | \$500,000 |
| b) Cash | \$ 25,000 | |
| Unrestricted Revenue | | \$ 25,000 |
| c) Salary Expense | \$1,000,000 | |
| Cash | | \$ 940,000 |
| Wages Payable | | \$ 60,000 |
| d) Operating Expenses | \$ 380,000 | |
| Supplies | \$ 20,000 | |
| Cash | | \$ 370,000 |
| Accounts Payable | | \$ 30,000 |
| e) Depreciation Expense | \$ 10,000 | |
| Accumulated Depreciation | | \$ 10,000 |
| f) Cash | \$ 150,000 | |
| Pledges Receivable | \$ 50,000 | |
| Allowance for Uncollectible Accounts | | \$ 30,000 |
| Temporarily Restricted Revenue | | \$ 170,000 |
| g) Cash | \$ 3,000 | |
| Investment | \$ 1,000 | |
| Investment Revenue | | \$ 4,000 |
| h) No entry required. Note disclosure is required. | | |
| i) Cash | \$ 250,000 | |
| Unrestricted Revenue | | \$ 250,000 |
| j) Acquisition Expense | \$ 310,000 | |
| Cash | | \$ 310,000 |
| (Note disclosure is required) | | |

Problem 3

Cash flows from operating activities

- a. Unrestricted contributions
- b. Sales of handmade crafts
- e. Investment earnings on endowments
- f. Salaries
- g. Interest paid on short-term loan
- k. Contributions made to other organizations

Cash flows from investing activities

- h. Capital asset purchases
- i. Investments sold

Cash flows from financing activities

- c. Contributions restricted to capital asset acquisition
- d. Contributions to endowments
- j. Short-term loan proceeds
- l. Capital lease payments

Problem 4

| | | |
|-----------------------------------|-------------|-------------|
| In June 2006: | | |
| Pledges receivable | \$2,828,610 | |
| Temporarily restricted revenue | | \$2,828,610 |
| In June 2007: | | |
| Cash | \$1,000,000 | |
| Pledges receivable | | \$ 915,142 |
| Interest revenue | | \$ 84,858 |
| Temporarily restricted net assets | \$ 915,142 | |
| Unrestricted net assets | | \$ 915,142 |

Problem 5

- a. This grant has the characteristics of an exchange transaction rather than a contribution. No entry would be required when the grant is received (the contract signed). In essence, the grant is a contract. At the time the grant is received, Technology has not yet performed its promised research services; the NHA has not yet made any payments.
- b. The grant is a contract that, by definition, is not *donor* restricted. All entries would be recorded in the unrestricted fund.

2007

| | | |
|---|---------------|---------------|
| Research expenses (direct) | \$1.5 million | |
| Cash (or accounts payable) | | \$1.5 million |
| <i>To record research expenses</i> | | |
| Grants and contracts receivable | \$2 million | |
| Revenue from sponsored research | | \$2 million |
| <i>To recognize revenue from the sponsored research</i> | | |

- c. If the research were to be made available to the general public rather than just to the NHA, the grant would be a nonexchange transaction rather than an exchange transaction. Restricted grant revenue would be recognized when the pledge was received.
- d. FASB Statement No. 116 stipulates that revenue from conditional contributions should not be recognized until the conditions are satisfied. Therefore, Technology would not recognize revenue from NHA's contribution until it had completed the research.

ESSAY ANSWERS (CHAPTER 12)

1. [Note: Asking for the students' explanations of WHY the FASB prohibited/permitted recognition of specific types of contributed services is designed to elicit thought by the student. There are no technically correct answers to WHY the FASB prohibited/permitted recognition of these specific types of contributed services.]

- a. The value of all of the contributed services can be recognized because the services are used to create or enhance a non-financial asset. The value that would be assigned to contributed services would be the difference between the appraised value of the building (\$3 million) and directly attributable costs (\$1 million for materials, \$700,000 for the architect and \$50,000 for the construction supervisor). In this case the entry would be

| | | |
|---------------------|-------------|-------------|
| Building | \$1,250,000 | |
| Contributed Revenue | | \$1,250,000 |

FASB probably permitted the recognition of contributed services that create or enhance a non-financial asset because not to do so would understate the value of the tangible asset on the financial statements. An alternative would have been to allow the asset to be valued at appraised value and record the \$1,250,000 as a direct addition to equity. If this approach were taken, however, not all changes in net assets would be reported in the statement of activities.

- b. The value of the contributed services cannot be recognized because the services, although provided by a person possessing specialized skills, would not have been purchased if not provided by donation. FASB probably prohibited recognition of this type because recognition would overstate the costs incurred in delivering the goods or services when the organization would not have otherwise have purchased these services.
- c. The value of the contributed services should be recognized because the services require specialized skill, are provided by someone with that skill, and would have to be purchased if not provided. The amount that should be recognized is \$2 (the difference between the market value of the services and the disbursements on behalf of the members of the order).

| | | |
|-----------------------------|-------------|-------------|
| Nursing Service Expense | \$2 million | |
| Contributed Service Revenue | | \$2 million |

FASB probably permitted the recognition of contributed services that would otherwise be purchased because to do otherwise would understate the cost of providing the goods or services for which the entity was organized. [Note: Why FASB limited it to professionals is less obvious. Students will probably have different ideas about why it is limited to professionals.]

2. All gifts, whether in tangible assets or in promises to give assets in the future, may be classified as conditional or unconditional and as restricted or unrestricted. Conditional promises or pledges are promises to give if, and only if, a specified future and uncertain event occurs. All other promises or pledges to give are considered unconditional. A conditional gift carries with it an uncertainty about its ultimate receipt. A restricted gift is a gift that must be used for a purpose that is more limited than the general nature of the operations of an entity. All other gifts are unrestricted. For example, in this case a gift to support the fine arts would be considered unrestricted because the nature of the entity is to support the fine arts. A gift to a comprehensive university to support fine arts would probably be restricted because the nature and purpose of the entity encompasses more than the fine arts.

In this case, the Director considers the gift conditional because holding the summer music camp is a future and uncertain event. The accountant must feel that there is little uncertainty about holding the summer music camp. Both agree the gift is restricted because its purpose is more limited than the purpose of the entity.

3. Current financial reporting standards specify that gross revenue should exclude the value of services performed for charity care. The standards require disclosure of the policies for providing charity care and the amounts provided based on the organization's rates, costs, or other measures.

[Note: Whether or not students agree with the standard will differ. The arguments against including the value of charity care are generally based on the fact that the amounts will never be recovered and were never intended to be recovered. The arguments for including charity care in gross revenues are generally based on the notion that omission of the amounts understates the value of services performed. There are costs incurred related to performing charity care and omission of the related revenues causes the ratios of costs to revenues to be misleading.

The best alternative, of course, is to treat charity care in the same manner as bad debts. Include within gross revenue the value of the charity care performed and include within the expenses an amount equal to the value of charity care performed. Many students will believe that this is a fairer presentation.]

Chapter 13

Health Care Providers and Colleges and Universities

TRUE/FALSE (CHAPTER 13)

1. The statement of financial position of a not-for-profit health care organization should distinguish among unrestricted, temporarily restricted, and permanently restricted net assets.
2. Unlike businesses, not-for-profit health care providers often serve patients who they know will be unable to pay any portion of the amounts billed.
3. Private not-for-profit colleges and universities are subject to the same FASB standards as other not-for-profit entities.

4. Restricted funds of a not-for-profit nursing home are not available for current use; however, the income earned on the funds is available.
5. Charity care provided by a health care organization would be recorded in a contra-revenue account.
6. In a not-for-profit health care organization, the cost of malpractice must be accrued if it is either probable that impairment has occurred or if the amount of loss can be reasonably estimated.
7. In a public university setting, general administration and sponsored research are examples of revenues classified by source.
8. Long lived assets held by public universities are carried at cost, or fair value if donated.
9. Investments of a public college must be reported at fair value.
10. Prepaid health care plans that earn revenue from agreements to provide service record revenue when services are rendered.
11. Tuition revenue should be reported net of tuition discounts and scholarships.
12. In accounting for colleges and universities, related entities should either be disclosed in the Notes to the Financial Statements or reported as component entities, depending on the degree of control and economic interest.
13. Under GASB 39, colleges and universities are required to bring their affiliated medical organizations into their financial reports.

MULTIPLE CHOICE (CHAPTER 13)

1. Financial statements for Smith College, a church-supported college, should be prepared according to standards set by
 - a) AICPA.
 - b) FASB.
 - c) GASB.
 - d) Smith may choose any of the above.

2. For a not-for-profit hospital, which of the following financial statements is NOT required?
 - a) Statement of financial position.
 - b) Statement of activities.
 - c) Statement of cash flows.
 - d) Statement of functional expenses.

2. For a not-for-profit college or university, which of the following categories of net assets is NOT appropriate in its external financial statements?
 - a) Unrestricted net assets.
 - b) Temporarily restricted net assets.
 - c) Permanently restricted net assets.
 - d) None. All of the above are appropriate.

3. Katerah College, a private college, received a \$1 million donation. The donor specified that the principal of her gift could never be used for program activities but the earnings on the principal must be used to provide scholarships to academically qualified students in the business school. The \$1 million gift would increase which of the following categories of net assets?
 - a) Unrestricted net assets.
 - b) Temporarily restricted net assets.
 - c) Permanently restricted net assets.
 - d) Either (b) and (c).

4. Intermountain Hospital, a not-for-profit health care provider, issued \$70 million in term bonds to finance construction of a new wing at its main hospital. Terms of the bond issue require that \$5 million of the proceeds of the bond issue be invested in U.S. government securities. The \$5 million must be held until maturity of the bonds. The \$5 million will increase which class of net assets?
 - a) Unrestricted net assets.
 - b) Temporarily restricted net assets.
 - c) Permanently restricted net assets.
 - d) Either (b) or (c).

5. During the current year, Kayla University received a \$50,000 gift from an alumna who specified that it must be used to pay travel costs for faculty to attend health care conferences in foreign countries. During the year the university spent \$8,000 to support travel to a health care conference in Italy. The \$8,000 disbursement will cause a NET decrease in which class of net assets?
- a) Unrestricted net assets.
 - b) Temporarily restricted net assets.
 - c) Permanently restricted net assets.
 - d) Cannot be determined.
6. In 2006 St. Joe's Hospital received a \$50,000 cash gift to be used to buy supplies and other items for the pediatric department of the hospital. In 2007, St. Joe's purchased puppets and other items to be used in explaining medical procedures to young children. The acquisition of the items causes a NET decrease in which class(es) of net assets?
- a) Unrestricted net assets only.
 - b) Temporarily restricted net assets.
 - c) Both unrestricted and temporarily net assets.
 - d) Neither unrestricted nor temporarily restricted net assets.
8. Voluntary health and welfare organizations must also report expenses by
- a) Object.
 - b) Function
 - c) Natural classification.
 - d) Budget code.

Use the following information to answer Questions 9 and 10.

Kale Hospital, a not-for-profit entity, received a pledge from a donor in support of a fund raising effort by the Hospital to finance construction of a new facility for cancer treatment. The donor promised to pay \$1 million in equal annual installments of \$100,000 over the next 10 years. The present value of the gift at the risk-free interest rate is \$736,000.

9. The amount of unrestricted revenue that should be recognized by Kale in the year of the gift is
- a) \$1 million.
 - b) \$736,000.
 - c) \$100,000.
 - d) \$0.
10. The amount of restricted revenue that should be recognized by Kale in the year of the gift is
- a) \$1 million.
 - b) \$736,000.
 - c) \$100,000.
 - d) \$0.

Use the following information for Questions 11 and 12.

Lane College Foundation is governed by a board, some members of which are appointed by the President of Lane College and some of which are elected by the alumni. It was created to solicit and accept donations on behalf of Lane College, a private not-for-profit college. Lane College

and its Foundation are deemed to be financially interrelated. All funds collected by the Foundation must be used to support activities of Lane College. The Foundation Board can select which activities of Lane College it supports. Lane Foundation received a \$1 million bequest from the estate of a 1940 graduate.

11. At the time the Foundation receives the donation, the Foundation should debit Cash for \$1 million and credit what account for \$1 million?
 - b) Unrestricted revenue.
 - c) Temporarily restricted revenue.
 - d) Liability.
 - e) No entry should be made by the Foundation.

12. At the time the Foundation receives the donation, Lane College should debit Asset \$1 million and Credit what account for \$1 million?
 - a) Unrestricted revenue.
 - b) Temporarily restricted revenue.
 - c) Liability.
 - d) No entry should be made by Lane College.

13. Sheridan Public School Foundation had available temporarily restricted gifts in excess of \$200,000. The Foundation decided to invest this money temporarily until it needs the funds for the restricted purpose. The donors had made no specific stipulations regarding investment earnings but the Foundation board had voted to use the earnings on the projects for which the gift had originally been restricted. At year-end, the securities had a fair value of \$200,500. The appropriate way to recognize the change in fair value is
 - a) Debit Investment \$500; Credit Unrestricted Revenue \$500.
 - b) Debit Investment \$500; Credit Temporarily Restricted Revenue \$500.
 - c) Debit Investment \$500; Credit Permanently Restricted Revenue \$500.
 - d) No entry should be made until the securities are sold.

14. An accountant has encountered a perplexing financial reporting issue related to the hospital for which she is preparing financial statements. The issue is not specifically addressed by FASB statements. To which of the following sources would the accountant probably look first for industry-specific guidance?
 - a) GASB Statements.
 - b) AICPA accounting and auditing guide, *Not-for-Profit Organizations*.
 - c) AICPA accounting and auditing guide, *Health Care Organizations*.
 - d) Pronouncements of the HFMA or AHA.

15. In prior years, a not-for-profit hospital received funds from a donor who restricted the use of those funds to providing nursing scholarships. During the current year \$8,000 of scholarships were awarded. These scholarships should be reported
- As expenses in the unrestricted fund.
 - As reductions in the revenue section in the unrestricted fund.
 - As expenses in the temporarily restricted fund.
 - As expenses in the permanently restricted fund.
16. During the current year, St. Mary's Hospital (a not-for-profit entity) earned, based on its normal billing rate, \$1 million in patient service revenues. Many of these patients belong to a health plan that has an established pay schedule. Based on the specific services rendered to members of the plan, the hospital estimates that \$.05 million will not be collectible from the plan or the patient. Some of the patients are Hospital employees. These employees are given a 50% discount on the services rendered. Employee discounts for the current year total \$.01 million. Some of the patients are uninsured and the hospital estimates that, of the amount billed to the uninsured patients, \$.2 million will not be collectible (bad debts). The amount of net patient service revenues for St. Mary's Hospital for the current year is
- \$1 million.
 - \$.94 million.
 - \$.87 million.
 - \$.74 million.
17. A consortium of physicians agrees to provide services to the employees of a large County government. The agreement calls for monthly payments from the County to the consortium in the amount of \$100,000 per month. County employees are not billed for services rendered by the consortium. All County employees are required to use the consortium under their health care program (any services rendered to County employees by other physicians are not covered under the health plan). During the month the consortium performed services for County employees for which it would have billed \$85,000. The consortium referred patients to other health care providers for services they could not perform. The consortium estimates that patients will be billed \$5,000 for those services. The amount of revenue that should be recognized for the month by the consortium is
- \$100,000.
 - \$95,000.
 - \$85,000.
 - \$80,000.
18. A hospital estimates that, based on past experience, it will incur \$5 million in malpractice claims as a result of services rendered in the current period. The hospital carries a malpractice insurance policy with a yearly \$2 million deductible clause. The amount that should appear on its year-end financial statement as Claims Expense (Loss) should be
- \$0.
 - \$2 million.
 - \$3 million.
 - \$5 million.
19. A hospital carried a 2-year malpractice insurance policy that allows for retroactive premium adjustments based on experience (claims actually incurred). The basic premium is \$150,000, payable in advance. At the end of the first year the hospital estimates that it will have to pay an additional \$40,000 in premiums as a result of claims filed in the current year and it estimates that it will incur additional premiums in the second year of \$50,000 as a

result of claims filed in the second year. The amount of insurance expense that should appear on the financial statements at the end of the first year should be

- a) \$75,000.
- b) \$115,000.
- c) \$150,000.
- d) \$240,000.

20. An accountant has encountered a perplexing financial reporting issue related to the private college for which he is preparing financial statements. The issue is not specifically addressed by FASB Statements. To what standards would the accountant first look for guidance?

- a) GASB Statements.
- b) AICPA accounting and auditing guide, *Not-for-Profit Organizations*.
- c) AICPA accounting and auditing guide, *Audits of Colleges and Universities* and/or AICPA SOP 74-8, *Financial Accounting and Financial Reporting by Colleges and Universities*.
- d) College textbooks.

21. Sponsors of not-for-profit health care organizations generally include:

- a) Universities
- b) Community Organizations
- c) Religious Organizations
- d) Any of the above

22. Current operating expenses of a public college may be classified by which of the following?

- a) Object classes
- b) Organizational Units
- c) Program functions
- d) All of the above
- e) Only B & C

23. A specialized health care facility normally purchases their medicine. However, this month a wealthy philanthropist donates the medicine. This medicine should be recorded at fair market value and should be credited directly to:

- a) Deferred Revenue
- b) Unrestricted Net Assets
- c) Non-operating Gains
- d) Other Revenues

24. The Gulf Coast bank is holding \$750,000 donation in an independent permanent trust with the investment income dedicated for use by the Coastal hospital for operating purposes. The \$750,000 principal should be:

- a) Disclosed in notes to the financial statements of the hospital
- b) Reported as a permanently restricted net asset of the hospital
- c) Reported as non-operating revenue of the hospital
- d) Reported as an asset limited as to use by the hospital

25. Which of the following would normally be considered ongoing or central transactions for a not-for-profit hospital?

- a) Recovery room fees for surgical patients
- b) Room and board fees from patients
- c) Both of the above
- d) Neither of the above

26. The community hospital of Briarwood normally includes proceeds from sales of meals in their cafeteria as

- a) Ancillary service revenues
- b) Other revenues
- c) Deductions from dietary meal service expenses
- d) Patient service revenues

27. In accounting for health care organizations, restricted net assets are:

- a) Not available for current operating use; however, the income generated is available for current operating use.
- b) Not available unless the directors remove the restrictions.
- c) Restricted as to use only for board-designated purposes.
- d) Restricted as to use by the donor, grantor, or other source of the resources.

28. In the process of general purpose external financial reporting, a health care organization is required to present

- a) A separate statement of changes in equity, net assets, or fund balance
- b) A statement of operations
- c) A performance indicator only by for-profit entities
- d) Fund group information by a not-for-profit organization

29. Hospital revenue usually includes which of the following?

| | <u>Revenue from Educational Programs</u> | <u>Unrestricted Gifts</u> |
|----|--|---------------------------|
| a) | Yes | Yes |
| b) | No | No |
| c) | Yes | No |
| d) | No | Yes |

30. The current rates of General Hospital provide that revenues should have been \$5 million for the current year; however, only \$3.8 million was actually collected due to allowances for charity care of \$700,000 and discounts of \$500,000 to third-party payors. What amount should General Hospital report as net health care services revenues in the statement of operations for the current year?

- a) \$5 million
- b) \$4.5 million
- c) \$4.3 million
- d) \$3.8 million

31. Which of the following criteria must be met for a public university to report affiliated organizations as component units?

- I. The university is entitled to access those resources
- II. The economic resources are significant to the component
- III. The economic resources received or held are almost entirely for the direct benefit of the university

- a) I only
- b) I & II only
- c) III only
- d) II only
- e) I, II, & III

32. Although it no longer applies to external financial reporting, AICPA 1973 Audit and Accounting Guide for Colleges and Universities provides which of the following in the fund structure

- a) Plant funds
- b) Loan funds
- c) Annuity funds
- d) All of the above

PROBLEMS (CHAPTER 13)

1. St. Anthony's hospital is a private not-for-profit entity that provides health care services to the citizens in the small rural community in which it is located. The most recent construction at the Hospital was financed using Hill-Burton funds. During the current month, St. Anthony's engaged in the following transactions. Using the following information, make the appropriate entries for St. Anthony's for the current month.
 - a. The Hospital would have billed \$1.2 million for services rendered to its patients. The \$1.2 million is based on the hospital's established billing rate. Of this amount \$800,000 will be billed to Delta Medical Group, a third-party payor that insures many state employees, \$150,000 will be billed to uninsured patients, \$200,000 is provided to indigents and will be considered charity care, and \$50,000 was for services rendered to Hospital employees.
 - b. Delta Medical Group pays for services rendered to its insurees on a rate schedule based on types of procedures rendered. For the services rendered during the current month to Delta insurees, Delta will reimburse the Hospital \$780,000. Part of the agreement between St. Anthony's and Delta is that Delta insurees will not be billed for the difference between the amount Delta pays and the amount the Hospital bills.
 - c. Based on prior experience with uninsured patients, the Hospital estimates that \$60,000 of the \$150,000 will be uncollectible.
 - d. The Hospital provides a 50% discount for services rendered to its employees.
 - e. The Hospital recognizes the value of charity services rendered.
 - f. The Hospital is the defendant in a malpractice suit. Attorneys for the Hospital are reasonably sure the Hospital will be found liable and that the best estimate of the amount of the loss is \$1,500,000. The Hospital carries medical malpractice insurance with a \$500,000 deductible clause.
 - g. The Hospital has numerous capital assets on its books. Straight-line depreciation on the assets is \$150,000 for the current period.

2. Richards College is a not-for-profit college. Record the following transactions for Richards College. The College has a June 30, 2007 fiscal year.
- a. Tuition revenue for the Fall semester 2006(August - December) was \$4 million; tuition for the Spring semester 2007 (January - May) was \$3.8 million; tuition for the Summer semester 2007 (June 1-August 15) was \$1 million. All tuition was received in cash.
 - b. Faculty salaries for the Fall semester were \$3 million; for the Spring semester, \$2.9 million; for the Summer semester were \$.5 million. All salaries are paid at the end of the month earned. Salaries earned in summer are June \$0.2 million, July \$0.2 and August \$0.1 million.
 - c. During June, \$3.2 million of tuition applicable to the Fall 2007 was received in cash.
 - d. During the year a wealthy benefactor pledged \$1 million to the University for the fund-raising campaign to renovate the oldest building on the campus. The benefactor will deliver the cash when renovation is substantially complete.
 - e. Fixed assets of the University have a historical cost of \$120 million, estimated salvage value of \$20 million and an estimated useful life of 50 years.
 - f. During the year the University's College of Business received notice of a \$100,000 grant from the federal government to conduct a research project on the effect of different budgeting techniques on the performance of government employees. During the year the University spent \$8,000 on printing questionnaires and \$12,000 on faculty salaries for activities directly related to the grant. By year-end the University had not received any cash from the federal government.
3. In January 2006, the Free Cancer Foundation accepted an endowment of \$500,000, the income from which is restricted to promoting research related to recovery from cancer. All gains, whether realized or unrealized are available for distribution. During 2006 the market value of endowment's investment portfolio increased to \$520,000. Accordingly, at year-end \$20,000 was credited to a temporarily restricted expendable fund. During 2007 the market value of the portfolio decreased to \$470,000 and the foundation spent \$12,000 on qualifying projects.

Owing to these events and transactions, what should be the reported net asset balance of the following categories during 2007 (assuming a zero beginning balance in unrestricted net assets):

1. Permanently restricted
2. Temporarily restricted
3. Unrestricted

ESSAYS (CHAPTER 13)

1. Austin Community College, a government institution, issues stand-alone financial statements. Although the college maintains its accounts on a fund basis, it does not include a combined fund balance sheet or statement of revenues and expenditures in its financial statements. Can such practice be consistent with generally accepted accounting principles? Explain, citing specific GASB provisions or pronouncements.
2. How do the three major financial statements of a government hospital differ from a private not-for-profit hospital?
3. What are the key reporting hospitals available to government (public) colleges and universities?
4. How do the three major financial statements of a government (public) college/university differ from a (private) not-for-profit college/university?

ANSWERS TO TRUE/FALSE (CHAPTER 13)

1. T
2. T
3. T
4. F
5. F
6. F
7. F
8. T
9. T
10. F
11. T
12. T
13. T

ANSWERS TO MULTIPLE CHOICE (CHAPTER 13)

1. B
2. D
3. D
4. C
5. A
6. A
7. B
8. C
9. D
10. B
11. A
12. B
13. A
14. C
15. A
16. B
17. A
18. C
19. B
20. C
21. D
22. D
23. D
24. A
25. C
26. B
27. D
28. B
29. C
30. D
31. E
32. D

ANSWERS TO PROBLEMS (CHAPTER 13)

Problem 1

- | | | | |
|----|---|----------------------|-------------|
| a. | Accounts Receivable | \$1,000,000 | |
| | Patient Service Revenue | | \$1,000,000 |
| b. | Patient Service Revenue—Contractual Adjustments | \$ 20,000 | |
| | Accounts Receivable-Allowance for Contractual Adjustments | | \$ 20,000 |
| c. | Bad Debt Expense | \$ 60,000 | |
| | Allowance for Bad Debts | | \$ 60,000 |
| d. | Patient Service Revenue—Discounts | \$ 25,000 | |
| | Accounts Receivable-Allowance for Employee Discounts | | \$ 25,000 |
| e. | No entry required. Note disclosure is required. The appropriate note disclosure explains the charity policies and reports the total value of the care provided. | | |
| f. | Claims Expense | \$ 500,000 | |
| | Claims Liability | | \$ 500,000 |
| g. | | Depreciation Expense | |
| | | \$ 150,000 | |
| | Accumulated Depreciation | | \$ |
| | 150,000 | | |

Problem 2

| | | | |
|----|--|---------------|---------------|
| a) | Cash | \$8.8 million | |
| | Revenue | | \$7.8 million |
| | Deferred Revenue | | \$1.0 million |
| b) | Salary Expense | \$5.9 million | |
| | Prepaid Salary | \$.2 million | |
| | Cash | | \$6.1 million |
| c) | Cash | \$3.2 million | |
| | Deferred Revenue | | \$3.2 million |
| d) | A pledge may be recorded when pledged or when received, depending on the circumstances. This appears to be a conditional pledge and should not be recorded until the specified conditions are met. | | |
| e) | Depreciation Expense | \$ 200,000 | |
| | Accumulated Depreciation | | \$ 200,000 |
| f) | Printing expense | \$ 8,000 | |
| | Salary expense | \$ 12,000 | |
| | Cash | | \$ 20,000 |
| | Due from federal government | \$100,000 | |
| | Temporarily restricted revenue | | \$ 80,000 |
| | Revenue | | \$ 20,000 |

Problem 3

1. Permanently restricted
\$500,000
2. Temporarily restricted
\$0
3. Unrestricted
 $\$20,000 - \$12,000 - \$50,000 = (\$42,000)$

ESSAY ANSWERS (CHAPTER 13)

1. Yes. The college can report as a special purpose entity engaged only in business-type activities. Hence, it need not present fund statements.
2. Although both government and not-for-profit health care organizations are accounted for similarly, there are also significant differences. Not-for-profit hospitals have to follow the provisions of FASB Statement No. 117 as to the form and content of their financial statements. Hence the balance sheet of a not-for-profit hospital, but not that of a government hospital, must display the three categories of donor restrictiveness. Similarly, the statement of changes in net asset must indicate the amount of resources released from restriction and the statement of cash flow must be divided into three categories of receipts and disbursements (operations, financing and investing) rather than the four required of governments (operations, capital financing, noncapital financing and investing).
3. Government universities may elect to report as special purpose entities engaging (1) only in business-type activities, (2) only in governmental activities, or (3) in both. If they elect to report as a government engaging in both business-type and governmental activities, they will have to present the full range of fund and government-wide statements. If they elect to report as a special purpose government engaging only in governmental activities they need also present both fund and government-wide statements, but can combine the two. If they elect to report as a government engaging only in business-type activities — as most government colleges and universities do — then they need present only a statement of net assets, statement of revenues and expenses, and a statement of cash flow. These would have to be on a full-accrual basis.
4. The answer to this question is basically the same as that to question No.2. That is, the statements of a not-for-profit university must adhere to the FASB not-for-profit accounting provisions. Accordingly the statement of net assets and the statement of changes in net assets must report on the three categories of donor-restricted resources and the statement of cash flow must be presented in three, rather than four, categories.

Chapter 14 Managing for Results

TRUE/FALSE (CHAPTER 14)

1. Zero-based budgeting requires the periodic review of all programs, not just new ones.
2. It is difficult for accountants to have a role beyond auditing the financial statements of governments and not-for-profits.
3. “Outputs” is a term used to indicate the quantity or units of service provided by an activity.

4. One of the principal disadvantages of zero-based budgeting is that it requires budgetary units to provide information that may never be used in the decision process.
5. Many of the benefits of program budgeting may be ascribed to the organizational self-examination that it requires at the outset.
6. Most accounting organizations support the notion that performance measures should be included in general-purpose annual financial reports.
7. The stated objective of the National Partnership for Reinventing Government is to “reinvent government to work better, cost less, and to get Americans to care about it.”
8. GASB SEA reporting proposals focus on measures of efforts, measures of accomplishments, and measures that relate efforts to accomplishments.
9. Rather than cash *inflows*, the potential benefits of many capital assets can be expressed as cash *savings* to governments and not-for-profits.
10. It is widely accepted that capital assets should be financed with resources on hand to achieve interperiod equity.

MULTIPLE CHOICE (CHAPTER 14)

1. In which of the following steps of the management cycle of governmental and not-for-profit entities are accountants least involved?
 - a) Performing cost benefit analysis on proposed programs.
 - b) Selecting among alternative programs.
 - c) Preparing financial reports.
 - d) Evaluating efficiency and effectiveness of programs.

2. Accountants are actively involved in collecting and analyzing data to be used by public policy makers. Which of the following other groups might also be involved in the data collection and analysis process?
 - a) Statisticians.
 - b) Economists.
 - c) Program managers.
 - d) All of the above.

3. Which of the following groups is least likely to be involved in evaluating the efficiency and effectiveness of government programs?
 - a) Accountants.
 - b) Legislators.
 - c) Economists.
 - d) Statisticians.

4. Which of the following is a true statement regarding the implementation phase of a government program?
 - a) Internal accountants are not involved; only program managers are involved.
 - b) Internal accountants are actively involved, preparing budgets, controlling costs, and preparing operating reports.
 - c) Internal accountants have only a minor role, preparing reports for external parties.
 - d) Internal accountants have final say in program choices.

5. Which of the following is NOT the role of policy makers in solving social problems?
 - a) Selecting among options
 - b) Developing alternatives.
 - c) Appropriating resources required to implement programs
 - d) Establishing expected goals.

6. All governments and not-for-profit entities should establish goals and objectives. Which of the following is a desirable characteristic of an operational objective?
 - a) An operational objective should be open to interpretation.
 - b) An operational objective should be measurable.
 - c) An operational objective should be a statement of aspirations.
 - d) An operational objective should be accomplishable by an unspecified future date.

7. An accounting program has determined that preparing students for careers in public accounting is the program's goal. Which of the following measurements is the best outcomes measurement for this accounting program?
- Number of accounting majors that graduate.
 - Number of students that pass the CPA examination.
 - Number of students in management positions in public accounting firms ten years after graduation.
 - Number of students employed in public accounting within one year of graduation.
8. Which of the following groups are involved in auditing a program?
- Accountants.
 - Statisticians.
 - Economists.
 - All of the above.

Use the following information to answer Questions 9 and 10.

A piece of federal legislation has as one of its objectives “improving the health of older Americans.” Title 20 of that legislation provides for granting federal funds to governmental or not-for-profit entities to provide nutritious hot meals to older Americans in congregate settings. Senior Citizens Center, a not-for-profit entity, receives funding under this legislation. The Center determines for one-month period, the following:

| | |
|--|--------|
| Number of meals served | 400 |
| Total number of individuals participating in the program | 25 |
| Total meals costs incurred | \$860 |
| Average cost per meal | \$4.15 |

9. The numerical value that best represents outputs of this program is
- 400
 - \$4.15
 - \$860
 - None of the above.
10. The numerical value that best represents outcomes is
- 400
 - \$4.15
 - \$860
 - None of the above.
11. College professors are evaluated on teaching, research, and service. Which of the following would be a surrogate for the desired operational objective of "engaged in research that expands the horizons of knowledge."
- Value of research grants received.
 - Number of publications in peer-reviewed journals.
 - Both of the above.
 - Neither of the above.

12. At many colleges and universities, students are asked to evaluate the quality of instruction received and course content for all undergraduate courses. The evaluations are used for which of the following?
- a) As an outcome measure.
 - b) As an output measure.
 - c) As a surrogate for an outcome measure.
 - d) As a surrogate for an output measure.
13. Because of the difficulty of measuring quality teaching, many colleges and universities rely heavily on student evaluations of the quality of instruction and accomplishment of course objectives. Which of the following is (are) a true statement(s)?
- a) This is a good practice, which may improve the quality of instruction.
 - b) This is a good idea but may have unintended negative consequences by causing faculty to decrease the rigor of a course.
 - c) Both are true.
 - d) Neither is true.
14. Aid for Friends, a not-for-profit entity, provides temporary shelter for the homeless, provides temporary housing and other assistance for victims of spousal abuse, serves meals to the needy in a congregate setting, operates a second-hand clothing store, and operates a food bank to provide food for those temporarily in need. Which of the following is the best statement of operating objectives for Aid for Friends?
- a) Our objective is to provide food and shelter for the needy.
 - b) Our objective is to provide assistance to those in need.
 - c) Our objective is to provide temporary assistance to those in need.
 - d) Our objective is to help the needy achieve financial independence.
15. Which of the following is NOT an example of a performance budget?
- a) Program budget.
 - b) Object classification budget.
 - c) Zero-based budget.
 - d) Priority-based budget.
16. Which of the following is true about zero-based budgeting?
- a) It is a variant of program budgeting.
 - b) It requires activities of the entity to be evaluated over a five-year period.
 - c) It currently is used by most state and local governments.
 - d) It is incremental in approach.

17. Help, Inc., a not-for-profit entity dedicated to providing assistance to the needy, has submitted to its governing body a budget that includes the following budgeted expenditures.
- | | |
|---------------------------|-----------|
| Nutrition | \$250,000 |
| Family housing assistance | \$300,000 |
| Shelter House | \$200,000 |
| Legal aid | \$100,000 |
| Medical assistance | \$150,000 |
- Which of the following best describes the budgeting practices of this entity?
- a) The entity uses program budgeting techniques.
b) The entity uses object classification budgeting techniques.
c) The entity uses zero-based budgeting techniques.
d) The entity uses priority-based budgeting techniques.
18. Which of the following is true about budgets prepared by entities that use program budgeting techniques?
- a) The budget package will include information about the object classification expenditures necessary to accomplish a specific goal or objective.
b) The budget package will generally include information about the costs of providing a variety of levels of service of the same program.
c) The budget package will generally include information about the importance of the activity in accomplishing the entity's objectives, alternatives methods of accomplishing the objective, and the consequences of not performing the activity.
d) All of the above can be true.
19. Which of the following is an advantage of program budgeting over traditional budgeting techniques?
- a) It promotes continuation of existing programs.
b) It relates expenditures to objectives.
c) It encourages consideration of alternative means of accomplishing the objective.
d) Both b) and c).
20. Program budgeting, although highly popular and successful, has many disadvantages or drawbacks. Which of the following is an advantage or benefit of program budgeting?
- a) It may provide too much information.
b) It may be applied perfunctorily after its initial implementation.
c) It may not live up to its expectations.
d) It may discourage funding at levels other than those that will result in actual increases in results.
21. Which of the following is a reason for governmental and not-for-profit entities to incorporate service efforts and accomplishments (SEA) measures into their management process?
- a) Measuring and reporting upon helps management determine short-term cash flow requirements.
b) SEA measures allow management to make objective assessments about whether the goals of the government are worth achieving.
c) SEA reporting fosters sound budgeting and administration.
d) SEA fosters budgetary compliance and custodianship of resources.

22. Which of the following is not one of the three categories of SEA measures identified by GASB?
- Measures of efforts.
 - Measures of financial stewardship.
 - Measures of accomplishment.
 - Measures that relate efforts to accomplishments.
23. Which of the following is an example of a cost-outcome measure?
- Cost per passenger-mile on public transit.
 - Cost per hot meal served.
 - Cost per legal case handled.
 - Cost per client placed in gainful employment.
24. Which of the following is an example of an efficiency measure?
- Cost per client placed in an appropriate job.
 - Cost per ton of garbage collected.
 - Cost per gallon of water suitable for drinking.
 - Cost per child reading at grade level.
25. With regard to audits of SEA, which of the following might be appropriate for an auditor to do?
- Assess the appropriateness of the organizations basic objectives.
 - Verify that the government selected the correct indicators to gauge whether its objectives were achieved.
 - Evaluate whether SEA data is fairly presented.
 - Evaluate the usefulness of SEA data.

Use the following information to answer Questions 26 through 29.

The City Swimming Pool is considering several options for maintaining the grounds around the pool area over the next ten years. One option is to buy a tractor with equipment for cleaning the underbrush and cutting the grass. A second option is to contract out with a local Garden and Nursery Center that provides this kind of service. A third option is to hire many local youths to do most of the work by hand. The City already has several small lawnmowers and grass-cutting equipment.

| | |
|--|-----------|
| Option #1 | |
| Cost of tractor and equipment (useful life 10 years) | \$110,000 |
| Salvage value of tractor in 10 years | 10,000 |
| Yearly cost of operator | 3,000 |
| Yearly maintenance and upkeep, supplies, etc. | 1,500 |
| Option #2 | |
| Yearly fees | \$ 18,000 |
| Option #3 | |
| Yearly cost of part-time labor | \$ 16,000 |
| Yearly cost of supplies, equipment repair, etc. | 500 |
| Present value factors @ 6% | |
| \$1 due in ten years | .55839 |
| Annuity of \$1 for 10 years | 7.36009 |

26. What is the present value of Option #1?
- a) \$110,000.
 - b) \$137,536.
 - c) \$148,704.
 - d) \$216,721.
27. What is the present value of Option #2?
- a) \$ 10,051.
 - b) \$ 18,000.
 - c) \$132,482.
 - d) \$142,533.
28. What is the present value of Option #3?
- a) \$ 9,213.
 - b) \$117,761.
 - c) \$118,040.
 - d) \$121,441.
29. Which option should the City select based solely on cost?
- a) Option #1
 - b) Option #2
 - c) Option #3
 - d) Unable to determine.
30. Due to limited resources, Johnson City must select from among the following capital projects. Which project should the City select?
- a) Court-ordered improvements to the City Jail.
 - b) Repairing the roof on City Hall.
 - c) Replacing an inefficient data processing system with a more efficient system.
 - d) Adding two new police cars to the fleet.
31. Which of the following best describes the role of benefit-cost analysis in the capital budgeting process by governmental and not-for-profit entities?
- a) It may be used to enhance the objectivity of decision-making.
 - b) Because all costs and all benefits can be quantified, it removes subjectivity from the decision process.
 - c) It eliminates the role of value judgments in the decision-making process.
 - d) It ensures that decisions about capital asset acquisition will be consistent with organizational goals and objectives.

PROBLEMS (CHAPTER 14)

- The City of Greenville is considering automating a process in their accounting department that has been labor-intensive. The equipment currently used in the department can be sold. The new equipment will have a projected useful life of 10 years. The old equipment has a remaining useful life of 10 years. The following data are available to be used in making the decision. Should the City invest in the new equipment? Support your answer with appropriate calculations.

| | |
|----------------------------------|-----------|
| Current equipment | |
| Current equipment book value | \$ 30,000 |
| Annual depreciation charges | 3,000 |
| Current estimated disposal value | 4,000 |
| New equipment | |
| Cost | \$120,000 |
| Annual depreciation charge | 10,000 |
| Expected disposal value | 20,000 |
| Labor savings each year | \$ 40,000 |
| Present Value @ 6% | |
| \$1 due in 10 years | .55839 |
| Annuity of \$1 for 10 years | 7.36009 |

- For each of the following entities or departments, propose at least one measure of outputs and two of outcomes.
 - State University Department of Accounting
 - City Parks and Recreation Department
 - Habitat for Humanity
 - American Cancer Society
 - University Foundation for support of athletics
- The City Parks and Recreation Department has determined the following costs related to its very popular 12-week summer youth program. The number of participants in the program has grown significantly over the past few years to 100 participants last year and the Director is preparing for another 10% increase in participants next summer. How much should the Director request for next year? Calculate and defend at least three different budget requests.

| | |
|--|----------|
| Direct variable costs for a group of 10 children (group worker and supplies) | \$ 4,500 |
| Number of participants last summer | 100 |
| Fixed costs for the summer program | \$25,000 |
| Allocated fixed overhead, 25% is directly associated with the program, 75% would not be eliminated if the program were eliminated. | |
| Allocated based on number of groups | \$20,000 |

[Continues on next page.]

4. The Kayla Public Library District currently prepares its budget on an object classification basis. Last year's budgeted expenditures included these line items:

| | |
|-------------------------|--------------------------|
| • Salaries | • Employee benefits |
| • Collection purchases | • Equipment purchases |
| • Library maintenance | • Dues and subscriptions |
| • Supplies | • Utilities |
| • Equipment maintenance | • Bookmobile maintenance |

The District has decided to use program-based budgeting in the future. Based on your knowledge of libraries, what are three programs that might be included in the District's budget? Establish a program objective for each of those three programs. What are possible measures of inputs, outputs, and outcomes for each program?

ESSAYS (CHAPTER 14)

1. One goal of State University is to prepare students to become valuable, contributing members of society. One goal of the Department of Accounting of State University is to prepare students for meaningful careers as professional accountants. What are goals and objectives? How do they differ and how are they similar? What are outputs and outcomes? What are the outputs and the outcomes directly associated with the goals adopted by the University and the Department? How would the University and the Department measure achievement of these goals?
2. GASB has encouraged governmental entities to publish service efforts and accomplishments data. What is the role of auditors in attesting to service efforts and accomplishment data?
3. Many governments use performance budgets in place of, or as a supplement to, the traditional object classification budget. What is a performance budget? What are the advantages and what are the disadvantages of performance budgets over traditional budgets?
4. The Patton Landfill Authority decides to use zero-based budgeting for the first time. Assume that you are asked to prepare the budget decision package for a proposal to establish a 24-hour drop off location for large refuse (such as for old appliances, furniture and so forth). Patton County, in which the Authority is located, has recently experienced a surge in the level of illegal dumping. What are four elements that should be included in your budget decision package for the proposed program?

ANSWERS TO TRUE/FALSE (CHAPTER 14)

- | | |
|-----|---|
| 1. | T |
| 2. | F |
| 3. | T |
| 4. | T |
| 5. | T |
| 6. | F |
| 7. | F |
| 8. | T |
| 9. | T |
| 10. | F |

ANSWERS TO MULTIPLE CHOICE (CHAPTER 14)

1. B
2. D
3. B
4. B
5. C
6. B
7. C
8. D
9. A
10. D
11. C
12. C
13. B
14. C
15. B
16. A
17. A
18. D
19. D
20. D
21. C
22. B
23. D
24. B
25. C
26. B
27. C
28. D
29. C
30. A
31. A

ANSWERS TO PROBLEMS (CHAPTER 14)

Problem 1

Buy new equipment

| | | | | | |
|------------------|---|---------|---|-----------|---|
| (\$120,000) | = | 1.00000 | x | \$120,000 | Purchase price of new equipment |
| 11,168 | = | .55839 | x | \$ 20,000 | Disposal value of new equipment in ten years. |
| 4,000 | = | 1.00000 | x | \$ 4,000 | Disposal value of old equipment. |
| <u>294,404</u> | = | 7.36009 | x | \$ 40,000 | Cost savings over the ten years. |
| <u>\$189,572</u> | | | | | |

Because the net present value is positive, this is a project that should be undertaken.

Problem 2

[Students will have a variety of answers. Remember that outputs measure quantity of service provided while outcomes measure accomplishments.]

- a) Output: Number of graduates
Outcomes: Number of students passing the CPA Exam
Number of graduates satisfied in their accounting employment after ten years
- b) Output: Number of children participating in the summer youth program.
Outcomes: Reduction in juvenile crime rates
Number of adults satisfied with the youth recreation programs.
- c) Output: Number of houses built.
Outcomes: Reduction in number of families living in substandard housing.
Reduction in number of families seeking public assistance for housing.
- d) Output: Number of brochures mailed.
Outcomes: Reduction in the number of deaths related to cancer.
Increase in the number of people seeking medical exams for cancer.
- e) Output: Amount spent in support of athletic programs.
Outcomes: Increase in the graduation rate among athletes.
Increase in the number of games won.

Problem 3

[Students may have a variety of answers but at least one should be a projection based on average cost.]

Average Cost Projection

\$25,000 Fixed costs
\$45,000 Direct Costs for 10 groups (\$4,500 x 10)
\$20,000 Allocated fixed costs
\$90,000 / 100 children = \$900 average cost per child

\$900 x 110 children = \$99,000

Variable Cost Projection

\$49,500 (\$4,500 x 11 groups)
\$25,000 Fixed costs
\$22,000 Allocated fixed costs (\$20,000 x 1.10)
\$96,500

\$49,500 (\$4,500 x 11 groups)
\$25,000 Fixed costs
\$20,500 [\$15,000 + (\$5,000 x 1.10)]
\$95,000

Problem 4

[Note: Students will provide a variety of answers to this question.]

Possible program categories might include:

- Bookmobile
- Teen reading
- Senior (large-print) reading
- Children's reading
- Library district/school district combined programs
- Community outreach
- Administrative support.

ANSWERS TO ESSAYS (CHAPTER 14)

1. One problem with goals such as these is that accomplishment is difficult to measure. How does one measure "valuable, contributing member of society"? How does one measure "meaningful career as a professional accountant"?

Generally, an entity should write its mission statement and then set forth goals and objectives. Goals are generalized statements of aspirations. Operational objectives are specific sought-after results. Objectives are derived from the organization's mission and its goals, and should be the basis for allocating resources, managing day-to-day activities, and distributing rewards and reprimands. Operational objectives should be doable, measurable, and accomplishable.

Outputs indicate the quantity or units of service provided by an activity or entity. Outcomes represent the results of an activity. Outcomes are generally more difficult to measure than outputs. In the absence of measures indicative of true outcomes, organizations often resort to surrogates.

The University will probably not be able to measure the desired outcome "valuable, contributing member of society." Outcomes would be very subjective. What makes one a contributing member of society? Is a man or a woman a contributing member of society because he or she becomes a parent, or is his or her contribution measured rather on the contribution made by the children they raise? Are people contributing members of society because they are gainfully employed, because they vote, or because they become leaders in their profession? These are value-driven questions. Perhaps the University will find surrogates, outputs, to measure what appears to be unmeasurable. Output measures might be graduation rates (probably not a good output measure for this goal), employment rates (maybe a slightly better measure).

The Department will probably find it somewhat easier to measure outcomes. Surveys of graduates ten years after graduation might well identify the success the students have had in the accounting careers. One would expect that in ten years, graduates who have meaningful careers would be at a supervisory level within their organization. Percentage of graduates in supervisory positions would be an output measure probably. The individual graduate can only define what constitutes a meaningful career. What is meaningful to one graduate may not be meaningful to another.

2. The role of auditors in attesting to reports on service efforts and accomplishments (SEA) can be similar to that in expressing an opinion on traditional financial statements. If the SEA data can be measured and reported upon, auditors can verify the measurements. Auditors can be involved not only in verifying the data, but also in evaluating the quality of the internal control system used to collect the SEA data. Auditors are trained in evaluative techniques that transcend the underlying data. We tend to think of auditors as auditors of financial statements, but they can audit almost anything if there are objective standards against which to measure. As SEA data becomes more available, citizens will want the same level of credibility attached to the SEA data as is currently attached to financial statements that have been attested to by a professional.
3. Performance budgets explicitly relate expenditures to operational objectives. Program budgets, the most common type of performance budgets, allocate funds by programs rather than by objects. Programs are composed of activities that are directed toward a common goal. Zero-based budgeting (priority-based budgeting) is a type of program budget.

The advantages of program budgeting include the following:

- a) Relates expenditures to objectives.
- b) Encourages explicit consideration both of alternative means of achieving the same objective and of whether the objective even needs to be achieved.
- c) Promotes analysis of the behavior of costs and discourages funding at levels other than those that will result in actual increases in results.
- d) Invites periodic review of all programs and activities to assure that they are consistent with the entity's current objectives.

The main disadvantages of program budgeting include the following:

- a) May provoke conflict over organizational objectives.
- b) Encourages governing boards to establish and make known their funding priorities.
- c) Links dollar expenditures with anticipated outcomes.
- d) May be prepared conscientiously in the first year and perfunctorily thereafter.
- e) May be imposed from above and resented by the entity.
- f) May require adjustments to the computer system to capture the data.
- g) May present managers with an overwhelming amount of data.
- h) May not live up to its expectations.
- i) Decision-makers may ignore rankings made by program officials.

4. [Note: Students will provide a variety of answers to this question. However, the key elements of any zero-base budget decision package should include:]
 - a) A statement of the activity's objectives;
 - b) The consequences of not performing the activity;
 - c) Alternative means of accomplishing the same objective;
 - d) Expected inputs, outputs and outcomes at various levels of funding.

Chapter 15

Auditing Governments and Not-For-Profit Organizations

TRUE/FALSE (CHAPTER 15)

- e) A “cognizant agency” can be either an employee of a federal agency or of an independent accounting firm.
 - f) The Single Audit Act of 1984 was passed to eliminate the costly practice of requiring separate audits for each federal program in which an organization participated.
 - g) Performance audits are sometimes referred to as “operational” audits.
 - h) Performance audits must be conducted by independent auditors.
 - i) To “attest” means to confirm that something is true, correct, or genuine.
 - j) An auditor of any governmental or not-for-profit that receives federal monies must include a report on the entity’s internal control structure within their audit report or provide a cross-reference to that report.
 - k) The AICPA originally established auditing standards for federal single audits.
 - l) Newly installed computer programs are one indicator that a government’s participation in a federal program may be at high risk of noncompliance.
 - m) GAO independence guidelines permit CPA firms to determine the estimated useful lives of their clients’ assets.
 - n) Under GAO (GAGAS) standards, independent auditors must report all instances of fraud or illegal acts that they discover during the course of an audit.
11. Regarding the single audit process, required supplemental information is considered to be within the scope of the audit.

MULTIPLE CHOICE (CHAPTER 15)

7. The GAO publication *Government Auditing Standards* (commonly known as the Yellow Book) is applicable in which of the following audit situations?
- To independent CPAs conducting a performance audit of a governmental entity that receives no federal financial assistance.
 - To independent CPAs auditing a nongovernmental entity that receives federal financial assistance.
 - To independent CPAs auditing a governmental entity that receives no federal financial assistance.
 - To state auditors auditing a local government that does not receive federal financial assistance.
8. Which of the following is an example of a financial audit?
- An audit of financial statements to determine if they are presented fairly in accordance with generally accepted accounting principles.
 - An audit to determine whether the objectives of a new program are suitable and relevant and whether the entity has complied with laws and regulations that may have a material effect on the financial statements.
 - An audit of the financial report on the Noxious Weed Special Revenue Fund to determine whether the entity has complied with specific financial-related requirements.
 - An audit to determine whether an entity is acquiring its resources economically and efficiently.
9. A performance audit includes which of the following?
- Economy and efficiency audit.
 - Program audits.
 - Both (a) and (b).
 - None of the above.
10. A program audit would include which of the following?
- Determining if sound procurement policies are being practiced.
 - Determining if efficient operating procedures are being used.
 - Determining if resources are being used efficiently.
 - Determining the factors inhibiting satisfactory performance.
11. Which the following is not included in the GAO auditing standards for financial statement audits?
- General standards.
 - Field work standards.
 - Reporting standards.
 - Statistical sampling standards.
12. Which of the following is NOT included in the general standards of GAGAS?
- Qualifications.
 - Quality control.
 - Planning.
 - Independence.

13. What amount of continuing professional education would an auditor, who is not a CPA but who is engaged in the audit of a City that receives significant amounts of federal financial assistance, be required to complete?
- a) Twenty-four hours every two years.
 - b) Forty hours a year.
 - c) Eighty hours every two years.
 - d) None because the auditor is not a CPA.
14. An independent CPA who conducts audits of entities that receive federal financial assistance has what responsibility related to peer review?
- a) Does not have to have one unless he/she belongs to the AICPA Private Companies Practice Section.
 - b) Must have one every year.
 - c) Must have one at least every two years.
 - d) Must have one at least every three years.
15. An independent CPA is conducting an audit of an entity that receives federal financial assistance and is subject to the GAO standards (GAGAS). The auditor must design the audit to provide reasonable assurance of detecting which of the following?
- e) Immaterial misstatements, if they result from illegal acts.
 - f) Noncompliance with entity policies and procedures.
 - g) Noncompliance with the terms of contracts or grant agreements.
 - h) All of the above.
16. An auditor is engaged to audit the Eastern Planning and Development District, a not-for-profit entity that receives federal financial assistance. The auditor designed his audit to provide reasonable assurance of detecting material misstatements resulting from illegal acts. What additional requirements does the auditor have with regard to compliance?
- e) None.
 - f) The auditor must design the audit to provide reasonable assurance of detecting noncompliance with terms of grants and contracts.
 - g) The auditor must design the audit to provide reasonable assurance of detecting all misstatements resulting from illegal acts.
 - h) The auditor must design the audit to provide reasonable assurance of detecting any fraud.
17. Which of the following is a true statement with regard to ‘working papers’ prepared by a CPA in an audit of an entity that receives federal financial assistance?
- e) There is no specific standard requiring working papers.
 - f) The AICPA has no specific standard requiring working papers, but the GAO standards require working papers.
 - g) The AICPA and the GAO standards concerning working papers are the same.
 - h) The GAO standards concerning working papers are more rigorous than the AICPA standards.

18. An independent CPA is conducting an audit of an entity that is subject to the GAO audit standards, but is not subject to the OMB audit standards. While conducting the audit, the CPA found that the entity had violated a law that had a large, but not material, potential penalty associated with such violation. There was no accrual for the potential penalty or disclosure of the violation. What action(s) must the CPA take with regard to this violation?
- e) Nothing, since the financial statements are not materially misstated.
 - f) Must issue an adverse opinion if the financial statements are not changed to reflect the violation.
 - g) Must issue a report that details the violation and the potential dollar effect.
 - h) Must report the incident to the local law enforcement agency.
19. An independent auditor has conducted an audit of the financial statements of an entity that receives federal financial assistance, but that is not subject to the OMB standards. What report(s) must the auditor issue at the completion of this engagement?
- e) Only an opinion (or disclaimer of opinion) on the financial statements.
 - f) An opinion (or disclaimer of opinion) on the financial statements and a report on internal control.
 - g) An opinion (or disclaimer of opinion) on the financial statements, a report on internal control, and a report on compliance.
 - h) An opinion (or disclaimer of opinion) on the financial statements, a report on internal control, and an opinion (or disclaimer of opinion) on compliance.
20. Reports issued by CPAs conducting audits subject to the GAO standards must include all of the following except:
- e) A description of the scope of compliance testing.
 - f) A description of the scope of internal control testing.
 - g) A description of any irregularities and illegal acts found.
 - h) A description of any sampling methodology and sampling plans used.
21. A CPA has conducted an audit of the financial statements of an entity that received federal financial assistance. The CPA identified one major federal program and four nonmajor federal programs. The CPA's responsibility related to the Schedule of Expenditures of Federal Awards is to:
- e) Express an opinion as to whether the Schedule is fairly presented.
 - f) Express an opinion as to whether the Schedule is fairly presented in relation to the financial statements taken as a whole.
 - g) Express negative assurance on the Schedule.
 - h) The CPA has no responsibility with regard to the Schedule.
22. Which of the following is an objective of the Single Audit Act?
- e) The financial statements of the entity are not affected by immaterial errors or misstatements.
 - f) The entity has not committed fraud.
 - g) The entity has in place a system of internal control sufficient to ensure that financial statements are prepared in accordance with generally accepted accounting principles.
 - h) The entity is satisfying the laws, regulations, and provisions that apply to each specific federal award.

23. Which of the following groups is responsible for administering the Single Audit Act?
- e) OMB.
 - f) GAO.
 - g) AICPA.
 - h) State Boards of Accountancy.
24. A CPA has conducted an audit of the financial statements of an entity that received federal financial assistance and had one program that qualified as a major program. The CPA's responsibility related to reporting on internal control for this entity is to:
- e) Issue a report on internal control relating to the financial statements.
 - f) Issue an opinion on internal control relating to the financial statements.
 - g) Issue a report on internal control relating to the financial statements and a report on internal control related to the federal program(s).
 - h) Issue a report on internal control relating to the financial statements and an opinion on internal control related to the major program.
25. A CPA has conducted an audit of the financial statements of an entity that received federal financial assistance and had one program that qualified as a major program. The CPA's responsibility related to reporting on compliance for this entity is to
- e) Issue a report on compliance related to the entity.
 - f) Issue an opinion on compliance related to the entity.
 - g) Issue a report on compliance related to the entity and a report on compliance related to the federal program(s).
 - h) Issue a report on compliance related to the entity and an opinion on compliance related to the federal program(s).
26. The Single Audit Act distinguishes between major and nonmajor federal programs. One factor that distinguishes a major from a nonmajor program is inherent risk. Which of the following is NOT a characteristic of "inherent risk"?
- e) Significant prior audit findings.
 - f) Significant violation of the terms of a specific grant due to a misunderstanding of the requirements.
 - g) Weakness in the entity's internal controls.
 - h) Lack of oversight by federal agencies.
27. Which of the following is NOT included in the general requirements for which the auditor must test compliance with federal regulations?
- e) Matching funds.
 - f) Drug-free workplace.
 - g) Political activity.
 - h) Prevailing wage.
28. Each federal financial assistance program has specific compliance requirements. Which of the following is not an example of the general nature of the specific compliance requirements?
- a) Eligibility of individuals or groups to participate in the program.
 - b) Allowability of certain types of goods or services that may be acquired.
 - c) Maximum dollar amounts of expenditures.
 - d) Matching fund requirements.

29. What is the auditor's responsibility for the Schedule of Expenditures of Federal Awards?
- a) The auditor has no responsibility for this Schedule.
 - b) The auditor should report on the Schedule without issuing an opinion.
 - c) The auditor should express an opinion on the fair presentation of the Schedule.
 - d) The auditor should express an opinion on the fair presentation of the Schedule in relation to the basic financial statements taken as a whole.
30. Under which set of auditing standards is the auditor required to test compliance with laws and regulations that could have a direct and material effect on the financial statements of the entity?
- e) AICPA standards.
 - f) GAO standards.
 - g) OMB standards.
 - h) All of the above.
31. Under which set of auditing standards is the auditor required to express an opinion on compliance with laws and regulations applicable to each major program?
- a) AICPA standards.
 - b) GAO standards.
 - c) OMB standards.
 - d) All of the above.
32. The Schedule of Findings and Questioned Costs should include all of the following except
- a) Information on types of opinions expressed on the financial statement.
 - b) Information on all weaknesses in internal control.
 - c) List of material noncompliance.
 - d) Known questioned costs.
33. Which of the following is NOT a necessary condition for a performance audit?
- e) The auditor must delineate specifically the activities and outcomes to be addressed.
 - f) Entity management must have clearly defined operational objectives.
 - g) The auditor must obtain an understanding of management controls relevant to the audit.
 - h) There must be a schedule of disbursements related to the program.
34. GAO performance audit standards do NOT include which of the following?
- a) The auditor should be independent of the entity being audited.
 - b) The work should be adequately planned.
 - c) The auditor should prepare written work papers.
 - d) The auditor should obtain an understanding of management controls relevant to the audit.
35. Which of the following is NOT a key difference between financial and performance audits?
- e) Financial statement audits focus on the entity as a whole while performance audits generally focus on a specific program or activity.
 - f) Financial statement audits are generally conducted annually while performance audits are generally are conducted irregularly.
 - g) Financial statement audits are conducted using very well defined standards while performance audits are conducted without reference to any standards.

h) Specialists in accounting generally conduct financial statement audits while performance audits may require more program-specific knowledge and fewer accounting skills.

36. If a program to be subjected to a performance audit lacks clearly defined objectives, what can the auditor do?
- e) Decline the audit until the entity defines its objectives.
 - f) Personally discern the objectives based on the auditor's opinion.
 - g) Examine the legislation to see if the legislation articulated the goals and objectives of the program.
 - h) Create a list of goals and objectives.
37. Which of the following is NOT a technique used by an auditor in a performance audit engagement to gain an understanding of the controls in place to assure that a program meets its objective?
- e) Reading the legislation.
 - f) Making inquiries of employees.
 - g) Flow-charting appropriate systems.
 - h) Preparing and administering questionnaires.
38. GAO standards specify that performance audit reports should be timely and include several items. Which of the following items is NOT required under the GAO standards?
- e) Significant audit findings.
 - f) Recommendation as to how to correct problems.
 - g) Explanation of the audit's objectives and of its scope and methodology.
 - h) Details about the number of items tested and the sampling techniques used.
39. Which of the following is true about the public availability of audit reports prepared under GAGAS?
- e) Only financial statements should be publicly available.
 - f) Only performance audits should be publicly available.
 - g) Neither financial statement audits nor performance audits should be publicly available.
 - h) Both financial statement audits and performance audits should be publicly available.
40. Which of the following is not a unique characteristic that distinguishes ethical decisions made by employees of governmental entities from those made by employees of for-profit entities?
- e) The public holds employees of governments to a higher standard of conduct than those of businesses.
 - f) Governments are guardians of public funds and are accountable to the public as to how they use them.
 - g) Government employees must safeguard assets.
 - h) Government activities are carried out in open view.
41. Which of the following is NOT a consideration in resolving an ethical dilemma?
- e) What are the facts?
 - f) Who is affected?
 - g) Who will know about this action?
 - h) What the alternative courses of action?
42. An elected State Auditor, employed by the State, would NOT be considered independent when auditing which of the following entities?
- a) A component unit of the State.
 - b) An agency of the State.

- c) The office of the State Auditor.
- d) All of the above.

43. An independent CPA is engaged to audit the financial statements of the City of Highland Hills. The City has a variety of revenue sources including a \$350,000 grant from the U.S. Department of Housing and Urban Development. Which of the following audit standards must the CPA use when conducting the audit?
- a) The AICPA audit standards.
 - b) The GAO audit standards.
 - c) The OMB audit standards.
 - d) All of the above.
38. Circular A-133, issued by the Office of Management and Budget,
- a) Applies only to state and local governmental units
 - b) Applies only to not-for-profit organizations
 - c) Applies to both
 - d) Applies to neither
39. Which of the following must have an audit under GAGAS?
- a) A state government that receives \$500,000 in federal awards during the year.
 - b) A local government that receives \$501,000 in federal awards during two years.
 - c) A state government that expends \$500,000 in federal awards during the year.
 - d) A local government that expends \$501,000 in federal awards during two years.

PROBLEMS (CHAPTER 15)

1. The following descriptions relate to an independent public accounting firm that has as clients some governmental entities and not-for-profit entities that receive federal financial assistance. For each of the following independent situations, describe the possible violations of GAO standards (Government Auditing Standards) and conclude whether or not the situation is a violation.

- a) A college graduate who is not a CPA is assigned by her firm to the audit of Grover County. Because she is not a CPA, the firm did not send her to any continuing education courses this year or last year.
- b) An auditor has prepared working papers using a new computer software package. The financial statements and audit reports generated by the software are well designed and incorporate all required accounting and auditing standards. Because the program is so powerful, it is also quite complex. Printouts of the financial statements and supporting schedules do not include much of the information necessary to determine that the auditor was justified in his/her conclusion. Most of that information is part of the computer program, however.
- c) While auditing a not-for-profit entity, the auditor discovered that a secretary had been embezzling money from the petty cash fund. In relation to the financial statements taken as a whole, the amount stolen was not material. The auditor discussed the issue with management of the entity. The theft was reported to the appropriate law enforcement personnel and the bonding company reimbursed the not-for-profit entity the full amount of its loss. Since there was no effect on the financial statements, the theft was not mentioned in the auditor's report.
- d) The internal auditor of the City of Seaburg, who reports to the chief financial officer of the City, audited the health and welfare division of the City for purposes of expressing an opinion on the financial statements prepared by that division and submitted to a federal agency.

2. As a staff member of the internal audit department of the City of Freeburg, you have been asked to write an audit program for a performance audit of the Neighborhood Housing Authority, a not-for-profit entity that is included in the City's Financial Reporting Entity. Critics of the Authority have been relentless in their opposition to the Authority and its executive director. Prepare a list of questions to which you would want answers before beginning the evidence-gathering phase of the audit.

3. In a highly controversial move, the Mayor and City Council approved the purchase of the Swim and Gym, a local private facility that was facing bankruptcy. The Mayor promised the public that the facility would be operated on a business-like basis and would be fully supported by user fees. No City money was to be spent on the Swim and Gym. Critics of the purchase complain that City laborers are frequently seen at the facility, the facility was re-roofed during the first year, and employees at the facility are considered City employees and earn the same benefits as other City employees. To quiet the vocal opponents to the operation of the Swim and Gym, the Mayor asked the internal audit department to conduct an audit of the operation. You are assigned to the task. What are the issues you want to address in this audit?

4. Your audit firm has been asked to perform a Single Audit of the Kayla Public Transportation Authority. The Authority receives well over half of its \$25 million in revenues from federal transportation grants and other federal programs. The Authority has a new controller, whose last position was in private industry. **REQUIRED:** You have been asked to brief the new controller on the criteria for determining major programs for purposes of your audit.

ESSAYS (CHAPTER 15)

1. What is the Single Audit Act? Your answer should address at least the following questions. What is its purpose? How does it affect audits of entities that receive federal financial assistance? How do its requirements differ from AICPA audit requirements?
2. What are performance audits and how do they differ from financial statement audits? Your answer should address the role of performance audits in governmental financial management, the purpose of performance audits, and significant differences between performance and financial statement audits.
3. The State accounts for the operations of its airplanes in a special revenue fund. The airplanes are reported in the government-wide statement of net assets, but not in the fund statements. GAAP allow an entity relative flexibility in accounting for this type of activity in either a special revenue fund or an internal service fund. Departments and agencies of the State are charged for the use of the airplanes on a schedule that allows the special revenue fund to breakeven each year. When criticized for allowing State employees to fly, rather than drive, to various sites around the State, the Governor responded that department use of the airplanes doesn't cost the State anything because the departments and agencies reimburse the special revenue fund for the full cost of operating the airplanes. When criticized by some outspoken citizens, the Governor referred them to the State Accountant for a further explanation. The Accountant is a member of another political party than the Governor. What are the practical issues and what are the ethical issues?
4. You are assigned to head up a financial audit of the Geneva City Public Housing Authority, which receives nearly all of its operating resources from participating in federal grant programs. The Authority's controller calls to complain that your audit staff is asking questions about costs reimbursements made to Authority's administrators for attending a fundraiser for Geneva's incumbent mayor. The controller notes that the mayor's office had requested the administrators' attendance. He also noted that you have been asked to perform a financial audit, not a grants audit. How do you reply?

ANSWERS TO TRUE/FALSE (CHAPTER 15)

1. F
2. T
3. T
4. F
5. T
6. T
7. F
8. T
9. F
10. F
11. F

ANSWERS TO MULTIPLE CHOICE (CHAPTER 15)

1. B
2. A
3. C
4. D
5. D
6. C
7. C
8. D
9. C
10. B
11. D
12. C
13. C
14. D
15. B
16. D
17. A
18. A
19. D
20. D
21. B
22. C
23. D
24. B
25. C
26. A
27. D
28. A
29. C
30. C
31. A
32. D
33. D
34. C
35. C
36. C
37. D
38. C
39. C

ANSWERS TO PROBLEMS (CHAPTER 15)

Problem 1

- a) The GAO standards state that ALL auditors who participate in government audits, not just CPAs, must take continuing professional education classes. The current requirement is 80 hours every two years. Because this auditor has had no training, the firm is in violation of the GAO standards.
- b) The GAO standards require that working papers must contain sufficient information to convince an auditor having no previous connection with the audit that the evidence supports the auditor's conclusions and judgments. It is not clear whether the 'paper' copies must contain the required evidence, or whether it would be acceptable for the program to contain the evidence. I would conclude that the firm is probably in violation of the existing standards because the standards deal specifically with the working papers.
- c) The GAO standards require that ANY irregularities, illegal acts, or other instances of material noncompliance be reported. The firm is in violation of the standard.
- d) Audit organizations are considered independent, even if employed by the same employer as the auditee, if one of the two following conditions exists:
 - e) The audit organization is from a different branch of the government than it is examining. (Branches are legislative, executive, and judicial.)
 - f) The audit organization is headed by an auditor who is elected by the citizens or is accountable to the legislative body.

Because the CFO of the City is in the same branch of government as the Health and Welfare Division, the internal audit would not be considered independent.

Problem 2

The questions to which I would want answers before beginning the evidence-gathering phase of the audit of the Neighborhood Housing Authority are primarily related to the scope and purpose of the program:

- e) What is the mission of the Authority, as expressed by executives of the Authority?
- f) What is the mission of the Authority, as expressed in the legislation creating the Authority?
- g) What are the goals of the Authority, as expressed by executives of the Authority?
- h) What are the goals of the Authority, as expressed in the legislation creating the Authority, or in minutes of legislative hearings on the legislation?
- i) What operating objectives did the Authority adopt?
- j) How does the Authority measure accomplishment of its objectives?
- k) What management controls are in place to insure that Authority goals and objectives are accomplished?
- l) What controls are in place to insure that the program meets its objectives?
- m) What controls are in place to insure that the data produced by the information system is valid and reliable?
- n) What controls are in place to insure that the Authority has complied with all applicable laws, regulations, and contractual provisions?
- o) What controls are in place to insure that the Authority's assets are safeguarded?
- p) What are the primary revenue sources for the Authority?
- q) What are the primary expenditures by the Authority?
- r) What is the role of the budget in the operation of the Authority?

Problem 3

The primary objective of the audit would be to determine that the Swim and Gym is fully supported by user fees. Because the intent is to account for all costs of operations, the Swim and Gym should be accounted for in an enterprise fund.

The auditor would want to look at the financial reports to determine that, indeed, revenues were equal to or exceeded operating expenses. In a governmental entity it is easy to charge operating expenditures of one operation to another fund. The auditor would want to find out if all of the costs of operating the Swim and Gym are charged to the S&G. There should be no problem with the S&G employees being considered City employees. What is important is that the S&G be charged with the appropriate costs.

- e) Are the salaries of all personnel who are actively involved in the operation of the S&G charged to the S&G operations?
- f) If other City employees are providing services to the S&G, is the S&G charged for the time spent on S&G activities?
- g) How was the new roof paid for?
- h) Is depreciation charged to the S&G?
- i) If the City has a blanket insurance policy, is a portion of that cost allocated to the S&G?

The auditor should also be concerned with performance. The Swim and Gym should use good cost accounting controls such as a flexible budget and variance analysis.

Problem 4

Major programs are those that make up a “relatively large” proportion of the *total* federal awards received and for which there is a high risk of noncompliance. Relatively large is assessed by a sliding scale based on that federal funds received under each award bears to the total of federal funds received by the Authority. Awards for which there is a high risk of noncompliance include:

1. Those that have weaknesses in related internal accounting controls
2. Those for which a significant portion passed through to subrecipients without effective systems of monitoring whether subrecipients are complying with award requirements.
3. Programs operated with newly installed computer systems that have not been adequately tested.
4. Those for which there have been no recent audits.
5. Programs with complex compliance requirements.
6. Programs that are relatively new to the organization.

ANSWERS TO ESSAYS (CHAPTER 15)

1. The Single Audit Act is a piece of federal legislation that applies to all entities that receive federal financial assistance of \$500,000 or more in a given year. The objectives of the single audit act are to assure:

- e) The financial statements of the entity as a whole can be relied upon
- f) The entity is adhering to the common set of federal laws and regulations that apply to all recipients of federal aid
- g) The entity is satisfying the laws, regulations, and provisions that apply to each specific federal award.

The federal Office of Management and Budget (OMB) is primarily responsible for administering the Single Audit Act. Detailed guidance on how the single audit is to be performed is available in OMB Circular A-133.

Entities that receive over \$500,000 of federal financial assistance must have audited the financial statements of the entity taken as a whole. The auditor must opine on the financial statements of the entity, report on the internal controls of the entity, and report on entity compliance with laws and regulations that will have a direct and material effect on the financial statements.

In addition, there must be an audit of federal financial awards. The auditor must opine on the Schedule of Expenditures of Federal Awards, report on internal controls over major programs, and opine on compliance by major programs.

The major differences between audits performed only in accordance with the AICPA standards and audits performed in accordance with the GAO Standards are:

- e) The attention given to the federal financial awards.
- f) The additional reports issued.
- g) The focus on understanding and testing internal control.

2. Performance audits focus on organizational accomplishments. Performance audits differ significantly from financial statement audits. Financial statement audits focus on inputs--how much did we spend on specific activities or objects. Performance audits focus on outputs or outcomes--how well did we accomplish our goals. Because government or not-for-profit entities rarely focus on maximizing net income, performance audits may be the best way to assess organizational performance.

Financial statement audits focus on the organization as a whole while performance audits generally focus on a specific program or activity. Financial statement audits are generally conducted annually while performance audits can be conducted at any time and cover any time period. Generally financial statement audits are performed by personnel with technical training in accounting. Performance audits are generally performed by personnel with training related to the program being conducted. For example, performance audits of health care facilities will generally utilize the talents of health care specialists.

[Continued on next page.]

Establishing the scope and purpose of a performance audit is generally more difficult than establishing the scope and purpose of a financial statement audit. Financial statement audits are designed to provide evidence that the financial statements present fairly the financial position and results of operations of the entity. Performance audits can have any of a multitude of purposes and are specifically tailored to accomplish the particular purpose for which the performance audit is performed.

3. The Governor either purposefully, or out of ignorance, misstated the facts. When one fund reimburses the special revenue fund of the same governmental entity for expenditures made by the special revenue fund, the State has still incurred costs. One could argue that even if the employees had traveled by car, costs also would have been incurred. However, the costs of operating the aircraft but would probably differ in amount from the amount spent on cars.

The fact that the State accounts for the operation of the aircraft in a special revenue fund rather than an internal service fund is important. If an internal service fund billed the departments for recovery of the costs incurred, the amount would be larger than the amount billed by the special revenue fund because the special revenue fund does not charge depreciation on the aircraft and the internal service fund would charge depreciation. This omission, by itself, implies an attempt to distort the costs incurred in operation of the aircraft.

If the State Accountant explains to the press the difference between an internal service fund and a special revenue fund, it could be interpreted as politically motivated. However, the State Accountant has an obligation to let the public know the full cost of operating the fleet of aircraft. The State Accountant cannot win in this situation. He must explain the facts of governmental accounting and incur the wrath of the Governor or he must perpetuate the lie that the use of the aircraft is without cost. This situation is not unusual in governmental accounting. Many executives, in an attempt to accomplish what they consider to be desirable goals, encourage the most creative accounting possible to report the financial effect of their actions.

4. Audit requirements for a financial audit of a governmental or not-for-profit organization that receives over \$500,000 in federal funds in more than one program differ from those of an organization that receive less than that amount or no federal funds. In addition to AICPA standards, auditors must also be governed by the Single Audit Act—OMB Circular A-133.

An auditor conducting an audit under the Single Audit Act must issue at least four audit reports. One of these reports is a schedule of findings and questioned costs. A questioned cost is one that is not subject to federal reimbursement because it is in violation of laws or provisions pertaining to a grant—that is, the cost is explicitly proscribed. Proscribed costs include costs incurred for political activities. It does not matter why the administrators attended the luncheon. The auditor must be certain that the Authority did not receive reimbursement for these costs under any of the grant programs in which it participates. If it did, the costs must be included in the required schedule.

Chapter 16

Federal Government Accounting

TRUE/FALSE (CHAPTER 16)

1. If the federal Treasury, GAO, or OMB objects to a FASAB standard, it is returned to the Board for reconsideration.
2. Federal operations consist of 5 fund types—the general fund, special funds, trust funds, capital funds, and revolving funds.
3. Proprietary accounts are used to report the business-type activities of the federal government.
4. Stewardship assets are long-lived assets that are not given balance sheet recognition by the federal government.
5. The federal agency balance sheet and statement of net cost are prepared on the full accrual basis of accounting.
6. FASAB requires nonexchange revenues to reported on both the accrual and the cash basis of accounting.
7. Federal social insurance liabilities (e.g. social security) to beneficiaries are recognized only when due.
8. Federal agencies recognize the cost of debt guarantees when it is probable that borrowers will default on their payments.
9. Military assets are required to be capitalized and depreciated until war is declared.
10. At an international level, the IFAC Public Sectors Committee recommends preparation of cash-basis financial statements for third-world governments.

MULTIPLE CHOICE (CHAPTER 16)

1. Which of the following is a unique characteristic of the federal government that necessitates special accounting and reporting practices?
 - a) The types of its expenditures.
 - b) The size of its obligations.
 - c) The extent of its powers.
 - d) The range of its influence.

2. Which of the following is a function of the U.S. Department of Treasury?
 - a) Adjudicating claims for and against the federal government.
 - b) Monitoring the education of the federal budget.
 - c) Overseeing the central accounting and reporting systems.
 - d) Apportioning federal appropriations.

3. Which of the following is a responsibility of the Office of Management and Budget?
 - a) Assisting the President in preparing the federal budget.
 - b) Resolving bid protests that challenge government contract awards.
 - c) Keeping track of monetary assets and liabilities.
 - d) Arranging for audits of federal agencies

4. The amount of its budgeted resources that is currently available to be spent by a federal agency is its
 - a) Appropriation.
 - b) Apportionment.
 - c) Cash balance.
 - d) Unencumbered obligations.

5. The CFO of the United States is
 - a) a position within OMB.
 - b) a position within GAO.
 - c) a position in the U.S. Treasury Department.
 - d) A cabinet position reporting to the U.S. President.

6. When a federal agency must have an independent audit which of the following can perform that audit?
 - a) OMB.
 - b) The agency's inspector general.
 - c) GAO.
 - d) The U.S. Treasury Department.

7. The Government Accountability Office (GAO) is part of which branch of the federal government
 - a) Executive branch.
 - b) Judicial branch.
 - c) Legislative branch.
 - d) None of the above; it is independent of any other branch of government.

8. Which of the following is a role that GAO plays in the accounting and information management policy of the United States?
 - a) Prescribing standards for auditing and evaluating government programs.
 - b) Developing integrated accounting systems that comply with applicable accounting standards.
 - c) Apportioning federal appropriations.
 - d) Reviewing federal agencies' spending plans.

9. Federal government accounting standards are the responsibility of which Federal government agency?
 - a) The Department of the Treasury.
 - b) The Office of Management and Budget.
 - c) The Government Accountability Office.
 - d) All of the above.

10. The Federal Accounting Standards Advisory Board is responsible for
 - a) Recommending federal accounting standards.
 - b) Setting federal accounting standards.
 - c) Implementing federal accounting standards.
 - d) Developing federal auditing standards.

11. Which of the following is a true statement about the Federal Accounting Standards Advisory Board?
 - a) It is an independent standard setting board.
 - b) It is a shared jurisdiction board created by joint agreement of three federal agencies.
 - c) It is an executive office function.
 - d) It was created by and reports to Congress.

12. Which of the following categories is included in the Objectives of Federal Financial Reporting?
 - a) Operating performance.
 - b) Congressional performance.
 - c) Executive performance.
 - d) Accountability.

13. Federal operations are accounted for in four types of funds. Which of the following is one of the types of funds used?
 - a) Capital funds.
 - b) Revolving funds.
 - c) Special revenue funds.
 - d) Fiduciary funds.

14. Federal government capital expenditures can be accounted for in which of the federal funds?
- General fund
 - Special funds.
 - Trust funds.
 - All of the above.
15. Which of the following types of expenditures are not accounted for in the federal government general fund.
- Operating expenditures.
 - Capital expenditures.
 - Medicare.
 - Interest on public debt.
16. Which of the following is a false statement about federal special funds?
- They are maintained primarily to account for resources that are designated for specific programs or activities.
 - They are typically financed by dedicated fees.
 - They account for resources used to pay for national defense.
 - Are included in the Unified federal budget.
17. Which of the following is a true statement regarding which funds are included in the category federal trust funds?
- Old-Age and Survivors Insurance Fund (Social Security) are included.
 - Supplementary Medical Insurance Fund (Medicare) is included.
 - Neither (a) nor (b) are included.
 - Both (a) and (b) are included.
18. Federal government trust funds are
- Composed of funds restricted by the donor/contributor.
 - Like endowment funds—only the income, not the principle, can be expended.
 - Any funds designed by laws as trust funds.
 - Composed of funds that by law are dedicated to certain activities or programs.
19. Which of the following federal fund types is most similar to state or local government's enterprise fund?
- General fund.
 - Special funds.
 - Trust funds.
 - Revolving funds.
20. The U.S. Postal Service is accounted for in which of the following fund types?
- General fund.
 - Special fund.
 - Trust fund.
 - Revolving fund.

21. The Unified Federal Budget was originally intended to include which of the following fund types?
- a) General fund, all special funds, all trust funds, and all revolving funds.
 - b) General fund, all special funds, some trust funds, and all revolving funds.
 - c) General fund, some special funds, some trust funds, and all revolving funds.
 - d) General fund, all special funds, and all revolving funds.
22. Which of the following federal government accounting terms is most similar to an encumbrance, as that term is used in state and local government accounting?
- a) Apportionment.
 - b) Allotment.
 - c) Commitment.
 - d) Obligation.
23. Which of the following federal government accounting terms is most similar to an appropriation, as that term is used in state and local government accounting?
- a) Apportionment.
 - b) Allotment.
 - c) Commitment.
 - d) Obligation.
24. Which of the following is NOT a criterion for a federal “component” to be considered a reporting entity?
- a) There is a management responsible for controlling and deploying the component's outputs and outcomes and for executing its budget. It is held accountable for its performance.
 - b) The component is of sufficient size and significance that its financial statements would provide a meaningful representation of its operations and financial condition.
 - c) The component is of sufficient cohesiveness of operations that its financial statements would provide a meaningful representation of a specific program or type of activity.
 - d) Users are interested in the information to be reported in its financial statements and could use it to make resource allocation and related decisions.
25. The Financial Report of the U.S. Government is prepared on which of the following bases of accounting?
- a) Cash.
 - b) Modified accrual.
 - c) Budgetary.
 - d) Accrual.
26. The U.S. Government Annual Report is prepared on which of the following bases of accounting?
- a) Cash.
 - b) Modified accrual.
 - c) Budgetary.
 - d) Accrual.

27. Which of the following is **NOT** one of the basic financial statements for the federal government-at-large?
- a) Balance sheet.
 - b) Statement of operations and changes in net position.
 - c) Statement of net cost
 - d) Statement of custodial assets.
28. Which of the following is NOT a main section of the Financial Report of the U.S. Government?
- a) Introductory Section including letter of transmittal and MD&A.
 - b) Stewardship Section.
 - c) Supplemental Information Section.
 - d) Statistical Section.
29. Which of the following is NOT a basic financial statement for a federal agency?
- a) Balance Sheet.
 - b) Statement of Budgetary Resources.
 - c) Statement of Financing.
 - d) Statement of Stewardship Assets.
30. The FASAB requires that federal government agencies recognize nonexchange revenue on which of the following bases of accounting?
- a) Cash.
 - b) Modified accrual.
 - c) Accrual.
 - d) Both (a) and (c).
31. If a federal agency should have collected \$400 from a nonexchange revenue source, but it actually collected \$430, the financial statements should reflect
- a) \$400 cash collections plus \$30 accrual adjustment.
 - b) \$430 total revenue.
 - c) \$430 cash collections less \$30 accrual adjustment.
 - d) \$400 revenue.
32. FASAB requires that federal agencies capitalize certain assets. Which of the following assets should be capitalized?
- a) Stewardship assets such as national parks and national forests.
 - b) Assets such as weapons systems and space exploration equipment.
 - c) Heritage assets that have only historical, artistic, or cultural significance.
 - d) Human capital.
33. The FASAB allows entities to value inventories held for sale at which of the following values?
- a) Historical cost, using FIFO.
 - b) Historical cost, using weighted average.
 - c) Latest acquisition cost.
 - d) All of the above.

34. The FASAB allows entities to value inventories held for use at which of the following values?
- Historical cost.
 - Latest acquisition cost.
 - Neither Historical cost nor latest acquisition cost.
 - No value is assigned. Assets held for use are not included on the financial statements.
35. The Allowance for Unrealized Holding Gains that appears in the cost of goods sold section of a federal financial statement effectively does which of the following?
- Adjusts the latest acquisition cost inventory valuation to the historical cost valuation.
 - Increases the cost of goods sold by the increase in market value of the inventory.
 - Decreases the cost of goods sold by the increase in market value of the inventory.
 - Adjusts the historical cost valuation to the latest acquisition cost inventory valuation.
36. The federal government is required to recognize liabilities on nonexchange transactions
- When an exchange takes place.
 - When the event occurs and the anticipated outflows of resources are both probable and measurable.
 - When due.
 - When formally acknowledged and an amount is due and payable as a result.
37. The federal government has declared a specific area a “natural disaster” area making residents of the area eligible for payments from the federal government. When should the liability for such payments be recorded?
- When an exchange takes place.
 - When the event occurs and the anticipated outflows of resources are both probable and measurable.
 - When due.
 - When formally acknowledged and an amount is due and payable as a result.
38. Amounts due to social security beneficiaries should be “booked” (recorded as a liability)
- When an exchange takes place.
 - When the event occurs and the anticipated outflows of resources are both probable and measurable.
 - When due.
 - When formally acknowledged and an amount is due and payable as a result.
39. When the federal government makes a direct loan at an interest rate below the prevailing Treasury rate (a subsidized loan), an asset should be recorded for which of the following amounts?
- The face amount of the loan.
 - The present value of the future principal and interest payments discounted at the stated rate.
 - The present value of the future principal and interest payments discounted at the comparable Treasury rate.
 - No asset should be recorded.

40. When the federal government makes a direct loan at an interest rate below the prevailing Treasury rate (a subsidized loan), an expense should be recorded for which of the following amounts?
- a) The difference between the face value of the loan and the present value of the estimated net cash receipts.
 - b) The difference between the present value of the estimated net cash receipts at the stated rate of interest and the present value of the cash receipts at the prevailing interest rates.
 - c) The fair value of the loans.
 - d) No expense is recognized.
41. When the federal government guarantees a loan made by a private lender, the federal government should record a liability for which of the following amounts?
- a) The face amount of the loan.
 - b) The present value of the anticipated payments to the private lender discounted at the government agency's rate.
 - c) The present value of the anticipated payments to the private lender discounted at the lender's rate.
 - d) No liability should be recorded.
42. The Government Performance and Results Act of 1993 requires federal agencies to do which of the following?
- a) Develop strategic plans and operational objectives.
 - b) Develop measures of performance.
 - c) Report on the extent to which they have met their objectives.
 - d) All of the above.
43. Which of the following differentiates the accounting and reporting for federal government agencies versus state and local governmental entities?
- a) State and local governments use accrual accounting in the proprietary and fiduciary funds as well as government-wide statements; federal agencies use only the cash basis of accounting.
 - b) State and local governments do not account for apportionments and most do not account for allotments.
 - c) The federal government uses a dual-track method of accounting for proprietary accounts and budgetary accounts; state and local governments do not use budgetary accounting.
 - d) The budget is recorded in the general ledger of a state or local government, but not in a federal agency.

PROBLEMS (CHAPTER 16)

1. In the current year, a federal government agency engaged in the following transactions. Prepare journal entries to record the transactions. If no entry is required write "No Entry Required."
 - a. The agency signed a long-term \$400,000 contract to provide management consulting services to small businesses in a depressed area. The government estimates that the total costs incurred in the contract will be \$500,000. During the year, the government incurred costs of \$50,000 and received payment of \$40,000.
 - b. Delivered to a customer \$14,000 of training manuals produced by the government. The amount was added to the customer's account.
 - c. Signed a \$100,000 contract to provide management consulting services for small businesses in the Intermountain area and received payment immediately. During the year, the agency completed 75% of the contract.
 - d. Collected \$200,000 of \$230,000 income taxes due.
 - e. Received a pledge of \$250,000 from an Foundation to support an educational program for children in economically depressed areas.
 - f. During the year the government received \$100,000 from the Foundation. The pledge is not legally enforceable.

2. A federal agency established to provide direct loans for older Americans enrolled in school or college made a 3-year, 3% direct loan of \$1,000 to be repaid in three equal yearly installments of \$353.53. The prevailing Treasury rate on short- and intermediate-term securities is 6%. Prepare journal entries for the loan and the three payments. If no entry is required, write "No Entry Required."

Present value factors, if needed

| | |
|--|-----------|
| Present value of an annuity for 3 periods @ 6% | = 2.67301 |
| Present value of an annuity for 3 periods @ 3% | = 2.82861 |
| Present value of \$1, @ 6%, 3 periods | = .83962 |
| Present value of \$1, @ 3%, 3 periods | = .91513 |

3. A federal agency was established to provide loan guarantees for students. At the beginning of year 1 the agency guarantees \$100,000 of student loans. The payments that the agency estimates it will have to make to lenders as a result of student defaults are as listed below. The agency uses a discount rate of 6 percent. Prepare the necessary journal entry to record the loan guarantee expense in Year 1 and the payment of \$200 to the lenders on defaulted loans in Year 2. If no entry is required, write "No Entry Required."

| Present value factors if needed, at 6% | <u>PV of \$1</u> | <u>PV of an Annuity</u> |
|--|------------------|-------------------------|
| 1 period | .94340 | .94340 |
| 2 periods | .89000 | 1.83339 |
| 3 periods | .83962 | 2.67301 |
| 4 periods | .79209 | 3.46511 |
| 5 periods | .74726 | 4.21236 |

| <i>Estimates made at the end of year 1</i> | | <i>Estimates made at the end of Year 2</i> | |
|--|---------------|--|---------------|
| <u>End of Year</u> | <u>Amount</u> | <u>End of Year</u> | <u>Amount</u> |
| 1 | \$200 | 2 | \$150 |
| 2 | \$100 | 3 | \$ 50 |
| 3 | \$ 50 | | |

4. The federal government general fund reports the following transactions during 2006. Prepare journal entries to record each of these transactions. If no entry is required, write "No Entry Required."
- The general fund contracts with a construction firm to build an Iraqi war memorial based on a design selected by the Iraqi War Veterans Commission. The estimated cost of the project is \$3.5 million.
 - The general fund makes a \$750,000 progress payment on the Iraqi War Memorial contract.
 - The general fund purchases new window treatments for the living areas of the White House. The cost is \$650,000.
 - The general fund reviews and accepts a design for the 2007 White House Christmas ornament. The design cost is \$500,000.
 - The general fund contracts for the manufacture of 1.5 million 2007 Christmas ornaments. The manufacturing cost for each ornament is \$2.00. The ornaments are paid for and will be available for sale in the White House beginning in August 2007.
 - The general fund elects to record its inventory of assets held for sale at historical cost.

ESSAYS (CHAPTER 16)

1. Why is the FASAB named an “advisory board”? What happens if the GAO, Treasury, or OMB rejects one of its standards?
2. One of the major problems encountered by FASAB in setting standards for financial statements for the federal government taken as a whole is how to classify future payments to social security beneficiaries. What are the underlying issues related to social security? How did FASAB resolve the issues? How will social security be presented in the federal government financial statements?
3. One of the more difficult issues to address in state and local governmental accounting is the reporting entity. A similar issue exists at the federal level. Discuss the financial reporting entity issue at the federal level.
4. Currently the federal government maintains a dual system of accounts--budgetary and proprietary accounts. What are the two types of accounts? Why does the federal government keep two types?
5. What is meant by a “unified budget”? Why are Social Security and Postal Service receipts and disbursements not included in the unified budget?

ANSWERS TO TRUE/FALSE (CHAPTER 16)

1. T
2. F
3. F
4. T
5. T
6. T
7. T
8. F
9. F
10. F

ANSWERS TO MULTIPLE CHOICE (CHAPTER 16)

1. C
2. C
3. A
4. B
5. A
6. B
7. C
8. A
9. D
10. B
11. B
12. A
13. B
14. D
15. C
16. C
17. D
18. C
19. D
20. D
21. A
22. D
23. A
24. C
25. D
26. A
27. D
28. D
29. D
30. D
31. C
32. B
33. D
34. A
35. A
36. C
37. D
38. C
39. C
40. A
41. B
42. D
43. D

ANSWERS TO PROBLEMS (CHAPTER 16)

Problem 1

| | | |
|------------------------|-----------|-----------|
| a) Cash | \$40,000 | |
| Loss | \$10,000 | |
| Revenue | | \$50,000 |
| b) Accounts receivable | \$14,000 | |
| Revenue | | \$14,000 |
| c) Cash | \$100,000 | |
| Revenue | | \$75,000 |
| Unearned Revenue | | \$25,000 |
| d) Cash | \$200,000 | |
| Taxes receivable | \$ 30,000 | |
| Revenue | | \$200,000 |
| Accrual adjustment | | \$ 30,000 |
| e) No Entry Required. | | |
| f) Cash | \$100,000 | |
| Contributions revenue | | \$100,000 |

Problem 2

| | | |
|---|----------|------------|
| a) Loan receivable | \$944.99 | |
| Loan subsidy expense | \$ 55.01 | |
| Revenue | | \$1,000.00 |
| (Present value of expected payments discounted at 6 percent— $\$353.33 \times 2.67301 = \944.99) | | |
| b) Cash | \$353.53 | |
| Loan receivable | | \$296.83 |
| Interest revenue | | \$ 56.70 |
| (Simple interest—outstanding balance $\$944.99 \times 6$ percent = $\$55.70$) | | |
| c) Cash | \$353.53 | |
| Loan receivable | | \$314.64 |
| Interest revenue | | \$ 38.89 |
| d) Cash | \$353.53 | |
| Loan receivable | | \$333.52 |
| Interest revenue | | \$ 20.01 |

Problem 3

| | |
|-------------------------------|-------------------------------|
| 200 x .94340 = \$188.68 | 150 x .94340 = \$141.50 |
| 100 x .89000 = \$ 89.00 | 50 x .89000 = <u>\$ 44.50</u> |
| 50 x .83962 = <u>\$ 41.98</u> | <u>\$186.00</u> |
| <u>\$319.66</u> | |

| | | |
|------------------------------|----------|----------|
| Interest expense | \$319.66 | |
| Liability for loan guarantee | | \$319.66 |

[Note: Students may label the expense as “loan guarantee expense,” however, as discussed on page 671 of the text, FASAB requires the expense to be classified as “interest expense.”]

| | | |
|------------------------------|----------|----------|
| Liability for loan guarantee | \$133.66 | |
| Interest expense | \$ 66.34 | |
| Cash | | \$200.00 |

Problem 4

- a. No entry required.
- b.
- | | | |
|---------------------------|-----------|-----------|
| Stewardship asset expense | \$750,000 | |
| Cash | | \$750,000 |
- c.
- | | | |
|----------------------------------|-----------|-----------|
| Capital assets—window treatments | \$650,000 | |
| Cash | | \$650,000 |
- d.
- | | | |
|--------------------------|-----------|-----------|
| Inventory—2007 ornaments | \$500,000 | |
| Accounts payable | | \$500,000 |
- e.
- | | | |
|--------------------------|-------------|-------------|
| Inventory—2007 ornaments | \$3 million | |
| Cash | | \$3 million |
- f. No entry required.

ANSWERS TO ESSAYS (CHAPTER 16)

1. The board is titled “advisory” because technically it has the authority only to recommend accounting standards to the Treasury, the OMB and the GAO — the three agencies through whose combined efforts the board was established by Congress. These agencies have the authority to review and reject any standards issued by the board. If a standard is rejected, the FASAB must continue to work on the standard until it reaches agreement among the three agencies.
2. In the U.S. Government annual report (prepared on the cash basis), Statement of Operations, social security receipts are presented as receipts but are noted as "off-budget". Payments to current social security beneficiaries are listed as outlays on the statement. Because the FASAB has determined that both the federal government at-large and the individual agencies should account for social insurance costs as if they were nonexchange transactions, social security receipts are displayed as revenues and payments to current beneficiaries are shown as expenses in the Financial Report of the U.S. Government (prepared on an accrual basis). The amount for the unfunded actuarial liability for social security does not appear on the balance sheet for either type of presentation.

Social security can be viewed as either a government-sponsored pension plan or a government-managed income redistribution program. If it is considered a pension plan, the underlying transactions are exchange transactions and the unfunded liability should appear on the financial statements. If it is considered an income redistribution program, the underlying transactions are nonexchange transactions and the unfunded liability does not need to appear on the financial statements.

Beginning in 2005, the federal government and its agencies must present a Statement of Social Insurance, which will be subject to audit just as are other basic financial statements. The schedule will be required to present key statistical information about social programs.

[Students may have personal comments about the decision made by FASAB, but then so do many practicing accountants—both government and private-sector.]

3. FASAB was faced with the question of what types of federal entities should be required to issue financial reports. FASAB identified three perspectives within which to categorize the federal government. The first perspective is organization; the second is budget authorization; the third is that of programs and activities.

Organization—Agencies and cabinet level departments are almost too large for their financial statements to be meaningful. Most of the very large departments or agencies are subdivided into many (maybe thousands) of smaller units (some of which are too small for their financial statements to be meaningful).

Budget authorization—Budgets frequently do not correspond to organizational lines. This creates an administrative problem of segregating the financial activities when they are not in the same agencies or departments.

Programs and activities—Just as the budget accounts do not correspond to organizational lines, neither do program and activities.

FASAB established three criteria for a component to be considered a reporting entity. Most top-level departments and agencies would satisfy the criteria but the consolidation of so many unrelated subunits could easily destroy the meaningfulness of the financial statements.

FASAB encouraged flexibility in financial reporting. The three criteria are as follows.

- a) There is a management responsible for controlling and deploying the component's outputs and outcomes and for executing its budget. It is held accountable for its performance.
 - b) The component is of sufficient size and significance that its financial statements would provide a meaningful representation of its operations and financial condition.
 - c) Users are interested in the information to be reported in its financial statements and could use it to make resource allocation and related decisions.
4. The two types of accounts maintained by the federal government are budgetary accounts and proprietary accounts. Budgetary accounts assure that the entity complies with budgetary mandates, does not overspend its appropriations, and is able to fulfill uniform budgetary reporting requirements. Proprietary accounts provide the information for the financial statements based on FASAB standards and are intended to provide an economic, rather than a budgetary, measure of operations and resources. The budgetary accounts are similar to the budgetary accounts kept by state and local governments and the proprietary accounts are similar to conventional revenue, expense, asset, liability, and equity accounts presented in the government-wide financial statements presented by state and local governments.
5. The unified budget encompasses all four types of funds — operating, special, trust and revolving. When it was originally established, it was intended to capture in a single tabulation the effect of all federal activities on the national economy. However, Social Security and Postal Service receipts and disbursements were removed because it was agreed that their disbursements are not subject to federal spending limitations in the way that other programs are.