Long-Term Obligations

Lcdo. Edwin Renán Maldonado, CPA, LL.M.©
Prim. Sem. 2016-17
Textbook: Government and Not-for-Profit Accounting, Granof

- This presentation contains information, in addition to the material prepared and provided by the professor, from the book Government and Not-for-Profit Accounting, 7th. Ed., Granof which is the textbook assigned for the course CONT 4059 – “Contabilidad para Entidades que no son Negocios” at the University of Puerto Rico, Río Piedras Campus.
Long-Term Obligations
Long-Term Obligation

1.1 Objective of Financial Reporting
Long-Term Obligation

1.1 Objective of Financial Reporting

- GASB Concepts Statement No. 1 states:
  - Financial reporting should provide information about the financial and condition of a government entity.
  - Financial reporting should provide information about resources and obligations, both actual and contingent, current and noncurrent.
  - The major financial resources of most governmental entities are derived form the ability to tax an disuse debt. As a result, financial reporting should provide information about tax sources, tax limitations, tax burdens and debt limitations.
Long-Term Obligation

1.2 Accounting for Long-Term Obligations
Long-Term Obligation

1.2 Accounting for Long-Term Obligations

• **Fund accounting**: Modified accrual basis.

• **Government-wide statements**: Accrual basis.

See examples on pages 330 to 332.
Long-Term Obligation
Types of Long-Term Debts
Long-Term Obligation
Types of Long-Term Debts

2.1 General Long-Term Debt
2.1 **General Long-Term Debt**

- General long-term debt is the obligation of the government at large and is thereby backed by the government’s general “full faith and credit” and revenue-raising powers.

- It is distinguished from **revenue debt**, which is secured only by designated revenue streams, such as from utility fees, highway tools, rents, receipts from student loans, and patient billings.
2.1 General Long-Term Debt

- As a general rule, only debts resulting from past transactions for which the government has already received a benefit are recognized.
Long-Term Obligation
Types of Long-Term Debts

2.2 Term versus Serial Bonds
2.2 Term versus Serial Bonds

- **Term Bonds:** A term bond will mature on a single date, perhaps 20 or 30 years in the future.

- **Serial Bonds:** A serial bond, by contrast, will mature in installments over a series of dates on a piecemeal basis, perhaps one-twentieth of the issue will mature each year over a period of 20 years.
Long-Term Obligation
Types of Long-Term Debts

2.3 *Demand Bonds*
2.3 **Demand Bonds**

- Demand bonds are obligations that permit the holder (the lender) to demand redemption within a specified period of time, usually 1 to 30 days after giving notice.

- Although demand bonds may have maturity periods of up to 30 years, their redemption date is not only uncertain but is beyond the issuers’ control.

- Issuers cannot classify them with confidence as long-term obligation because they may have to redeem them at any time. Otherwise, issuers would be overly conservative to classify the bond as short-term obligation.
2.3 Demand Bonds

- Most issuers provide for the possibility of redemption by arranging with a financial institution to convert the bonds to long-term notes.

- In a contract called a take-out agreement, the financial institution promises to lend the issuer sufficient funds to repay the bonds.
2.3 **Demand Bonds**

- GASB Standard

- **Government-wide Statement:** Demands bonds that are exercisable within one year of the balance sheet date, should be reported as a long-term liabilities only in the government-wide statement of net position (not in the balance sheet of a governmental fund) as long as the entity has entered into a take-out agreement that satisfies the following criteria:
  1. It does not expire within one year.
  2. It is not cancelable by the lender or prospective lender during that year.
  3. The lender or prospective lender is financially capable of honoring the take-out agreement.
Long-Term Obligation
Types of Long-Term Debts

2.3 Demand Bonds

• GASB Standard
  • **Governmental Fund**: If the demand bonds do not satisfy these criteria, then they should be **reported as liabilities** of the governmental fund receiving the proceeds. Usually this would be a capital projects fund.
Example 1 – Demand Bonds

- A government issues $20 million of demand bonds and obtains an acceptable take-out agreement from a bank.
Long-Term Obligation
Types of Long-Term Debts

Example 1 – Demand Bonds

- A government issues $20 million of demand bonds and obtains an acceptable take-out agreement from a bank.

GOVERNMENT-WIDE STATEMENTS

<table>
<thead>
<tr>
<th>Date</th>
<th>DESCRIPTION</th>
<th>DR.</th>
<th>CR.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td></td>
<td>20,000,000</td>
<td></td>
</tr>
<tr>
<td>Bond Payable</td>
<td></td>
<td></td>
<td>20,000,000</td>
</tr>
</tbody>
</table>

To record the proceeds of the demand bonds.
Long-Term Obligation
Types of Long-Term Debts

Example 1 – Demand Bonds

- A government issues $20 million of demand bonds and obtains an acceptable take-out agreement from a bank.

<table>
<thead>
<tr>
<th>Date</th>
<th>DESCRIPTION</th>
<th>DR.</th>
<th>CR.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Proceeds from sale of demand bonds</td>
<td>20,000,000</td>
<td>20,000,000</td>
</tr>
</tbody>
</table>

To record the proceeds of the demand bonds (in capital projects or other fund receiving the bond proceeds).
Long-Term Obligation
Types of Long-Term Debts

Example 2 – Demand Bonds

- A government issues $20 million of demand bonds. However, the demand bond do not qualify as long-term debt because the government did not obtain an acceptable take-out agreement.
Example 2 – Demand Bonds

- A government issues $20 million of demand bonds. However, the demand bond do not qualify as long-term debt because the government did not obtain an acceptable take-out agreement.

GOVERNMENT-WIDE STATEMENT

<table>
<thead>
<tr>
<th>Date</th>
<th>DESCRIPTION</th>
<th>DR.</th>
<th>CR.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>20,000,000</td>
<td>20,000,000</td>
<td></td>
</tr>
<tr>
<td>Bond Payable (short-term)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

To record the proceeds of the demand bonds.
Long-Term Obligation
Types of Long-Term Debts

Example 2 – Demand Bonds

- A government issues $20 million of demand bonds. However, the demand bond do not qualify as long-term debt because the government did not obtain an acceptable take-out agreement.

GOVERNMENTAL FUND

<table>
<thead>
<tr>
<th>Date</th>
<th>DESCRIPTION</th>
<th>DR.</th>
<th>CR.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>To record the proceeds of the demand bonds (in capital projects or other fund receiving the bond proceeds).</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bonds Payable (short-term)</td>
<td></td>
<td>20,000,000</td>
<td></td>
</tr>
</tbody>
</table>
Long-Term Obligation
Types of Long-Term Debts

2.4 Bond Anticipation Notes (BANs)
2.4 **Bond Anticipation Notes (BANs)**

- BANs are *short-term notes* issued by the lender with the expectation that they will soon be replaced by long-term *bonds*.
- Governments can issue BANs only after obtaining the necessary voter approval and legislative authorization to issue long-term bonds.
- Their advantage is that BANs enable governments to postpone issuing the bonds in the hope of obtaining more favorable long-term interest rates or to begin work on construction projects without having to wait until they have cleared the lengthy administrative and legal hurdles to issue the bonds.
2.4 **Bond Anticipation Notes (BANs)**

- **GASB Standard**
  - GAAP provides that a government may recognize BANs as long-term obligations if, by the date the financial statements are issued, “all legal steps have been taken to refinance the bond anticipation notes and the intent is supported by an ability to consummate refinancing of the short-term note on a long-term basis.”
Example 1 – Bond Anticipation Notes

- A government issues $3 million of 90-day BANs. The government expects to roll them over into long-term bonds.
Long-Term Obligation
Types of Long-Term Debts

Example 1 – Bond Anticipation Notes

- A government issues $3 million of 90-day BANs. The government expects to roll them over into long-term bonds.

**GOVERNMENTAL FUND**

<table>
<thead>
<tr>
<th>Date</th>
<th>DESCRIPTION</th>
<th>DR.</th>
<th>CR.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td></td>
<td>3,000,000</td>
<td></td>
</tr>
<tr>
<td>Proceeds from sale of BANs</td>
<td></td>
<td></td>
<td>3,000,000</td>
</tr>
</tbody>
</table>

*To record the proceeds of the BANs.*
Long-Term Obligation
Types of Long-Term Debts

Example 1 – Bond Anticipation Notes

- A government issues $3 million of 90-day BANs. The government expects to roll them over into long-term bonds.

<table>
<thead>
<tr>
<th>Date</th>
<th>DESCRIPTION</th>
<th>DR.</th>
<th>CR.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Bond Anticipation Notes (BANs) Payable</td>
<td>3,000,000</td>
<td>3,000,000</td>
</tr>
<tr>
<td></td>
<td>To record the proceeds from the issuance of BANs.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Long-Term Obligation
Types of Long-Term Debts

Example 2 – Bond Anticipation Notes

- A government issues $3 million of 90-day BANs. However, by the time the financial statements were issued, the government was unable to demonstrate the ability to refinance the BANs.
Long-Term Obligation
Types of Long-Term Debts

Example 2 – Bond Anticipation Notes

- A government issues $3 million of 90-day BANs. However, by the time the financial statements were issued, the government was unable to demonstrate the ability to refinance the BANs. Assume the cash was already recorded.

**GOVERNMENTAL FUND**

<table>
<thead>
<tr>
<th>Date</th>
<th>DESCRIPTION</th>
<th>DR.</th>
<th>CR.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Proceeds from the sale of BANs</td>
<td></td>
<td>3,000,000</td>
</tr>
<tr>
<td></td>
<td>Bond Anticipation note (BANs) Payable</td>
<td></td>
<td>3,000,000</td>
</tr>
</tbody>
</table>

*To reclassify the BANs as a short-term fund obligation.*
Long-Term Obligation
Types of Long-Term Debts

Example 2 – Bond Anticipation Notes

- A government issues $3 million of 90-day BANs. However, by the time the financial statements were issued, the government was unable to demonstrate the ability to refinance the BANs. Assume the cash was already recorded.

GOVERNMENT-WIDE STATEMENT

<table>
<thead>
<tr>
<th>Date</th>
<th>DESCRIPTION</th>
<th>DR.</th>
<th>CR.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>NONE, the liability is already recorded since the issuance date.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Long-Term Obligation
Types of Long-Term Debts

2.5 Tax Anticipation Notes (TANs) and Revenue Anticipation Note (RANs)
2.5 Tax Anticipation Notes (TANs) and Revenue Anticipation Note (RANs)

- Governments usually do not receive their taxes or other revenues evenly throughout the year.
- To meet cash and other expenditure needs earlier in the year, governments can issue TANs and RANs or a combination of both known as TRANs – short term notes payable out of specified streams of revenues.
- Like BANs, TANs and RANs are a means of borrowing against expected cash proceeds. However, they will not be converted into long-term instruments. Therefore, they must be accounted for in the funds in which the related revenues will be reported.
- See Example on page 335.
Long-Term Obligation
Types of Long-Term Debts

2.6 Capital Lease
Long-Term Obligation
Types of Long-Term Debts

2.6  **Capital Lease**

- GASB Standard
  - In its Statement No. 13, Accounting for Leases, the GASB has adopted the criteria of a FASB Statement.
  - A capital lease meets any one of the following four (4) conditions:
    - Transfer of ownership at the end of lease.
    - Option to purchase at a bargain price.
    - The lease term is equal to or greater than 75% of the useful life of leased property.
    - The present value of rental and other minimum lease payments equals or exceeds 90% of the Fair Value of the leased property.
  - An operating lease does not meet any of these four requirements.
2.6 Capital Lease

- **GASB Standard**
  - If the lease meets the criteria of a capital lease, then the entity would record (Government-Wide Statement) both the acquired asset and the incurred debt at the present value of the required lease payments, an amount that would ordinarily be equal to the FMV of the property. The government would depreciate the asset over the term of the lease. Each payment of the lease, a portion is attributable to principal and a portion to interest.
  - In a governmental fund, such as the general-fund or a capital projects fund, it would debit an expenditure for the acquisition of the asset and credit “other financing sources – capital lease.”
Long-Term Obligation
Types of Long-Term Debts

Example – Capital Leases

- A Municipality agrees to lease an office building with a remaining economic life of 20 years. The building has a fair market value of $3 million. Based on an interest rate of 6%, annual lease payments are set at $261,554 ($180,000 interests; $81,554 principal).
Example – Capital Leases

- A Municipality agrees to lease an office building with a remaining economic life of 20 years. The building has a fair market value of $3 million. Based on an interest rate of 6%, annual lease payments are set at $261,554 ($180,000 interests; $81,554 principal).

GOVERNMENTAL FUND

<table>
<thead>
<tr>
<th>Date</th>
<th>DESCRIPTION</th>
<th>DR.</th>
<th>CR.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acquisition</td>
<td>Fixed assets (building) expenditure</td>
<td>3,000,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Other financing sources – Capital Lease</td>
<td></td>
<td>3,000,000</td>
</tr>
<tr>
<td></td>
<td>To record the acquisition of an office building under a capital lease.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Example – Capital Leases

- A Municipality agrees to lease an office building with a remaining economic life of 20 years. The building has a fair market value of $3 million. Based on an interest rate of 6%, annual lease payments are set at $261,554 ($180,000 interests; $81,554 principal).

GOVERMENTAL FUND

<table>
<thead>
<tr>
<th>Date</th>
<th>DESCRIPTION</th>
<th>DR.</th>
<th>CR.</th>
</tr>
</thead>
<tbody>
<tr>
<td>First Payment</td>
<td>Debt service expenditure (lease principal)</td>
<td>81,554</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Debt service expenditure (lease interest)</td>
<td></td>
<td>180,000</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
<td>261,554</td>
</tr>
</tbody>
</table>

To record the first lease payment.
Example – Capital Leases

A Municipality agrees to lease an office building with a remaining economic life of 20 years. The building has a fair market value of $3 million. Based on an interest rate of 6%, annual lease payments are set at $261,554 ($180,000 interests; $81,554 principal).

GOVERNMENT-WIDE STATEMENT

<table>
<thead>
<tr>
<th>Date</th>
<th>DESCRIPTION</th>
<th>DR.</th>
<th>CR.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acquisition</td>
<td>Building held under lease</td>
<td>3,000,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Capital lease obligation</td>
<td></td>
<td>3,000,000</td>
</tr>
</tbody>
</table>

To record the acquisition of an office building under a capital lease.
Example – Capital Leases

- A Municipality agrees to lease an office building with a remaining economic life of 20 years. The building has a fair market value of $3 million. Based on an interest rate of 6%, annual lease payments are set at $261,554 ($180,000 interests; $81,554 principal).

GOVERNMENT-WIDE STATEMENT

<table>
<thead>
<tr>
<th>Date</th>
<th>DESCRIPTION</th>
<th>DR.</th>
<th>CR.</th>
</tr>
</thead>
<tbody>
<tr>
<td>First Payment</td>
<td>Capital Lease Obligation</td>
<td>81,554</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Interest Expense</td>
<td>180,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
<td>261,554</td>
</tr>
</tbody>
</table>

To record the first lease payment.
Long-Term Obligation
Types of Long-Term Debts

Example – Capital Leases

- A Municipality agrees to lease an office building with a remaining economic life of 20 years. The building has a fair market value of $3 million. Based on an interest rate of 6%, annual lease payments are set at $261,554 ($180,000 interests; $81,554 principal).

GOVERNMENT-WIDE STATEMENT

<table>
<thead>
<tr>
<th>Date</th>
<th>DESCRIPTION</th>
<th>DR.</th>
<th>CR.</th>
</tr>
</thead>
<tbody>
<tr>
<td>At year End</td>
<td>Depreciation Expense</td>
<td>150,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Accumulated Depreciation</td>
<td></td>
<td>150,000</td>
</tr>
<tr>
<td></td>
<td>To record the first year’s depreciation ($3 million divided by 20 years)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>