



Accounting for General Long-Term Liabilities and Debt Service

Learning Objectives

After studying Chapter 6, you should be able to:

- ⚡ Explain what types of liabilities are classified as general long-term liabilities
- ⚡ Make journal entries in the governmental activities general journal to record the issuance and repayment of general long-term debt
- ⚡ Prepare note disclosures for general long-term debt

Learning Objectives (Cont'd)

- ⚡ Describe the reasons for statutory debt limits and explain the terms *debt margin* and *overlapping debt*
- ⚡ Explain the purpose and types of debt service funds
- ⚡ Describe budgeting for debt service funds and make appropriate journal entries to account for activities of debt service funds

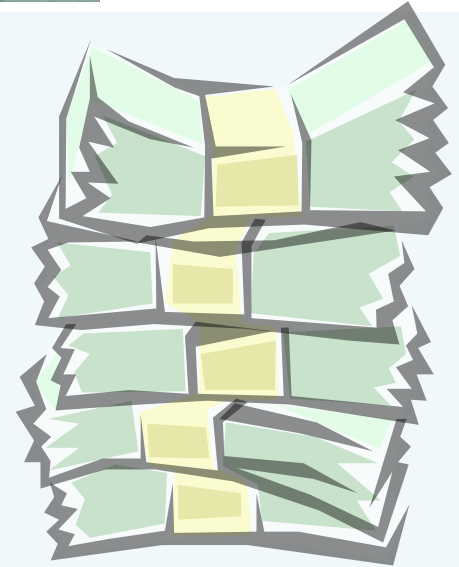
What Are General Long-term Liabilities?

- ❖ **Answer:** Debt and other long-term liabilities that arise from the activities of governmental funds that are *not* accounted for as liabilities of a proprietary or fiduciary fund
- ❖ If debt reported in a proprietary or fiduciary fund also has general obligation (“full faith and credit”) backing the contingent liability should be disclosed in the notes to the financial statements



Examples of General Long-term Liabilities

- ❖ Tax-supported bonds
- ❖ Long-term warrants
- ❖ Long-term notes
- ❖ Capital lease obligations
- ❖ Unfunded compensated absences (vacation and sick leave)
- ❖ Unfunded pension obligations
- ❖ Long-term portion of judgments and claims
- ❖ Pollution remediation obligations



Pollution Remediation Obligation

- ❖ Addressed by GASB *Statement No. 49*
- ❖ Relates to liabilities arising from the clean-up of hazardous waste or hazardous substances resulting from existing pollution
- ❖ Recognize if the liability is reasonably estimable and an obligating event (as defined by GASB) has occurred
- ❖ The liability is measured using expected cash flows

Accounting for General Long-term Liabilities

- ❖ All general long-term liabilities are reported in the Governmental Activities column of the government-wide statement of net assets
- ❖ General long-term liabilities are *not* reported as liabilities of governmental funds
- ❖ A debt service fund (a governmental fund) should be established to account for the principal and interest payments on general long-term liabilities

Terms Used in Describing Debt Burden

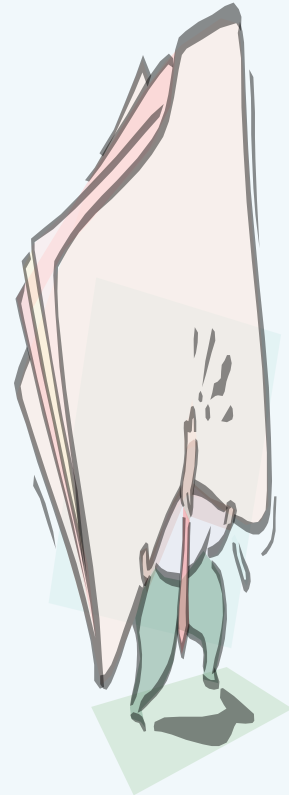
- ❖ *Direct debt*—obligations that will be repaid by the government whose debt is being evaluated
- ❖ *Overlapping (indirect) debt*—obligations of *other* governments that also have the power to tax property located in the jurisdiction of the government whose debt is being evaluated

See III. 6-4



Example—Overlapping Debt

- ❖ In a given city property owners might be taxed by the city, a county government, and an independent school district, among others
- ❖ With respect to the city, the portion of the county's total assessed valuation that lies within the city's boundaries multiplied by the county's debt is the amount of *overlapping debt* of the county borne by city residents



Debt Burden

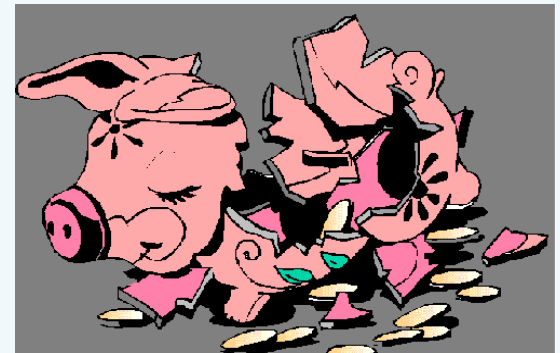
Debt Limit: A ceiling on the amount of debt, defined as a statutory percentage of assessed valuation or some other valuation of taxable property

Debt margin: The difference between the debt limit and the amount of debt outstanding subject to the limit

- ❖ Self-supporting debt being repaid from user charges, such as water or sewer charges, typically are not subject to the limit
- ❖ Usually only *net* debt (debt minus cash available for principal repayment in a debt service fund) is subject to the limit

Debt Burden Measures

- ❖ Debt per capita (ratio of debt to population)
- ❖ Ratio of debt to estimated true value of taxable property
- ❖ Ratio of debt service expenditures to total general expenditures
- ❖ Multiple year trends in the above ratios
- ❖ See Chapter 10 for benchmark values for debt measures



Debt Service Funds

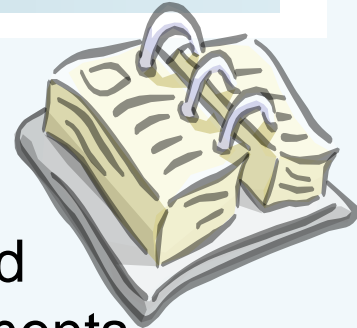
Characteristics of debt service funds (DSF)

- ❖ Account for financial resources set aside for principal and/or interest on *general* long-term liabilities only and payments of said amounts
- ❖ Resources may come from
 - Taxes levied by DSF
 - Taxes levied by the GF and transferred to DSF
 - Special assessments
- ❖ The number of DSF should be held to a minimum; GASB recommends a single DSF for all tax-supported debt serviced by property taxes

Types of Tax-Supported Bonds

Serial bonds

- ❖ Principal matures in annual installments
- ❖ For regular serial bonds, the resources raised each year approximate debt service requirements, thus investments will be minimal. However, any idle cash balances should be invested
- ❖ For deferred serial bonds, some resources are likely to be raised and invested during the years before the first principal payment becomes due
- ❖ Advantage of serial bonds: Self-amortizing; no sinking fund needed



Types of Tax-Supported Bonds (Cont'd)

Term bonds

- ❖ Principal matures in one lump-sum amount at the end of the bond term
- ❖ Not used as frequently for municipal financing as serial bonds
- ❖ Disadvantages of term bonds: Usually requires a sinking fund, and therefore investment management; accounting is more complex for serial bonds

Accounting Principles and Procedures for Debt Service Funds

- ❖ Use modified accrual, with one exception: Expenditures for interest and principal are generally recognized in the period in which they are legally due
- ❖ Budgetary accounting typically is used—except there is no need for encumbrance accounting since the debt service fund does not order goods or enter into contracts for services
- ❖ For serial bonds, the amount budgeted for revenues or interfund transfers in is usually just what is needed that fiscal year for matured principal and interest

Accounting Principles and Procedures for Debt Service Funds (Cont'd)

- ❖ For term bonds (or deferred serial bonds), additional revenues or interfund transfers in are usually budgeted to meet sinking fund requirements, in addition to the amount needed for interest paid during the year
- ❖ Sinking fund investments are reported at fair value at year end. Changes in fair value are reported as a component of investment earnings

Financial Statements/Schedules

- ❖ Combining balance sheet (see III. 6-7)
- ❖ Combining statement of revenues, expenditures, and changes in fund balance (see. III. 6-6)
- ❖ Note disclosures showing all future debt service requirements (both for principal and interest) for all outstanding debt (see III. 6-2)
- ❖ **Note:** Interest to be paid in future periods is not recorded as a liability of the government

Debt Service Fund Example

Assume bonds are issued on January 1, 2011 and pay interest semiannually on January 1 and July 1 in the amount of \$100,000. The fiscal year ends on December 31, 2011

Q: What amount of expenditures would be recognized in fiscal 2011?

A: Only the July 1, 2011 interest payment, or \$100,000, would be recognized as an expenditure of 2011



Accounting Principles and Procedures for Debt Service Funds (Cont'd)

- ❖ If taxes are levied by the debt service fund, record *Estimated Revenues* in the budget entry and use the same property tax accounting as for the General Fund
- ❖ If taxes are levied by the General Fund and transferred to the debt service fund, record *Estimated Other Financing Sources* in the budget entry and *Interfund Transfers In* (an Other Financing Sources account) for the transfer

Illustrative Transactions— Serial Bond DSF

A certain city issued \$100,000 of 6% serial general obligation (G.O.) bonds on Dec. 1, 2010. Interest on the G.O. bonds of \$3,000 is due on June 1, 2011 and December 1, 2011, and in decreasing amounts every June 1 and December 1 for the next 19 years after that. The first principal maturity of \$5,000 is due on December 1, 2011

At Issuance

<i>Governmental Activities:</i>	<u>Dr.</u>	<u>Cr.</u>
Cash	100,000	
Serial Bonds Payable		100,000

Illustrative Transactions— Serial Bond DSF (Cont'd)

The budget approved for FY 2011 requires the General Fund to transfer \$11,000 to the DSF for debt service which includes principal repayment of \$5,000 and two interest payments totaling \$6,000 (\$3,000 each)

<i>Debt Service Fund:</i>	<u>Dr.</u>	<u>Cr.</u>
Estimated Other Financing Sources	11,000	
Appropriations		11,000
Due from General Fund	11,000	
OFS—Interfund Transfers In		11,000

Governmental Activities:

No entry needed

Illustrative Transactions— Serial Bond DSF (Cont'd)

On May 28, 2011, the transfer from the General Fund was received

<i>Debt Service Fund:</i>	<u>Dr.</u>	<u>Cr.</u>
Cash	3,000	
Due from General Fund		3,000

(Note: If OFS-Interfund Transfers In had not been accrued at the time the budget was recorded, then OFS-Interfund Transfers In would be credited here rather than Due from General Fund)

Governmental Activities:

No entry needed

Illustrative Transactions— Serial Bond DSF (Cont'd)

The June 1, 2011, the interest payment was made on schedule

<i>Debt Service Fund:</i>	<u>Dr.</u>	<u>Cr.</u>
Expenditures—Bond Interest	3,000	
Cash		3,000
 <i>Governmental Activities:</i>		
Expenses—Interest on Long-Term Debt	3,000	
Cash		3,000

Illustrative Transactions— Serial Bond DSF (Cont'd)

The remaining \$8,000 transfer was received from the General Fund on November 29, 2011. On December 1, the city paid the interest and principal maturing that date

<i>Debt Service Fund:</i>	<u>Dr.</u>	<u>Cr.</u>
Cash	8,000	
Due From General Fund		8,000
Expenditures—Bond Principal	5,000	
Expenditures—Bond Interest	3,000	
Cash		8,000
 <i>Governmental Activities:</i>		
Expenses—Interest on Long-Term Debt	3,000	
Serial Bonds Payable	5,000	
Cash		8,000

Illustrative Transactions— Serial Bond DSF (Cont'd)

Adjusting entry on December 31, 2011:

<i>Governmental Activities:</i>	<u>Dr.</u>	<u>Cr.</u>
Expenses—Interest on Long-Term Bonds	475	
Accrued Interest Payable		475
(Calculation: 1 month of accrued interest = \$95,000 of remaining bonds X .06 / 12 = \$475)		

Note: Interest is not accrued in debt service fund since no interest is due on December 31

Illustrative Transactions— Serial Bond DSF (Cont'd)

Closing entry on December 31, 2011:

<i>Debt Service Fund:</i>	<u>Dr.</u>	<u>Cr.</u>
Appropriations	11,000	
Estimated Other Financing Sources		11,000
OFS—Interfund Transfers In	11,000	
Expenditures—Bond Principal		5,000
Expenditures—Bond Interest		6,000

Governmental Activities:

Closing entry not shown. All governmental activities temporary accounts would be closed in a single entry to Net Assets—
Unrestricted

Illustrative Transactions—Term Bond Debt Service Fund

- ❖ On January 1, 2010, \$100,000 of 6% term bonds maturing on January 1, 2015 (5 years) were issued
- ❖ The first transfer to a sinking fund will occur on December 31, 2010 and at the end of each following year until December 31, 2014
- ❖ Interest of \$3,000 is due every 6 months on January 1 and July 1
- ❖ Sinking fund investments are estimated to earn 7% per year
- ❖ The General Fund transfers money to the DSF semi-annually for interest and annually for sinking fund investments

NOTE: Governmental activities journal entries are omitted for brevity (see Chapter 6 for these entries)

Illustrative Transactions—Term Bond Debt Service Fund (Cont'd)

Computations: Annual installments rather than the more common semiannual installments are illustrated here for simplicity. Periodic sinking fund additions = $\$100,000 / \text{Future amount of an annuity of 5 periods at 7\% per annum} = 100,000 / 5.750739 = \$17,389$

Sinking Fund Amortization Table

<u>Year</u>	<u>Required Additions</u>	<u>Estimated Earnings</u>	<u>Estimated Increase</u>	<u>Estimated Fund Balance</u>
2010	\$17,389	\$- 0 -	\$17,389	\$ 17,389
2011	\$17,389	1,217	\$18,606	\$ 35,995
2012	\$17,389	2,520	\$19,909	\$ 55,904
2013	\$17,389	3,913	\$21,302	\$ 77,206
2014	\$17,389	5,404	\$22,794	\$100,000

Illustrative Transactions—Term Bond Debt Service Fund (Cont'd)

The budgetary entry at the beginning of year includes the \$17,389 sinking fund addition as well as two interest payments (even though only the July 1, 2010 interest payment is due during the fiscal year ending December 31, 2010)

<i>Debt Service Fund:</i>	<u>Dr.</u>	<u>Cr.</u>
Estimated Other Financing Sources	23,389	
Appropriations		3,000
Budgetary Fund Balance		20,389
Due from GF	23,389	
OFS—Interfund Transfer In		23,389

Illustrative Transactions—Term Bond Debt Service Fund (Cont'd)

Entries for the two transfers during the year from the General Fund and payment of the July 1 interest

Just before 7-1-10

<i>Debt Service Fund:</i>	<u>Dr.</u>	<u>Cr.</u>
Cash	3,000	
Due from General Fund		3,000
Expenditures—Bond Interest	3,000	
Cash		3,000

Just before 12-31-10

Cash	20,389	
Due from General Fund		20,389

Illustrative Transactions—Term Bond Debt Service Fund (Cont'd)

The sinking fund addition is invested on 12-31-10:

<i>Debt Service Fund:</i>	<u>Dr.</u>	<u>Cr.</u>
Investments	17,389	
Cash		17,389

Illustrative Transactions—Term Bond Debt Service Fund (Cont'd)

Closing Entry, 12-31-10

<i>Debt Service Fund:</i>	<u>Dr.</u>	<u>Cr.</u>
Appropriations	3,000	
Budgetary Fund Balance	20,389	
Estimated Other Financing Sources		23,389
OFS—Interfund Transfers In	23,389	
Expenditures—Bond Interest		3,000
Fund Balance		20,389

Illustrative Transactions—Term Bond Debt Service Fund (Cont'd)

Second fiscal year—January 1, 2011:

<i>Debt Service Fund:</i>	<u>Dr.</u>	<u>Cr.</u>
Estimated Other Financing Sources	23,389	
Estimated Revenue—Investment		
Earnings (See amortization table)	1,217	
Appropriations		6,000
Budgetary Fund Balance		18,606
Due from General Fund	23,389	
OFS—Interfund Transfers In		23,389
Expenditures—Bond Interest	3,000	
Cash		3,000

Illustrative Transactions—Term Bond Debt Service Fund (Cont'd)

Entries for the two transfers during 2011 from the General Fund and payment of the July 1 interest

<i>Debt Service Fund:</i>	<u>Dr.</u>	<u>Cr.</u>
<i>Just before 7-1-11</i>		
Cash	3,000	
Due from General Fund		3,000
Expenditures—Bond Interest	3,000	
Cash		3,000
<i>Just before 12-31-11</i>		
Cash	20,389	
Due from General Fund		20,389

Illustrative Transactions—Term Bond Debt Service Fund (Cont'd)

The sinking fund addition was invested on 12-31-11

<i>Debt Service Fund:</i>	<u>Dr.</u>	<u>Cr.</u>
<i>12-31-11</i>		
Investments	17,389	
Cash		17,389

Investment earnings in year 2011 were \$1,517 compared with the budgeted amount of \$1,217, or \$300 more than expected

Investments	1,517	
Investment Earnings		1,517

Illustrative Transactions—Term Bond Debt Service Fund (Cont'd)

<i>Debt Service Fund:</i>	<u>Dr.</u>	<u>Cr.</u>
<i>Closing Entry, 12-31-11</i>		
OFS—Interfund Transfers In	23,389	
Investment Earnings	1,517	
Expenditures—Bond Interest		6,000
Fund Balance		18,906
Appropriations	6,000	
Budgetary Fund Balance	18,606	
Estimated Other Financing Sources		23,389
Estimated Revenues—		
Investment Earnings		1,217

Illustrative Transactions—Term Bond Debt Service Fund (Cont'd)

- ❖ Entries for fiscal years 2012 and 2013 are omitted for brevity; actual investment earnings in those two years were the same as budgeted (see amortization table)
- ❖ Year 2014: The 1-1-14 budgetary entry is the same as in 2011 except that Estimated Revenues—Investment Earnings is the amount shown in the amortization table. The 1-1-14 and 7-1-14 interest payments are the same as in 2011
- ❖ Journal entries for the interfund transfer from the General Fund on 12-31-14, and the 1-1-15 budgetary entry and other transactions are shown on next two slides

Illustrative Transactions—Term Bond Debt Service Fund (Cont'd)

The entry for the final transfer from the General Fund just before 12-31-14 is shown below:

<i>Debt Service Fund:</i>	<u>Dr.</u>	<u>Cr.</u>
Cash	20,389	
Due from General Fund		20,389

Actual investment earnings for 2014 were \$5,604 compared with a budgeted amount of \$5,404

Investments	5,604	
Investment Earnings		5,604

(Closing entry omitted; see year 2011 for example)

Illustrative Transactions—Term Bond Debt Service Fund (Cont'd)

On 1-1-15

The final budgetary entry for FY 2015 is:

<i>Debt Service Fund:</i>	<u>Dr.</u>	<u>Cr.</u>
Budgetary Fund Balance	103,000	
Appropriations		103,000

Disinvestment, assuming a cumulative favorable earnings variance of \$500, amounts to \$83,111. This amount plus the cash received but not invested near the end of FY 2014 of \$20,389, totals \$103,500. After the final interest payment and debt retirement, there will be a \$500 fund equity

Cash	83,111	
Investments		83,111

Illustrative Transactions—Term Bond Debt Service Fund (Cont'd)

1-1-15

<i>Debt Service Fund:</i>	<u>Dr.</u>	<u>Cr.</u>
<i>Payment of final interest and bond retirement</i>		
Expenditures—Bond Principal	100,000	
Expenditures—Bond Interest	3,000	
Cash		103,000
<i>Closing entry</i>		
Appropriations	103,000	
Budgetary Fund Balance		103,000
Fund Balance	103,000	
Expenditures—Bond Principal		100,000
Expenditures—Bond Interest		3,000

Illustrative Transactions—Term Bond Debt Service Fund (Cont'd)

1-1-15

All debt having been repaid, the balance of \$500 is transferred to the General Fund and the fund is closed:

<i>Debt Service Fund:</i>	<u>Dr.</u>	<u>Cr.</u>
Other Financing Uses—		
Interfund Transfers Out	500	
Cash		500
Fund Balance	500	
Other Financing Uses—Interfund		
Transfers Out		500

Special Assessment Debt Service Funds

- ❖ Account for debt service for special assessment debt in a debt service fund when the government is obligated in some manner for the debt
- ❖ If the government is not obligated in some manner, an agency fund is used to account for both the debt and the debt service

Special Assessment Debt Service Funds (Cont'd)

Example: \$1,000,000 of special assessments were levied on property owners in a special benefit district, payable in 10 equal annual installments of \$100,000 each

<i>Debt Service Fund:</i>	<u>Dr.</u>	<u>Cr.</u>
Assessments Receivable—Current	100,000	
Assessments Receivable—Deferred	900,000	
Revenues		100,000
Deferred Revenues		900,000

Governmental Activities:

Not shown here—see Chapter 6

Special Assessment Debt Service Funds (Cont'd)

Assume all Assessments Receivable—Current were collected during the fiscal year, along with 8% of interest on the previous unpaid balance. The entry is:

<i>Debt Service Fund:</i>	<u>Dr.</u>	<u>Cr.</u>
Cash	180,000	
Assessments Receivable—Current		100,000
Revenues		80,000

Special Assessment Debt Service Funds (Cont'd)

Bond principal of \$100,000 and interest of 8% were paid on schedule:

<i>Debt Service Fund:</i>	<u>Dr.</u>	<u>Cr.</u>
Expenditures—Bond Principal	100,000	
Expenditures—Bond Interest	80,000	
Cash		180,000

Special Assessment Debt Service Funds (Cont'd)

At year-end, the following reclassification entries would be made:

<i>Debt Service Fund:</i>	<u>Dr.</u>	<u>Cr.</u>
Assessments Receivable—Current	100,000	
Assessments Receivable—Deferred		100,000
Deferred Revenues	100,000	
Revenues		100,000

Liabilities Arising from Capital Lease Agreements

The acquisition of a long-lived asset through a capital lease was shown in Chapter 5. The general long-term liability arising from that capital lease is recorded by the following entry in the governmental activities journal at the government-wide level:

<i>Governmental Activities:</i>	<u>Dr.</u>	<u>Cr.</u>
Equipment	50,000	
Capital Lease Obligation Payable		50,000

Capital Lease Agreements (Cont'd)

See illustrated transactions in Chapter 6

Assume for a particular capital lease the unpaid lease obligation at the beginning of the year was \$57,590 and a \$10,000 lease payment is made at the end of each year. If the lease has an implicit interest rate of 10% per annum, the end of year payment would be recorded as follows:

<i>Debt Service Fund:</i>	<u>Dr.</u>	<u>Cr.</u>
Expenditures—Interest		
on Capital Lease (.10 X \$57,590)	5,759	
Expenditures—Principal of Capital		
Lease Obligation	4,241	
Cash		10,000

Debt Refunding Transactions



Entries in DSF—Assume that because of reduced market rates of interest, \$100,000 of previously issued bonds are refunded by a new \$100,000 bond issue with lower interest payments

When refunding (new) bonds are issued:

<i>Debt Service Fund:</i>	<u>Dr.</u>	<u>Cr.</u>
Cash	100,000	
Other Financing Sources—		
Proceeds of Bonds		100,000

If old bonds are not retired by the end of the fiscal year, both issues would be reported as long-term debt in governmental activities

Debt Refunding Transactions (Cont'd)

Assuming old bonds are retired shortly after issue of refunding bonds:

<i>Debt Service Fund:</i>	<u>Dr.</u>	<u>Cr.</u>
Other Financing Uses—Refunded Bonds	100,000	
Cash		100,000

(Note: Report only the new issue as debt in governmental activities)

Advance Refundings

- ❖ Legal and in-substance defeasance
- ❖ Journal entries are similar to those for regular refundings shown on preceding slide
- ❖ Old liability is removed from governmental activities

Concluding Comments

- ❖ A debt service fund is a governmental fund type, that focuses on current financial resources using the modified accrual basis of accounting. However, matured principal and interest on debt are usually recognized in the period due
- ❖ Budgetary accounting is normally used although there is no need to use encumbrance accounting
- ❖ Serial bond, special assessment, and capital lease debt service funds typically expend each year nearly all revenues or other financing sources provided
- ❖ Term bond debt service funds involve more complex accounting because of sinking fund investments

END