Question 1 of 25

Which of the following is the basic governmental fund accounting equation?

A. Assets + Deferred outflows − Liabilities − Deferred inflows = Net position

B. Assets − Liabilities = Fund balance

C. Current assets + Deferred Inflows − Current liabilities − Deferred Outflows = Fund balance

D. Current assets + Deferred outflows − Current liabilities − Deferred Inflows = Fund balance ✓

Explanation:

Governmental funds: General balance sheet presentation	
Current assets	✓
Deferred outflows	✓
Long-term assets	X
Current liabilities	✓
Deferred inflows	✓
Long-term liabilities	X
Fund balances	✓
Equity	X
Retained earnings	X

Governmental funds (eg, general fund) are used to account for the general and administrative activities of a government entity. These funds are *budgetary* in nature and use a unique accounting system called **modified accrual accounting**.

Modified accrual combines elements of both accrual-basis and cash-basis accounting. The basic governmental fund accounting equation is **Current financial assets + Deferred outflows − Current financial liabilities – Deferred inflows = Fund balance**.

Under modified accrual, governmental fund *long-term assets and long-term liabilities* are not part of the fund balance, as they are future, **unavailable** items and, therefore, *are not*

accrued. Items such as current assets/liabilities and deferred outflows/inflows are current and, therefore, *are* accrued **(Choices B and C)**.

(Choice A) Assets + Deferred outflows − Liabilities − Deferred inflows = Net position is the accounting equation for **proprietary funds**, which use accrual accounting.

Things to remember:
Governmental funds use a unique accounting system called modified accrual accounting. Only currently available items are accrued (including deferred outflows and inflows); long-term assets/liabilities are not accrued. The basic governmental fund accounting equation is: Current assets + Deferred outflows − Current liabilities − deferred inflows = Fund balance.

Question 2 of 25

In the year a city enters into a capital lease to finance a new fire engine, the General Fund will report the purchase in its funds-level financial statements as an

A. Increase in capital assets.

B. Long-term liability for the present value of future lease payments.

C. Other financing source. ✓

D. Other financing use.

Explanation:

Governmental funds: classification of financial inflows	
Revenues	• All financial inflows not classified as other financing sources • Examples include taxes, fines, licenses, permits, charges for services, grants, voluntary donations
Other financing sources	• Certain financial inflows, excluding revenues • Examples include transfers in from other funds and proceeds of long-term borrowings

In governmental accounting, the purchase or lease of a long-lived asset for a governmental fund (which uses modified accrual accounting) requires recording a **one-time outflow** called an **expenditure** for the asset's full amount. The asset is neither capitalized nor depreciated over time (ie, no matching principle).

The **source** of the funds for the lease must be reported on the General Fund fund-level F/S. In this scenario, the funds for the lease are not from a revenue stream such as taxes, fines, or licenses. As such, the source of the financial inflow for the lease is classified as an **other financing source** at the lease's inception.

(Choice A) Governmental funds do not report long-term assets on fund-level financial statements.

(Choice B) Governmental funds do not report long-term liabilities on fund-level financial statements.

(Choice D) The "use" of the funds is to lease a fire truck.

Things to remember:
In governmental accounting, purchasing or leasing a long-lived asset for a governmental fund (ie, modified accrual accounting) requires recording a one-time outflow called an expenditure for the asset's full amount. The source of the financial inflow for the lease is classified as an other financing source.

Question 3 of 25

Rodder, Inc. manufactures a component in a router assembly. The selling price and unit cost data for the component are as follows:

Selling price	$15
Direct materials cost	3
Direct labor cost	3
Variable overhead cost	3
Fixed manufacturing overhead cost	2
Fixed selling and administration cost	1

The company received a special one-time order for 1,000 components. Rodder has an alternative use for production capacity for the 1,000 components that would produce a contribution margin of $5,000. What amount is the lowest unit price Rodder should accept for the component?

A. $9.

B. $12.

C. $14. ✓

D. $24.

Explanation:

(Choice A) This is the minimum price required to break even, as it equals the total variable cost of $9. Selling the units at breakeven is not appropriate, as the alternative use provides a contribution margin of $5 per unit ($5,000/1,000 units).

(Choice B) This number represents the total of the variable costs and allocated fixed costs. Allocated fixed costs should not be considered in a pricing decision of this type.

(Choice C) This price covers the total variable cost of $9 and provides a contribution margin equal to that of the alternative use ($14-$9 = $5 CM per unit; $5,000/1,000 units = $5 CM per unit).

(Choice D) This price is too high to serve as the lowest acceptable price, as it produces a contribution margin of $15 per unit ($24 - $9 = $15) or a total contribution of $15,000. This is substantially more than the contribution margin provided by the alternative use.

Question 4 of 25

Which of the following scenarios would encourage a company to use short-term loans to retire its ten-year fixed-rate callable bonds that have five years until maturity?

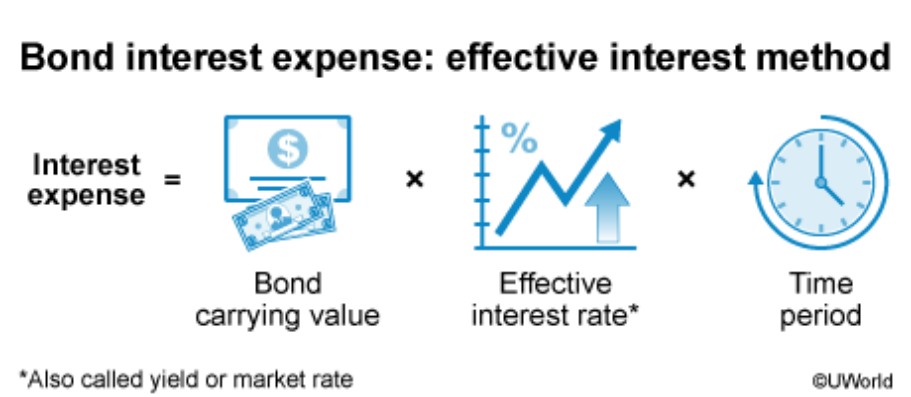
A. Interest rates have declined over the last five years. ✓

B. Interest rates have increased over the last five years.

C. The company expects interest rates to increase over the next five years.

D. The company is experiencing cash flow problems.

Explanation:



Refinancing means **replacing existing debt** (eg, loans, bonds, notes) with new debt instruments. Ideally, these new debt instruments should benefit the entity with better terms or features that improve the entity's overall financial situation. A **reduction in interest expense** over the course of a loan is a common goal of refinancing.

If interest rates have declined over the last five years, a company could obtain short-term loans at a **lower interest rate** than that of its existing older, fixed-rate debt. Thus, a company would be encouraged to replace the outstanding fixed-rate bonds with short-term borrowings that have a lower interest cost, resulting in a **lower overall interest expense**.

(Choices B and C) If interest rates have increased over the last five years or are expected to rise over the **next** five years, a company would not replace a long-term fixed-rate debt with short-term loans at a higher rate.

(Choice D) If a firm is experiencing cash flow problems, it might not be able to obtain short-term borrowings. If a loan can be obtained, the loan's interest rate would most likely be higher than the market rate.

Things to remember:
If interest rates have declined over the last five years, a company could obtain new short-term loans at an interest rate lower than that of the existing older fixed-rate debt. Replacing the high-interest-rate debt with lower-interest-rate debt will result in a lower overall interest expense.

Question 5 of 25

A corporation is in the final stages of developing a computer software program that will be sold to the general public. The company's costs related to the software are as follows:

Development of a working model of the software	$4 million
Customer support	2 million
Product master production	1 million

The costs associated with the product master production were incurred after the establishment of technological feasibility. What amount, if any, should the corporation expense against earnings?

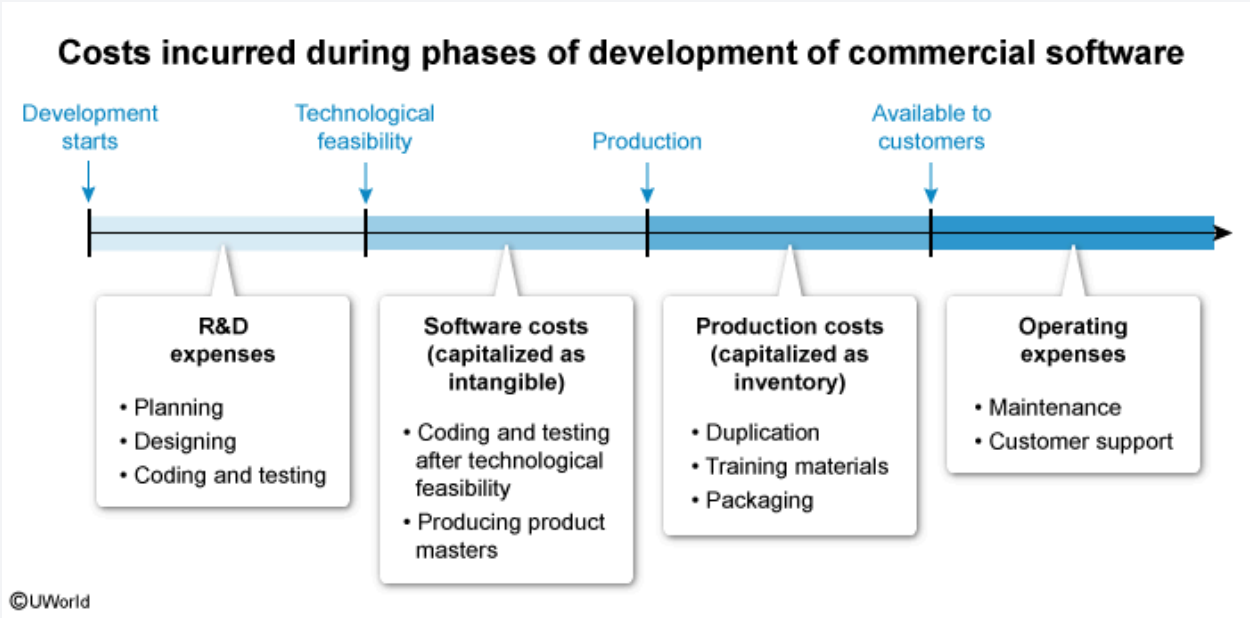
A. $6 million. ✓

B. $5 million.

C. $4 million.

D. $0

Explanation:



Costs associated with developing commercial software (ie, software not exclusively for internal use) are accounted for based on the program's development timeline and technological feasibility. Technological feasibility is the point at which the software *can be produced* to meet its intended purpose (ie, a working prototype exists). These costs are accounted for as follows:

- Costs incurred **prior to technological feasibility** are **expensed** as research and development (**R&D**).
- Costs incurred after technological feasibility and before sales begin are capitalized (ie, an intangible asset).

- Costs incurred **after sales begin** are generally **expensed** as non-R&D **operating** expenses.

The $4 million of working model development costs will be expensed as R&D because they occurred prior to technological feasibility. The $2 million of customer support costs were incurred *after* sales began and are considered ongoing operational expenses. The corporation will **expense** a total of **$6 million** of software costs.

(Choice B) Expense of $5 million includes product master costs ($1 million) and excludes customer support costs. The former occurs after technological feasibility and before customer availability and is *capitalized*.

(Choice C) Expense of $4 million excludes the customer support costs.

(Choice D) Expense of $0 assumes all the software costs should be capitalized.

Things to remember:
Technological feasibility is the point at which commercial software has a working prototype. Software costs incurred prior to technological feasibility are expensed as research and development; costs incurred after technological feasibility but before sales begin are capitalized; and costs incurred after sales begin are generally expensed as operating expenses.

Question 6 of 25

An asset with a market value of $125,000 and a cost of $110,000 is leased on January 1, Year 1. The lease is a sales-type lease for the lessor. Five annual lease payments are due on January 1 beginning in Year 1. The asset will have no residual value. The lessor sets a rate of return of 6%.

Present value factor of an ordinary annuity for five years at 6%	4.21236
Present value factor of an annuity due for five years at 6%	4.46511
Present value factor of a single sum for a five-year term at 6%	.74726

What amount will the lessor charge the lessee in annual lease payments?

A. $25,000

B. **$27,995** ✓

C. $29,675

D. $93,408

Explanation:

Types of leases recorded by lessor	
Sales-type lease (with or without selling profit)	Lease meets one of the five criteria for a finance lease: • Derecognize leased asset (similar to a sale) • Record net investment in lease equal to PV of lease payments plus PV of any residual value guarantee • Record profit equal to difference between lease receivable and leased asset's carrying value • Recognize interest income over lease term
Operating lease	Lease does not meet any of the criteria for a finance lease (similar to renting) • Recognize lease payments as revenue on straight-line basis
Direct financing lease *(very rare)*	Lease does not meet any of the criteria for a finance lease but is *not an operating lease* because the following conditions exist: • Collectability of lease payments is probable • Residual value guaranteed by a compensated third party (insurance company) • PV of payments plus PV of guaranteed residual value constitutes substantially all the leased asset's FV

The five criteria a lessor uses to identify a **sales-type lease** are the same criteria used by a lessee to identify a finance lease. A **sales-type lease** is a lease in which the ownership and associated responsibilities are transferred from the lessor to the lessee.

The lessor:

- Removes (ie, derecognizes) the leased asset from its balance sheet,
- Calculates the net investment in the lease as the lease receivable (ie, PV of lease payments) plus the PV of any residual value guarantee, and
- Recognizes profit as the net investment in the lease less the leased asset's carrying value (CV).

For the **lessor**, lease payments are calculated by dividing the market value of the leased asset by the appropriate present value (PV) factor. In this example, the PV for an annuity due is appropriate because the first payment is made at the beginning of the payment interval. Thus, the appropriate calculation is $125,000 / 4.46511 = **$27,995**, meaning that lease payments will be $27,995 each.

(Choice A) A lease payment of $25,000 is equal to the market value of the asset divided by the number of years in the lease.

(Choice C) A lease payment of $29,675 is equal to the market value of the asset divided by the PV factor of an ordinary annuity.

(Choice D) A lease payment of $93,408 is equal to the market value of the asset multiplied by the PV factor of a single sum.

Things to remember:
For lessors engaging in a *sales-type lease*, annual lease payment amounts are calculated by dividing the market value of the leased item by the appropriate present value (PV) factor. The PV factor is a function of timing and number of payments as well as the interest rate.