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Accounting for government and non profit entities

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Brief Contents

CHAPTER ONE

INTRODUCTION TO FINANCIAL REPORTING GOVERNMENTAL AND NFP ENTITIES

Learning Objectives

After studying this chapter, you should be able to:

- Identify and explain the characteristics that distinguish governmental and not-for-profit entities from for-profit entities.
- Identify the authoritative bodies responsible for setting financial reporting standards for (1) state and local governments, (2) the federal government, and (3) not-for-profit organizations.
- Contrast and compare the objectives of financial reporting for (1) state and local governments, (2) the federal government, and (3) not-for-profit organizations.
- Explain the minimum requirements for general purpose external financial reporting for state and local governments and how they relate to comprehensive annual financial reports.
- Explain the different objectives, measurement focus, and basis of accounting of the government-wide financial statements and fund financial statements of state and local government

1.1. Introduction

Welcome to the strange new world of accounting for governmental and not-for-profit organizations! Initially, you may find it challenging to understand the many new terms and concepts you will need to learn. Moreover, if you are like most readers, you will question at the outset why governmental and not-for-profit organizations find it necessary to use accounting practices that are very different from those used by for-profit entities.

As you read this first chapter of the course, the reasons for the marked differences between governmental and not-for-profit accounting and for-profit accounting should become apparent. Specifically, governmental and not-for-profit organizations serve entirely different purposes in society than do business entities. Furthermore, because such organizations are largely financed by taxpayers, donors, and others who do not expect benefits proportional to the resources they provide, management has a special duty to be accountable for how those resources are used in providing services. Thus, the need to report on management's accountability to citizens, creditors, oversight bodies, and others has played a central role in shaping the accounting and reporting practices of governmental and not-for-profit organizations.

This first chapter will give you a basic conceptual foundation for understanding the unique characteristics of these organizations and how their accounting and financial reporting concepts and practices differ from those of for-profit organizations. By the time you finish subsequent chapters assigned for your course, you should have an in-depth practical knowledge of governmental and not-for-profit accounting and financial reporting.

1.2. What Are Governmental and Not-for-Profit Organizations?

Governmental and not-for-profit organizations are vast in number and range of services provided. In many countries, governments exist at the federal, state, and local levels and serve a wide variety of functions.

States, counties, municipalities (for example, cities and villages), and townships are **general purpose governments -** governments that provide many categories of services to their residents (such as police and fire protection; sanitation; construction and maintenance of streets, roads, and bridges; and health and welfare). Independent school districts, public colleges and universities, and special districts are **special purpose governments** - governments that provide only a single function or a limited number of functions (such as education, drainage and flood control, irrigation, soil and water conservation, fire protection, and water supply). Special purpose governments have the power to levy and collect taxes and to raise revenues from other sources as provided by state laws to finance the services they provide.

Not-for-profit organizations also exist in many forms and serve many different functions. These include private colleges and universities, various kinds of health care organizations, certain libraries and museums, professional and trade associations, fraternal and social organizations, and religious organizations.

The major types of government and nonprofit organizations may be classified as:

1. **Governmental:** federal, state, county, municipal, township, village, and other local governmental authorities and special districts.
2. **Educational:** kindergarten, elementary and secondary schools, vocational and technical schools, and colleges and universities.
3. **Health and welfare:** hospitals, nursing homes, child protection agencies, the American red Cross, and United Service Organizations (USO)
4. **Religious:** Young Men's Christian Association (YMCA), Young Women's Christian Association (YWCA), Salvation Army, and other church-related organizations.
5. **Charitable:** United Way, Community Chest, and similar fund-raising agencies; related charitable agencies; and other charitable organizations.
6. **Foundations:** private trusts and corporations organized for educational, religious, or charitable purposes.

This general classification scheme has much overlap among the classifications. Many charitable organizations are operated by churches, for example, and governments are deeply involved in education, health, and welfare activities.

1.3. Distinguishing Characteristics of Governmental and Not-for-Profit Entities

Governmental and not-for-profit organizations differ in important ways from business organizations. Not surprisingly then, accounting and financial reporting for governmental and not-for-profit organizations is markedly different from accounting and financial reporting for businesses.
An understanding of how these organizations differ from business organizations is essential to understanding the unique accounting and financial reporting principles that have evolved for governmental and not-for-profit organizations.
Broad generalizations about such a diversified group as G&NP organizations are difficult. Nonetheless, the major differences arise from differing:

1) **Organizational Objectives**

Expectation of income or gain is the principal factor that motivates investors to provide resources to profit-seeking enterprises. But the objective of most governmental and nonprofit organizations is to provide as much service each year as their financial and other resources permit. G&NP organizations typically operate on a ***year-to-year basis***—that is, each year they raise as many financial resources as necessary and expend them in serving their constituencies. They may seek to increase the amount of resources made available to them each year—and most do—but the purpose is to enable the organization to provide more or better services, not to increase its wealth.

In sum, private businesses seek to increase their wealth for the benefit of their owners; G&NP organizations seek to expend their available financial resources for the benefit of their constituency**.** Financial management in the G&NP environment thus typically focuses on acquiring and using financial resources—up on sources and uses of expendable financial resources (working capital), budget status, and cash flow—rather than on net income or earnings per share. Even G&NP entities whose external financial reports do not require primary emphasis on acquisition and use of financial resources emphasize this information for internal reporting and management decision-making purposes.

2) **Sources of Financial Resources**

The sources of financial resources differ between business and G&NP organizations, as well as among G&NP organizations. In the absence of a net income objective, no distinction generally is made between invested capital and revenue of G&NP organizations. A dollar is a financial resource whether acquired through donations, user charges, sales of assets, loans, or some other manner.
The typical non-debt sources of financial resources for business enterprises are **investments by owners and sales of goods or services to customers.** These sources of financing usually are not the primary sources of G&NP organization financial resources.

Governments have the unique power to force involuntary financial resource contributions through taxation−of property, sales, and income−and all levels rely heavily on this power. Grants and shared revenues from other governments also are important state and local government revenue sources, as are charges levied for goods or services provided, such as utilities.
Religious groups and charitable organizations usually rely heavily on donations, although they may have other revenue sources. Some colleges and universities rely heavily on donations and income from trust funds; others depend primarily on state appropriations and/or tuition charges for support.

Hospitals generally charge their clientele, although few admit their patients solely on the basis of ability to pay. Indeed, many G&NP hospitals serve numerous charity patients and/or have large amounts of uncollectible accounts; and some hospitals rely heavily on gifts and bequests.

There are other, more subtle, differences in sources of G&NP organization financial resources as compared with profit-seeking businesses. For example,

- Many services or goods provided by these organizations are monopolistic in nature, and there is no open market in which their value may be objectively appraised or evaluated.
- User charges, where levied, usually are based on the cost of the goods or services provided rather than on supply-and demand-related pricing policies common to private enterprise.
- Charges levied for goods or services often cover only part of the costs incurred to provide them; for example, tuition generally covers only a fraction of the cost of operating state colleges or universities, and token charges (or no charges) may be made to a hospital's patients.

3) Regulation and Control

The operation of most business enterprise is usually regulated by the **market;** i.e., the interaction of demand and supply. In the business environment, there exist a direct relationship between the financial resources each consumer provides and the goods or services that consumer receives from enterprise essentially dictates the type and quality of goods or services each profit-seeking enterprise will provide. Firms with responsive management will be profitable and will continue in the market. Firms with unresponsive management will be unprofitable and ultimately will be forced out of business. Therefore, the profit motive and profit measurement constitute an automatic allocation and regulating device in the free enterprise segment of our economy.

This profit test/regulator device is not present in the usual G&NP situation, and most G&NP organizations must strive to attain their objectives without its benefits. In addition, as noted earlier, many G&NP organizations provide goods or services having no open market value measurement by which to test consumer satisfaction. This problem exists because the goods or services are unique or are provided to some or all consumers without charge, or at a token charge. Thus, these consumers have no "dollar vote" to cast.

Evaluating the performance and operating results of most G&NP organizations is extremely difficult for the several reasons.

1. There is no open market supply and demand test of the value of the goods or services they provide.
2. The relationship, if any, between the resource contributors and the recipients of the goods and services is remote and indirect.
3. Such organizations are not profit oriented in the usual sense and are not expected to operate profitably; thus, the profit test is neither a valid performance indicator nor an automatic regulating device.
4. Governments can force resource contributions through taxation.

Accordingly/due to the above reasons, other operating results measures and controls must be employed to ensure that G&NP organization resources are used appropriately and to prevent uneconomical or ineffective G&NP organizations from continuing to operate in that manner indefinitely. Governmental and nonprofit organizations, particularly governments, are therefore subject to more stringent legal, regulatory, and other controls than are private businesses.

All facets of a G&NP organization`s operations may be affected by legal or quasi-legal requirements (1) imposed externally, such as by federal or state statue, grant regulations, or judicial decrees, or (2) imposed internally by charter, bylaw, ordinance, trust agreement, donor stipulation, or contract. Furthermore, the need to ensure compliance with such extensive legal and contractual requirements often results in more stringent operational and administrative controls that in private enterprise.

4) Ownership Interest

G and NP organizations are usually owned collectively by their constituents. Ownership is not evidenced by equity shares that can be sold or traded. Because of this feature, there is no equity interest to be sold or traded. This implies that ownership interest is not clearly defined. *In general, absence of defined ownership interests that cannot be sold, transferred, or redeemed, or that convey entitlement to a share of a residual distribution of resources in the event of liquidation of the organization characterizes most G&NFP organization.*

But for profit seeking enterprises, ownership interest is clearly defined which can be sold or traded or transferred to other parties. A business enterprise might either be owned by a sole proprietor or partners or stockholders who they do have the right to sell or transfer their ownership interest to other parties.

5) Cost-Benefit Relationship

Those contributing resources (donors or taxpayers) do not necessarily receive an equivalent or proportionate share of the government`s or not-for-profit organization`s goods or services. Someone may contribute more but may receive less or nothing. On the contrary, others may contribute less or nothing but may earn more. For example, welfare recipient (probably) did not pay the taxes from which welfare benefit are paid. However, there exist a direct relationship between costs and benefits in profit-seeking organizations. This implies that those who are capable of afford (incur) more costs are entitled to get a proportionate more benefits. Moreover, resource contributors (creditors and owners) can receive equity interest in the net assets of the organization.

6) Scope of Operations

The scope of operation of G&NFP organizations, especially for governmental organizations, is mostly diversifies. i.e., they are engaged in a wide area of activity. For example, consider the city municipality of Adigrat. Its common operations cover health, security, administration, investments, construction, and others. Relatively speaking, the operation or area of activity of profit-seeking organizations is more specific. Based on their activity, we may categorize a given business entity in a service, a merchandising or a manufacturing classification.

Due to the above characteristics and characteristics, which would be discussed in the subsequent sections, there is a need of complex accounting treatment for G&NFP organizations as compared to profit-seeking organizations.

In its Statement of Financial Accounting Concepts No. 4,the Financial Accounting Standards Board (FASB) emphasized and noted the following characteristics that it felt distinguished governmental and not-for-profit entities from business organizations:

A. Receipts of significant amounts of resources from resource providers who do not expect to receive either repayment or economic benefits proportionate to the resources provided.
B. Operating purposes that are other than to provide goods or services at a profit or profit equivalent.

C. Absence of defined ownership interests that can be sold, transferred, or redeemed, or that convey entitlement to a share of a residual distribution of resources in the event of liquidation of the organization.

In the Governmental Accounting Standards Board (GASB) view, accounting and financial reporting standards for governments must be separate and distinct from those for business organizations because the needsof users of financial reports are unique and different

The **Governmental Accounting Standards Board (GASB)** further distinguishes governmental entities from not-for-profit entities and from businesses by stressing that governments exist in an environment in which the power ultimately rests in the hands of the people. Voters delegate that power to public officials through the election process. The power is divided among the executive, legislative, and judicial branches of the government so that the actions, financial and otherwise, of governmental executives are constrained by legislative actions, and executive and legislative actions are subject to judicial review. Further constraints are imposed on state and local governments by the existence of the federal system in which higher levels of government encourage or dictate activities by lower levels and finance the activities (partially, at least) by an extensive system of intergovernmental grants and subsidies that require the lower levels to be accountable to the entity providing the resources, as well as to the citizenry. Revenues raised by each level of government come, ultimately, from taxpayers. Taxpayers are required to serve as providers of resources to governments even though they often have very little choice about which governmental services they receive and the extent to which they receive them.

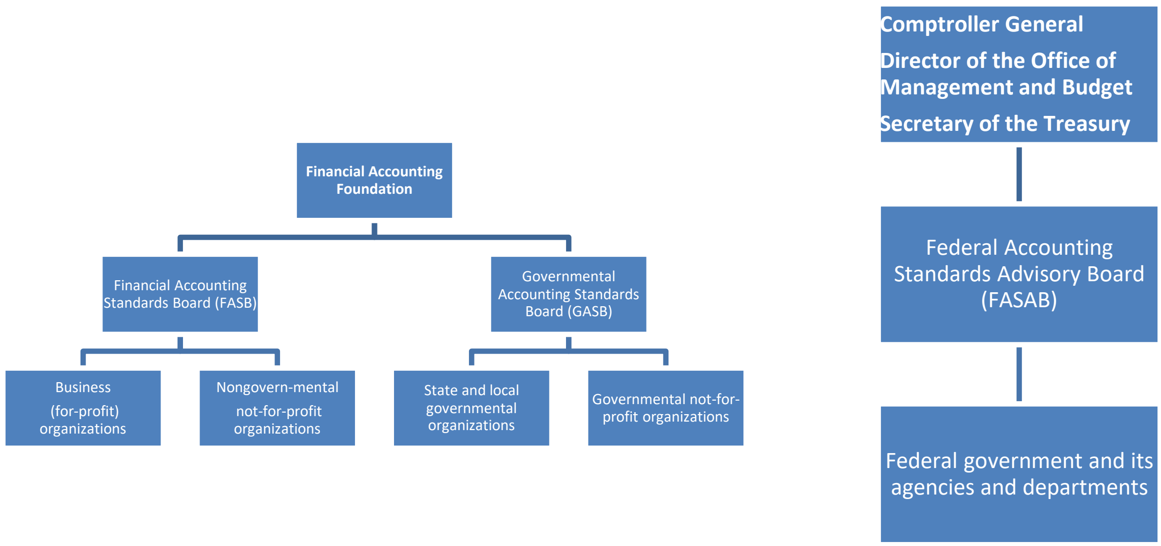
Since governments may have a monopoly on the services they provide to the public, the lack of a competitive marketplace makes it difficult to measure efficiency in the provision of the services. It is also extremely difficult to measure optimal quantity or quality for many of the services rendered by government - for example, how many police are “enough”? The Governmental Accounting Standards Board notes the determination of optimal quantity or quality of government services is complicated by the involuntary nature of the resources provided. “A consumer purchasing a commercial product can determine how much to purchase and may choose among ‘good,’ better,’ or best’ quality and pay accordingly. A group of individuals paying for governmental services (and paying in different proportions for services that some of them may or may not use or desire) presents a far more complex situation.” For example, two homeowners may pay the same amount of property taxes but consume different amounts of government services if one does not drive and use the roads or has no children in public schools.

1.4. Sources of Financial Reporting Standards

Figure 1.1 shows the primary sources of accounting and financial reporting standards for business and not-for-profit organizations, state *and local governments, and the federal government. Specifically, the FASB sets standards for for-profit business organizations and nongovernmental not-for-profit organizations; the* ***GASB sets standards*** *for state and local governments, including governmental not-for-profit organizations; and the Federal Accounting Standards Advisory Board (FASAB)* sets standards for the federal government and its agencies and departments.

The GASB and the FASB are parallel bodies under the oversight of the ***Financial Accounting Foundation*****.** The foundation appoints the members of the two boards and supports the boards` operations by obtaining contributions from business corporations; professional organizations of accountants, financial analysts, and other groups concerned with financial reporting; CPA firms; debt-rating agencies; and state and local governments (in the case of the GASB). The federal Sarbanes-Oxley Act greatly enhanced financial support for the FASB by mandating an assessed fee on corporate security offerings. Because of the breadth of support and the lack of ties to any single organization or governmental unit, the **GASB** and the **FASB** are referred to as *"independent standards-setting boards in the private sector."*

Figure 1.1: Primary Sources of Accounting and Financial Reporting Standards for Businesses, Governments, and Not-for-Profit Organizations. (Source: Statement on Auditing Standards (SAS) 69, amended by SAS 91, April 2000, AICPA Professional Standards, v.1, Au Sec. 411.)



Before the creation of the GASB and the FASB, financial reporting standards were set by groups sponsored by professional organizations: The forerunners of the GASB (formed in 1984) were the National Council on Governmental Accounting (1973—84), the National Committee on Governmental Accounting (1948—73), and the National Committee on Municipal Accounting (1934—41). The forerunners of the FASB (formed in 1973) were the Accounting Principles Board *(1959—73)* and the Committee on Accounting Procedure *(1938—59)* of the American Institute of Certified Public Accountants.

Federal statutes assign responsibility for establishing and maintaining a sound financial structure for the federal government to three officials: the *Comptroller General, the Director of the Office of Management and Budget, and the Secretary of the Treasury*. In 1990, these three officials created the *Federal Accounting Standards Advisory Board (FASAB)* to recommend accounting principles and standards for the federal government and its agencies. It is understood that, to the maximum extent possible, federal accounting and financial reporting standards should be consistent with those established by the GASB and, where applicable, by the FASB.

In Rule 203 of its Code of Professional Conduct, the American Institute of Certified Public Accountants (AICPA) has formally designated the *GASB, the FASAB, and the FASB as the authoritative bodies to establish generally accepted accounting principles (GAAP) for state and local governments, the federal government, and business organizations and nongovernmental not-for-profit organizations, respectively***.** "Authority to establish accounting principles" is interpreted in practice to mean "authority to establish accounting and financial reporting standards."

Determining Whether a Not-for-Profit Organization Is Governmental

Figure 1–1 suggests that the kinds of organizations for which the FASB and GASB are responsible for setting standards are clear cut. Unfortunately, this is sometimes not the case. In practice, it may be difficult to determine whether some not-for-profits are governmental in nature or not, and thus which standards-setting body to look to for authoritative guidance.

Public corporations and bodies corporate and politic are governmental organizations. Other organizations are governmental organizations if they have one or more of the following characteristics:

I. Popular election of officers or appointment (or approval) of a controlling majority of the members of the organization's governing body by officials of one or more state or local governments,

II. the potential for unilateral dissolution by a government with the net assets reverting to a government, or

III. the power to enact and enforce a tax levy.

Users of Financial Reports

Users of G&NP entity accounting information as both internal and external; Major external users are:

- ✓ Resource provides (tax payers, donors and potential donors, investors and potential investors, bond-rating agencies and grant providing organizations).
- ✓ Legislative and oversight bodies (higher-level governments and regulating agencies)
- ✓ Service recipients (citizen advocate groups)

1.5. Objectives of Financial Reporting

In its Concepts Statement No. 1, "Objectives of Financial Reporting," the Governmental Accounting Standards Board stated that "**Accountability** is the cornerstone of all financial reporting in government. Accountability requires governments to answer to the citizenry – to justify the raising of public resources and the purposes for which they are used." The board elaborated:

Governmental accountability is based on the belief that the citizenry has a '**"right to know,"** *a right to receive openly declared facts that may lead to public debate by the citizens and their elected representatives.* Financial reporting plays a major role in fulfilling government's duty to be publicly accountable in a democratic society.

Table 1.1 shows several ways that state and local governmental financial reporting is used in making economic, social, and political decisions and assessing accountability. Closely related to the concept of accountability as the cornerstone of governmental financial reporting is the concept the GASB refers to as **inter-period equity.** The concept and its importance are explained as follows:

> *The Board believes that inter period equity is a significant part of accountability and is fundamental to public administration. It therefore needs to be considered when establishing financial reporting objectives. In short, financial reporting should help users assess whether current-year revenues are sufficient to pay for services provided that year and whether future taxpayers will be required to assume burdens for services previously provided.*

Accountability is also the foundation for the financial reporting objectives the Federal Accounting Standards Advisory Board (FASAB) has developed for the federal government. The FASAB's Statement of Accounting and Reporting Concepts Statement No. 1 identifies four objectives of federal financial reporting (see Table 1.1) focused on evaluating budgetary integrity, operating performance, stewardship, and adequacy of systems and controls.

Table 1.1: Comparison of Financial Reporting Objectives- State and Local Governments, Federal Government, and Not-for-Profit Organizations

State and Local Governments	Federal Government	Not-for-Profit Organizations
Financial reporting is used in making economic, social, and political decisions and in assessing accountability primarily to: • Comparing actual financial results with legally adopted budget • Assessing financial condition and results of operations • Assisting in determining compliance with finance-related laws, rules, and regulations • Assisting in evaluating efficiency and effectiveness	Financial reporting should help to achieve accountability and is intended to assist report users in evaluating: • Budgetary integrity • Operating performance • Stewardship • Adequacy of systems and controls	Financial reporting should provide information useful in: • Making resource allocation decisions • Assessing services and ability to provide services • Assessing management stewardship and performance • Assessing economic resources, obligations, net resources, and changes in them

Unlike the ***FASB and the GASB***, which base their standards on *external financial reporting, the FASAB* and its sponsors in the federal government are concerned with both *internal and external financial reporting***.** Accordingly, the FASAB has identified four major groups of users of federal financial reports: citizens, Congress, executives, and program managers. Given the board role the FASAB has been assigned, its standards focus on cost accounting and service efforts and accomplishment measures, as well as on financial accounting and reporting.

Financial reports of not-for-profit organizations—voluntary health and welfare organizations, private colleges and universities, private health care institutions, religious organizations, and others—have similar uses. However, as Table 1.1 shows, the reporting objectives for not-for-profit organizations emphasize decision usefulness over financial accountability needs, presumably reflecting the fact that the financial operations of not-for-profit organizations are generally not subject to as detailed legal restrictions as those of governments.

Note that the objectives of financial reporting for governments and not-for-profit entities stress the need for the public to understand and evaluate the financial activities and management of these organizations.

Readers will recognize the impact on their lives and on their bank accounts, of the activities of the layers of government they are obligated to support and of the not-for-profit organizations they voluntarily support. Since each of us is vitally affected, it is important that we be able to read intelligently the financial reports of governmental and not-for-profit entities. In order to make informed decisions as citizens, taxpayers, creditors, and donors, readers should make the effort to learn the accounting and financial reporting standards developed by authoritative bodies.

1.6. Financial Reporting of State and Local Governments

Like the FASB, the GASB continues to develop concepts statements that communicate the framework within which the Board strives to establish consistent financial reporting standards for entities within its jurisdiction.

The GASB, as well as the FASB, is concerned with establishing standards for financial reporting to ***external users***— those who lack the authority to prescribe the information they want and who must rely on the information management communicates to them. The board does not intend to set standards for reporting to managers and administrators or others deemed to have the ability to enforce their demands for information.

Figure 1.2 displays the minimum requirements for general purpose external financial reporting under the governmental financial reporting model specified by GASB *Statement No. 34.* Central to the new model is the management's **discussion and analysis (MD&A).** The MD&A is **required supplementary information** (RSl) designed to communicate in narrative, easily readable form the purpose of the basic financial statements and the government's current financial position and results of financial activities compared with those of the prior year

The MD&A should provide a narrative explanation of the contents of the CAFR, including the nature of the government-wide and fund financial statements, and the distinctions between those statements. The remainder of the MD&A should describe the governments financial condition, financial trends of the government as a whole and of its major funds, budgetary highlights, and activities affecting capital assets and related debt.

Finally, the MD&A should discuss economic factors and budget and tax rates for the next year.

GASBS 34 prescribes two categories of **basic financial statements**, government-wide and fund. **Government-wide financial statements** are intended to provide a highly aggregated overview of a government's net assets and results of financial activities. The government-wide financial statements report on the government as a whole and assist in assessing ***operational* accountability** - whether the government has used its resources efficiently and effectively in meeting operating objectives. The GASB concluded that reporting on operational accountability is best achieved by using essentially the same basis of accounting and measurement focus used by business organizations: the accrual basis and flow of economic resources measurement focus.

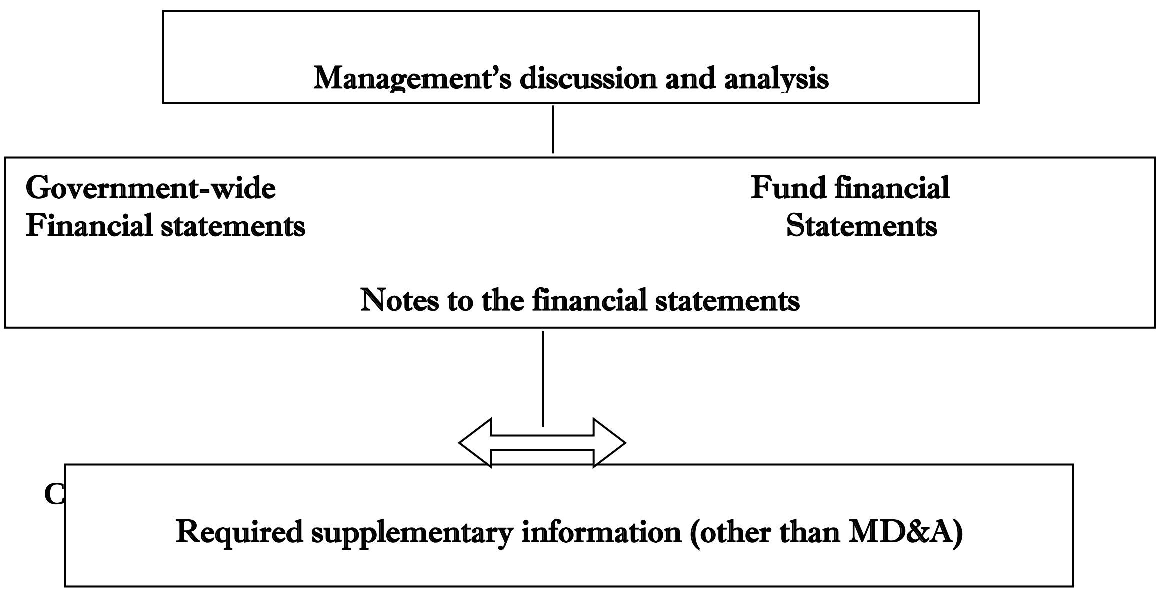
(Note: Measurement focus—refers the nature of the resources, claims against resources, and flow of resources that are measured and reported by a fund or other entity. For example, governmental funds currently measure and report available financial resources, whereas proprietary and fiduciary funds measure and report economic resources.

Basis of accounting —refers the standards used to determine the point in time when assets, liabilities, revenues, and expenses (expenditures) should be measured and recorded as such in the accounts of an entity).

Fund financial statements, the other category of basic financial statements, assist in assessing fiscal accountability—whether the government has raised and spent financial resources in accordance with budget plans and in compliance with pertinent laws and regulations.
Certain funds, referred to as governmental funds, focus on the short-term flow of current financial resources rather than on the flow of economic resources. Other funds, referred to as proprietary and fiduciary funds, account for the business-type and certain fiduciary activities of the government.
These funds follow accounting and reporting principles similar to those of business organizations, although a number of GASB standards applicable to these funds differ substantially from FASB standards applicable to business organizations.

The notes to the financial statements are considered integral to the financial statements. In addition, governments are required to disclose certain RSI other than MD&A.

Figure 1.2 Minimum Requirement for General Purpose External Financial Reporting—GASB Statement No. 34 Reporting Model



Comprehensive Annual Financial Report

Serious users of governmental financial information need much more detail than is found in the MD&A, basic financial statements, and RSI (other than MD&A). For state and local governments, much of that detail is found in the governmental reporting entity's comprehensive annual financial report (CAFR), which is considered the entity's official annual report published as a matter of public record. Standards for the content of the CAFR are found in the GASB's *Codification of Governinental Accounting and Financial Reporting Standards.* Each CAFR should contain the following sections.

Introductory Section: Introductory material includes items such as title page and contents page, the letter of transmittal, and other material deemed appropriate by management. The letter of transmittal may be literally that - a letter from the chief financial officer addressed to the chief executive and governing body of the governmental unit - or it may be a narrative over the signature of the chief executive. In either event, the letter or narrative material should cite legal and policy requirements for the report.

Financial Section: The financial section of a comprehensive annual financial report should include (1) an auditor's report, (2) management's discussion and analysis (MD&A), (3) basic financial statements, (4) required supplementary information (other than MD&A), and (5) other supplementary information, such as combining statements and individual fund statements and schedules. To determine and demonstrate compliance with laws, regulations, and agreements, governmental units use **fund accounting.** The technical definition of *fund* and the characteristics of each fund type and category as provided in GASB standards will be explained later.

The basic financial statements of a reporting entity, which should also be included in the financial section of a CAFR, consist of

a. **Government-wide financial statements**
   1. Statement of net assets
   2. Statement of activities

Points of interest:

- ❖ Information is reported separately for the primary government and discretely presented component units
    - ✓ **primary government** is a state government or general purpose local government or a special purpose government that has a separately elected governing body, is legally separate, and is fiscally independent of other state and local governments
    - ✓ **Component units** are legally separate organizations, including organizations such as governmental hospitals, library districts, and public building authorities for which the elected officials of the primary government are financially accountable.
- ❖ Within the primary government, information is reported separately for governmental and business-type activities
- ❖ All financial information in the government-wide financial statements is reported on the accrual basis with an economic resources focus—similar to business financial reporting
- ❖ Assists in assessing *operational accountability*—how efficiently resources are being used

b. **Fund financial statements** ;

Governmental Funds

1. Balance Sheet – Governmental Funds
2. Statement of Revenues, Expenditures, and Changes in Fund Balances – Governmental Funds

These statements report information separately for the General Fund and other *major funds (*Any governmental or enterprise fund that a government considers of significant importance can be designated as a *major fund)*

Points of interest:

- ❖ Focus on flow of current (i.e., short-term) financial resources recognized on the modified accrual basis of accounting
- ❖ Assist in assessing *fiscal accountability*—whether financial resources were raised and expended in compliance with budgetary and other legal provisions
- ❖ Reporting the same information about governmental activities in two different ways creates a need to reconcile the information reported in the governmental fund financial statements to that in the Governmental Activities Column of the government-wide statements

Proprietary Funds:

1. Statement of Net Assets – Proprietary Funds
2. Statement of Revenues, Expenses, and Changes in Fund Net Assets – Proprietary Funds
3. Statement of Cash Flows – Proprietary Funds

Points of interest

- ❖ Reports information for enterprise funds and internal service funds using an economic resources focus *(Measure inflows and outflows of economic resources - current and noncurrent)* and accrual basis of accounting
- ❖ Information is reported in separate columns for major enterprise funds. All internal service fund information reported is combined in a single column

Fiduciary fund:

1. Statement of Fiduciary Net Assets
2. Statement of Changes in Fiduciary Net Assets

Points of interest:

- ❖ Fiduciary activities relate to the government's responsibility as an agent or trustee to hold and/or manage resources for the benefit of private parties
- ❖ Since fiduciary resources cannot be used by the government, they are reported only in the fiduciary fund financial statements—not in the government-wide statements

Statistical Section: In addition to the introductory and financial sections of the CAFR, which were just described, a CAFR should contain a statistical section. The statistical section typically presents tables and charts showing social and economic data, financial trends, and the fiscal capacity of the government in detail needed by readers who are more than casually interested in the activities of the governmental unit. The GASB *Codification* suggests the content of the statistical tables usually considered necessary for inclusion in a CAFR.

End of chapter questions

1. Explain how general purpose governments differ from special purpose governments and give a few examples of each type of government.
2. .“Governmental and not-for-profit organizations do not differ significantly from for-profit organizations and therefore should follow for-profit accounting and reporting standards.” Do you agree or disagree with this statement? Why or why not?
3. Which standard-setting bodies have responsibility for establishing accounting and reporting standards for (1) state and local governments, (2) business organizations, (3) not-for-profit organizations, and (4) the federal government and its agencies and departments?
4. How should one determine whether FASB or GASB standards should be followed by any particular not-for-profit organization?
5. Distinguish between accountability and inter period equity.
6. “GASB financial reporting standards assist users in assessing the operational accountability of a government’s business-type activities and the fiscal accountability of its governmental activities.” Do you agree or disagree with this statement? Why or why not?
7. Why do governmental fund financial statements use a different basis of accounting and measurement focus than the Governmental Activities column of the government-wide financial statements? Also, which basis of accounting and which measurement focus apply to each?
8. How does the modified accrual basis of accounting differ from the accrual basis?
9. What are the three sections of a comprehensive annual financial report (CAFR)?
10. What information is contained in each section? How do the minimum requirements for general purpose external financial reporting relate in scope to the CAFR?

Chapter Two

Principles of accounting and financial reporting of governmental entities

2.1. Activities of government

Government may involve in three types of activities:

Governmental Activities: Governmental organizations differ from those of for-profit business organizations in that governments are not profit seeking but exist to meet citizens' demand for services, consistent with the availability of resources to provide those services.

Although the types and levels of service vary from government to government, most general purpose governments provide certain core services: those related to protection of life and property (e.g., police and fire protection), public works (e.g., streets and highways, bridges, and public buildings), parks and recreation facilities and programs, and cultural and social services. Governments must also incur costs for general administrative support such as data processing, finance, and personnel. Core governmental services, together with general administrative support, comprise the major part of what GASB Concepts Statement No. 1 refers to as governmental-type activities. In its more recent pronouncements, GASB refers to these activities as simply governmental activities.

Business-Type Activities: Governments also engage in business-type activities. These activities include, among others, public utilities (e.g., electric, water, gas, and sewer utilities), transportation systems, toll roads, toll bridges, hospitals, parking garages and lots, liquor stores, golf courses, and swimming pools. Many of these activities are intended to be self-supporting by charging users for the service they receive. Operating subsidies from general tax revenues are not uncommon, however, particularly for transportation systems.

Fiduciary Activities: Governments often act in a fiduciary capacity, either as an agent or trustee, for parties outside the government. For example, a government may serve as agent for other governments in administering and collecting taxes. Governments may also serve as trustee for investments of other governments in the government`s investment pool, for escheat properties that revert to the government when there are no legal claimants or hears to a deceased individuals estate, and for assets being held for employee pension plans, among other trustee roles.

Under *GASBS 34*, only *private-purpose* agency and trust relationships - those that benefit individuals, private organizations, and other governments - are reported as fiduciary activities. Public-purpose agency and trust activities, those that primarily benefit the general public and the government's own programs, are treated as governmental activities for accounting and financial reporting purposes.

2.2. Summary Statement of Governmental Accounting and Financial Reporting Principles

Following is a summary statement of accounting and financial reporting principles for state and local governments, as modified by GASB *Statement No. 34.*

1. Accounting and Reporting Capabilities

A governmental accounting system must make it possible both: (a) to present fairly and with full disclosure the funds and activities of the government in conformity with generally accepted accounting principles, and (b) to determine and demonstrate compliance with finance-related legal and contractual provisions.

2. Fund Accounting Systems

Fund accounting is an accounting system for recording resources whose use has been limited by the donor, grant authority, governing agency, or other individuals or organisations or by law. It emphasizes accountability rather than profitability, and is used by Nonprofit organizations and by governments.

Thus, Governmental accounting systems should be organized and operated on a fund basis. A fund is defined as a fiscal and accounting entity with a self-balancing set of accounts recording cash and other financial resources, together with all related liabilities and residual equities or balances, and changes therein, which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions, or limitations. Fund financial statements should be used to report detailed information about the primary government, including its blended component units. The focus of governmental and proprietary fund financial statements is on major funds.

3. Types of Funds

The following types of funds should be used by state and local governments to the extent that they have activities that meet the criteria for using those funds.

a. **Governmental Funds**

(1) *The General Fund - to* account for all financial resources except those required to be accounted for in another fund.

(2) *Special Revenue Funds - to* account for the proceeds of specific revenue sources (other than private-purpose trusts or for major capital projects) that are legally restricted to use for specified purposes.

(3) *Capital Projects Funds - to* account for financial resources to be used for the acquisition or construction of major capital facilities (other than those financed by proprietary funds and trust funds).

(4) *Debt Service Funds - to* account for the accumulation of resources for, and the payment of, general long-term debt principal and interest.

(5) *Permanent Funds - to* account for legally restricted resources provided by trust in which the earnings but not the principal may be used for purposes that support the primary government's programs (those that benefit the government or its citizenry). [Note: Similar permanent trusts that benefit private individuals, organizations, or other governments—that is, private- purpose trust funds—are classified as fiduciary funds, as shown below.]

b. **Proprietary Funds**

(6) *Enterprise Funds - to* account for operations (a) that are financed and operated in a manner similar to private business enterprises—where the intent of the governing body is that the costs (expenses, including depreciation) of providing *goods* or services to the general public on a continuing basis be financed or recovered primarily through user charges; or *(b)* where the governing body has decided that periodic determination of revenues earned, expenses incurred, and/or net income is appropriate for capital maintenance, public policy, management control, accountability, or other purposes.

(7) *Internal Service Funds - to* account for the financing of goods or services provided by one department or agency to other departments or agencies of the governmental unit, or to other governmental units, on a cost-reimbursement basis.

c. **Fiduciary Funds** (and similar component units). These are *trust* and *agency funds* that are used to account for assets held by a governmental unit in a trustee capacity or as an agent for individuals, private organizations, and other governmental units. These include:

(8) Agency funds.
(9) Pension (and other employee benefit) trust funds.
(10) Investment trust funds.
(11) Private-purpose trust funds.

4. Number of Funds

Governmental units should establish and maintain those funds required by law and sound financial administration. Only the minimum number of funds consistent with legal and operating requirements should be established, however, because unnecessary funds result in inflexibility, undue complexity, and inefficient financial administration.

5. Reporting Capital Assets

A clear distinction should be made between general capital assets and capital assets of proprietary and fiduciary funds. Capital assets of proprietary funds should be reported in both the government-wide and fund financial statements. Capital assets of fiduciary funds should be reported in only the statement of fiduciary net assets. All other capital assets of the governmental unit are general capital assets. They should not be reported as assets in governmental funds but should be reported in the governmental activities column in the governmental-wide statement of net assets.

6. Valuation of Capital Assets

Capital assets should be reported at historical cost. The cost of a capital asset should include capitalized interest (not applicable to general capital assets) and ancillary charges necessary to place the asset into its intended location and condition for use. Donated capital assets should be reported at their estimated fair value at the time of the acquisition plus ancillary charges, if any.

7. Depreciation of Capital Assets

Capital assets should be depreciated over their estimated useful lives unless they are either inexhaustible or are infrastructure assets using the modified approach as set forth in GASB *Statement No. 34,* pars. 23-26. Inexhaustible assets such as land and land improvements should not be depreciated. Depreciation expense should be reported in the government-wide statement of activities; the proprietary fund statement of revenues, expenses, and changes in fund net assets; and the statement of changes in fiduciary net assets.

8. Reporting Long-Term Liabilities

A clear distinction should be made between fund long-term liabilities and general long-term liabilities. Long-term liabilities directly related to and expected to be paid from proprietary funds should be reported in the proprietary fund statement of net assets and in the government-wide statement of net assets. Long-term liabilities directly related to and expected to be paid from fiduciary funds should be reported in the statement of fiduciary net assets. All other unmatured general long-term liabilities of the governmental unit should not be reported in governmental funds but should be reported in the governmental activities column in the government-wide statement of net assets.

9. Measurement Focus and Basis of Accounting in the Basic Financial Statements

a.. Government-wide Financial Statements

The government-wide statement of net assets and statement of activities should be prepared using the economic resources measurement focus and the accrual basis of accounting. Revenues, expenses, gains, losses, assets, and liabilities resulting from the exchange and exchange-like transactions should be recognized when the exchange takes place. Revenues, expenses, assets, and liabilities resulting from non-exchange transactions should be recognized in accordance with [C*odification]* Section N50. “Non-exchange Transactions.”

b. Fund Financial Statements

In fund financial statements, the modified accrual or accrual basis of accounting, as appropriate, should be used in measuring financial position and operating results.

(1) Financial statements for governmental funds should be presented using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues should be recognized in the accounting period in which they become available and measurable. Expenditures should be recognized in the accounting period in which the fund liability is incurred, if measurable, except for unmatured interest on general long-term liabilities, which should be recognized when due.

(2) Proprietary fund statements of net assets and revenues, expenses, and changes in fund net assets should be presented using the economic resources measurement focus and the accrual basis of accounting.

(3) Financial statements of fiduciary funds should be reported using the economic resources measurement focus and the accrual basis of accounting, except for the recognition of certain liabilities of defined benefit pension plans and certain postemployment healthcare plans.

(4) Transfers between funds should be reported in the accounting period in which the interfund receivable and payable arise.

10. Budgeting, Budgetary Control, and Budgetary Reporting

a. An annual budget(s) should be adopted by every governmental unit.

b. The accounting system should provide the basis for appropriate budgetary control.

c. Budgetary comparison schedules should be presented as required supplementary information (RSI) for the general fund and each major special revenue fund that has a legally adopted annual budget.

11. Transfer, Revenue, Expenditure, and Expense Account Classification

a. Transfers should be classified separately from revenues and expenditures or expenses in the basic financial statements.

b. Proceeds of general long-term debt issues should be classified separately from revenues and expenditures in the governmental fund financial statements.

c. Governmental fund revenues should be classified by fund and source. Expenditures should be classified by fund, function (or program), organization unit, activity, character, and principal classes of objects.

d. Proprietary fund revenues should be reported by major sources, and expenses should be classified in essentially the same manner as those of similar business organizations, functions, or activities.

e. The statement of activities should present *governmental* activities at least at the level of detail required in the governmental fund statement of revenues, expenditures, and changes in fund balance—at a minimum by *function.* Governments should present *business-type* activities at least by *segment.*

12. Common Terminology and Classification

A common terminology and classification should be used consistently throughout the budget, the accounts, and the financial reports of each fund.

13. Annual Financial Reports

a. A comprehensive annual financial report (CAFR) should be prepared and published, covering all activities of the primary government (including its blended component units and providing an overview of all discretely presented component units of the reporting entity—including introductory section, management's discussion and analysis (MD&A), basic financial statements, required supplementary information other than MD&A, combining and individual fund statements, schedules, narrative explanations, and statistical section. The reporting entity is the primary government (including its blended component units) and all discretely presented component units presented in accordance with [*Codification*] Section 2100, "Defining the Financial Reporting Entity."

b. The minimum requirements for MD&A. basic financial statements and required supplementary information other than MD&A are:

(1) Management's discussion and analysis.

(2) Basic financial statements. The basic financial statements should include:

(a) Government—wide financial statements.

(b) Fund financial statements.

(c) Notes to the financial statements.

(3) Required supplementary information other than MD&A.

c. As discussed in [Codification] Section 2100, the financial reporting entity consists of (1) the primary government, (2) organizations for which the primary government is financially accountable, and (3) other organizations for which the nature and significance of their relationship with the primary government are such that exclusion would cause the reporting entity's basic financial statements to be misleading or incomplete. The reporting entity's government-wide financial statements should display information about the reporting government as a whole distinguishing between the total primary government and its discretely presented component units as well as between the primary government's governmental and business-type activities. The reporting entity's fund financial statements should present the primary government's (including its blended component units, which are, in substance, part of the primary government) major funds individually and nonmajor funds in the aggregate. Funds and component units that are fiduciary in nature should be reported only in the statements of fiduciary net assets and changes in fiduciary net assets.

d. The nucleus of a financial reporting entity usually is a primary government. However, a governmental organization other than a primary government (such as a component unit, joint venture, jointly governed organization, or other stand-alone government) serves as the nucleus for its own reporting entity when it issues separate financial statements. For all of these entities, the provisions of *[Codification]* Section 2100 should be applied in layers “from the bottom up.” At each layer, the definition and display provisions should be applied before the layer is included in the financial statements of the next level of the reporting government.

2.3. Summary Accounting characteristics of fund types

Three categories of activities in which governments engage were described early in this chapter: governmental, business-type, and fiduciary. There are three closely related categories of funds: **governmental, proprietary, and fiduciary**. Except for the fact that most internal service funds are treated as part of Governinental activities rather than as part of business-type activities for purposes of government-wide financial reporting, the activity and fund categories are the same. Accounting characteristics and principles unique to each fund category are discussed in the sections that follow.

Governmental Funds

The governmental funds category comprises five types of funds: the General Fund, special revenue funds, debt service funds, capital projects funds, and permanent funds. Every state and local government has a General Fund although it may be called by a different name such as *general revenue fund, general operating fund,* or *current fund.* Other governmental funds will be created as needed. Most departmental operating activities, such as those of police and fire, public works, parks and recreation, culture, education, and social services, as well as general government support services, such as the city manager’s office, finance, personnel, and data processing, are typically accounted for in the General Fund. Unless a financial resource is required to be accounted for in a different fund type, it is usually accounted for in the General Fund.

When tax or grant revenues or private gifts are legally restricted for particular operating purposes, such as the operation of a library or maintenance of roads and bridges, a special revenue fund is created. The number of special revenue funds used by state and local governments varies greatly, ranging from a few to many. Nevertheless, GASB standards recommend that governments establish only the minimum number of funds needed to comply with legal requirements and to provide sound management. An excessive number of funds creates undue complexity and contributes to inefficient financial administration.

Governments that have bond obligations outstanding and certain other types of long-term general liabilities may be required by law or bond covenants to create a debt service fund. The purpose of a debt service fund is to account for financial resources segregated for the purpose of making principal and interest payments on general long-term debt. (General long-term debt is distinguished from long-term debt issued and serviced by a proprietary or fiduciary fund. Because those funds follow accounting principles similar to those of for-profit entities, interest and principal on debt issued by proprietary or fiduciary funds and payable from the revenues of those funds is accounted for in those funds rather than in a debt service fund.) Some governments account for all debt service on general long-term debt in their General Fund, but governments ordinarily create one or more debt service funds if they have general long-term debt.

Governments often engage in capital projects to accommodate a growing population or to replace existing capital assets. These projects typically involve major construction of items such as buildings, highways or bridges, or parks. To account for tax or grant revenues or bond proceeds earmarked for a capital project, as well as payments to architects, engineers, construction contractors, and suppliers, a **capital projects fund** is typically created. Multiple capital projects funds may be created if a government has multiple capital projects.

Permanent fund is the final type of governmental fund. A **permanent fund** is used to account for permanent endowments created when a donor stipulates that the principal amount of a contribution must be invested and preserved but earnings on amounts so invested can be used for some public purpose. Public purposes include activities such as maintenance of a cemetery or aesthetic enhancements to public buildings. If the earnings from a pertinent fund can be used to benefit only *private* individuals, organizations, or other governments, rather than supporting a program of the government and its citizenry, a private-purpose trust fund—a fiduciary fund—is used instead of a permanent fund.

Accounting and financial reporting for the governmental funds category, the five fund types just described, have evolved to meet the budgetary and financial compliance needs of government, as stated earlier, to achieve and report on the government's *fiscal accountability*. Thus, it is hardly surprising that accounting for governmental funds has focused on the inflows and outflows of current **financial resources.** Current financial resources are cash or items such as receivables that will be converted into cash during the current fiscal period or that will be available soon enough after the end of the period to pay current-period liabilities. With the lone exception of property tax revenues, which GASB standards require to be collectible within 60 days of the end of the current year to be deemed available, governments are free to establish their own definition of *available* and thus which items to recognize in their financial statements as current financial resources and revenues. In practice, the definition of *available* may range anywhere from 30 days to one year.

Because governmental funds account for the inflows and outflows or current financial resources, the balance sheet for governmental funds reports only current assets and current liabilities and **fund balances** (or **fund equity**), the difference between current assets and current liabilities. One can readily see, for example, that no long-lived assets, such as land, buildings, and equipment, nor any long-term liabilities, such as bonds payable, are reported on the governmental funds balance sheet.

Similarly inflows and outflows of current financial resources of the governmental funds are reported in a statement of revenues, expenditures, and changes in fund balances. As explained previously, financial resources must be *available* to pay current-period obligations (that is. they must be expected to be received during the current period or soon thereafter) before they can be reported as a revenue of the current period. Recognizing as revenues only those inflows that are available to pay current-period obligations and recognizing as expenditures all obligations that will he paid from currently available financial resources is referred to as the **modified accrual** basis of accounting.

Accounting for financial resource inf1ows and outflows in the governmental funds on the modified accrual basis is much different than accounting for the corresponding *economic resource* inflows and outflows for governmental activities on the accrual basis as they are reported in the government-wide financial statements. As puzzling as this may seem at this early point in the course, the reason for the differential accounting treatment is simple: The governmental fund financial statements report on short-term fiscal accountability; the government-wide financial statements report on long-term operational accountability. Thus, governmental activities at the government-wide level are accounted for using essentially the same principles used by for-profit business organizations.

In the next few chapters, you will become familiar with the "dual-track" approach the authors have developed to account for the different effects of certain transactions on the governmental fund financial statements and the Governmental Activities column of the government-wide financial statements.

Even if it will be discussed later in detail, for now it is important to differentiate between expenditure and expense. The essential difference to note is that an **expenditure** is the amount of financial resources used to acquire an asset (i.e., the cost), and an **expense** is how much of that cost expired or was used up in producing services of the period. Note that the concept of expense, particularly depreciation expense, has no relevance in accounting for the General Fund because depreciation expense generates no financial resources that can be expended.

Proprietary Funds

Proprietary funds of a government follow accounting and financial reporting principles that are similar to those for commercial business entities. As in business, if a government intends to charge users for the goods or services provided, its officials need to know the full cost of those goods and services in order to determine appropriate prices. Determining the full cost is also essential in deciding whether the government should continue to produce or provide particular goods or services or to contract for them with an outside vendor. Accrual accounting, including depreciation of capital assets, is essential for governments to determine the full cost of providing business-type services and to report on the extent to which each such activity is covering its full cost of operation.

There are two types of proprietary funds: *internal* service *funds* and *enterprise funds.* Legislative approval is ordinarily required to establish proprietary funds, although they may be required by law or contractual provisions such as debt covenants. The two funds differ primarily in terms of their objectives and the way the financial information of each type of fund is reported in the fund and governmental financial statements.

Internal service funds are created to improve the management of resources and generally provide goods or services to departments or agencies of the same government and sometimes to other governments on a cost-reimbursement basis. Examples of services typically accounted for by internal service funds include central purchasing and warehousing of supplies, motor pools, centralized data processing, and self-insurance pools.

Enterprise funds *may* be used to account for activities in which goods or services are provided to the public for a fee that is the principal source of revenue for the fund. GASB standards *require* the use of an enterprise fund if:

1. The activity is financed with debt that is secured solely by a pledge of the net revenues from fees and charges of the activity.
2. Laws or regulations require that the activity's costs of providing services, including capital costs (such as depreciation or debt service), be recovered with fees and charges rather than with taxes or similar revenues.
3. The pricing policies of the activity establish fees and charges designed to recover its costs, including capital costs.

As noted earlier, financial reporting differs for internal service funds and enterprise funds. *Major* enterprise funds are reported in separate columns of the three proprietary fund financial statements: statement of net assets; statement of revenues, expenses, and changes in fund net assets; and statement of cash flows. Major fund reporting does not apply to internal service funds. Instead, these funds are all reported in a single column of the proprietary fund financial statements.

As discussed previously, internal service fund financial information is generally reported in the Governmental Activities column of the government-wide financial statements unless an internal service fund predominantly serves a proprietary fund, in which case it is reported in the Business-Type Activities column of the government-wide financial statements. Thus, for most governments the information reported in the Business-Type Activities column of the government-wide financial statements is the same as the enterprise fund totals reported in the proprietary fund financial statements. Furthermore, since the business-type activity financial information is reported using the same measurement focus and basis of accounting in the proprietary fund and government-wide financial statements, there usually is no need to reconcile any differences between the statements or to use a dual-track accounting approach.

Fiduciary Funds

Fiduciary activities of a government are reported using the same principles as for proprietary fund and government-wide financial statements: the economic resources measurement focus and accrual basis of accounting. Fiduciary activities are reported *only* in the fiduciary fund financial statements (statement of fiduciary net assets and statement of changes in fiduciary net assets), not in the government-wide financial statements. The reason for *not* reporting fiduciary activities in the government-wide financial statements is simple: The resources of fiduciary funds are held for the benefit of private parties and cannot be used to support the government's own programs.

The fiduciary fund category consists of agency funds and three types of trust funds: investment trust funds, pension trust funds, and private-purpose trust funds. **Agency funds** generally are used when the government holds monies on a custodial basis for a private party (individual, organization, or government). Examples are taxes or fees collected by a government on behalf of other governments. There are no net assets in agency funds since for every dollar of assets held there is a dollar of liability to the private party (total assets in the fund always equal total liabilities).

Trust funds differ from agency funds primarily in the length of time and the manner in which resources are held and managed. In most cases, trust fund assets include investments whose earnings add to the net assets of the fund and that can be used for a specified purpose. Earnings that are used or are transferred to another fund where they can be used are deducted from the fund's net assets. Examples of trust funds are funds that hold assets in trust to provide retirement benefits for employees **(pension funds), investment trust funds** used to report the equity of external participants (typically other governments) in a sponsoring government's investment pool, and **private-purpose trust funds** created to benefit private individuals, such as a fund to provide scholarships for the children of fallen firefighters and police officers. Fiduciary fund financial statements are prepared using the accrual basis of accounting and economic resources measurement focus. Accounting for some trust funds is much more complex than just accounting for investments. For example, a large, legally separate state pension plan often has significant capital assets such as land, buildings, and equipment to report in its financial statements. The expenses of the plan include personnel, supplies, utilities, depreciation, and other items in addition to investment-related expenses.

Illustration 2-1: Summary of Fund Characteristics

Characteristics	Governmental Funds	Proprietary Funds	Fiduciary Funds
Types of funds	General, special revenue, debt service, capital projects, permanent	Enterprise, internal service	Agency, investment trust, pension trust, private-purpose trust
Accountability focus	Fiscal accountability	Operational accountability	Operational accountability
Measurement focus	Current financial resources	Economic resources	Economic resources
Basis of Accounting	Modified accrual	Accrual	Accrual
Required financial statements	Balance sheet; statement of revenues, expenditures, and changes in fund balances	Statement of net assets; statement of revenues, expenses, and changes in fund net assets; statement of cash flows	Statement of fiduciary net assets, statement of changes in fiduciary net assets
Balance sheet/statement of net assets accounts	Current assets, current liabilities, fund balances (equity)	Current and noncurrent assets, current and noncurrent liabilities, net assets	Current and noncurrent assets, current and noncurrent liabilities, net assets
Operating statement accounts	Revenues, expenditures, other financing sources and uses	Revenues, expenses	Additions, deductions
Budgetary accounting	Budgetary accounts formally integrated into funds	Budetary accounts ordinarily not integrated into the funds	Budgetary accounts ordinarily not integrated into the funds

2.4. Budgeting and uses of budget

Budgeting is the process of allocating scarce resources to unlimited demands. More specifically, it can be defined as a plan of financial operation embodying an estimate of proposed expenditures for a given time and the proposed means of financing them. Budget is a statement that shows the financial plan for accomplishment of an operation. It is plan stated in terms of money. When we assigned/estimate resources required for a certain task on our plan, that is called budgeting.

We might summarize the process of budgeting into three basic questions.

- How much can we send?
- Why will we spend it?
- Where will we get the money from?

The second question, "why," is arguably the most important. Ironically, it is the question which is most often <u>not</u> asked.

Budgets are key elements of legislative control over governmental units. Budgets are, usually, proposed by executive branches, reviewed, modified and enacted by the legislative branch and finally administrated by executives. The adoption of budget implies that decisions have been made, on the basis of the planning process, about how the unit is to reach to its objectives. The accounting system then helps the administrators (1) control the activities authorized to carry out the plans and (2) prepare the statements that permit comparison of actual operations with the budgeted and evaluation of variances. These three budgetary phases and functions – planning, controlling and evaluation – are crucial aspects of all budgetary approaches and processes.

2.4.1. Governmental budgeting vs. FP budgeting

Budgeting has a greater role in governmental accounting than in FP accounting. First, consider budgeting in a profit-seeking enterprise. Budgeting in profit-making enterprise is usually fairly flexible, and can be changed as conditions warrant during the year. In an FP, money is spent for the purpose of making more money. As long as the FP is profitable, the specific purpose of the spending doesn't matter so much, as long as it is helping to contribute to the bottom line. Similarly, if it is felt that a particular usage of money is not generating additional profits, then money can cease to be spent on that item. For example, "Pepsi" soft drink advertises on television. No doubt its maker has budgeted for this expense. However, if it feels that this advertising is not helping to increase its sales, it can drop the item from its budget and cancel the adverting in order to use the money for something more effective in increasing its sales, like producing a higher quality product. The profit motive provides the guide to employ resources in the "right" way.

On the other hand, governments have no profit motive to guide the resources represented by their budgets into the "right" usage. Therefore, they rely on legal requirements to insure that money is used for the appropriate purpose. Governmental budgets, once fixed by law for the year, are generally unchangeable without much effort. Altering or exceeding the budget typically carries severe penalties for the administrator who dose so.

Given the unchanging nature of government budgets, and the penalties for non-compliance, it logically follows that the accounting system should support the budget. The accounting system, at the very least, should give the necessary information for keeping within the budgetary restrictions.

2.4.1. Uses of Budgets

The primary usefulness of FP budgets is planning, i.e. "What resources do we have, and how can we plan to spend them in order to maximize profit?" In governments also, the budget is also used for planning, especially in clarifying priority goals.

Planning is a special concern for the following reasons:

1. The type, quantity and quality of governmental goods and services provided are not normally evaluated and adjusted through the open market mechanism
2. Governmental goods/services (education, health, police etc) are often among the most critical to the public interest
3. The immense scope and diversity of modern government activities make comprehensive, thoughtful and systematic planning a pre-requisite to orderly decision making
4. Government planning and decision making is generally a joint process involving its citizens

However, government administrators often overlook the planning aspects of a budget and use the government budget primarily as a control device. The government will have certain objectives, and it assigns resources – money, personnel, etc. – for the accomplishment of those objectives. The budget is a way of controlling the assigned resources; ensuring that they are used for the intended purpose.

In addition to the primary use of control and the secondary use of planning, the budge provides information to decision-makers and indicates to the public what decisions have been made about the objectives of the government.

2.5. Classifications of budgets

States and local governments typically prepare and utilize several types of financial plans. It is therefore important to distinguish among the various types of budgets, to understand the phases through which each may pass and to be familiar with commonly used budgetary terminology. There are five classifications of budgets and two types within each classification.

Capital or Current

Sound governmental fiscal management requires continual planning for several periods in to the future. Most governments are involved in programs to provide certain goods and services continuously and/or for acquisition of capital items. Multi-year schedule for acquisition of capital items is called capital program. At the beginning of each year the balance that fall in the current period will be included in the capital budget.
Capital budgets deal with the acquisition of fixed assets. The legislature will likely approve the acquisitions one year at a time. But planning for the acquisitions several years in advance (called the Capital Program) is very helpful to wise management of resources.

Current budgets are concerned with the current year‘s operating expenditures, sometimes called recurring expenditures, because similar sorts of expenditures are needed year after year.

Tentative or enacted

One key distinction among budgets is their legal status. Various documents may be called budgets prior to approval by the legislative body. As the name implies, the *tentative budget* is still in process. It has not yet been officially approved. An *enacted budget* has been officially approved and is a binding legal document.

General or Special

The names of this classification are not quite as they sound. Budgets of governmental activities commonly financed through the General, Special Revenue, and Debit Service Funds are referred as *General budges*. A budget prepared for any other fund is *Special*. Special budgets are commonly limited to Capital project funds, though Enterprise and Internal service funds do sometimes formally budgeted.

Fixed or Flexible

Fixed budgets are for a fixed total dollar (or Birr) amount and cannot be exceeded. The allocated amount should not be exceeded. *A flexible budget, on the other hand, fixes* the cost per unit of goods and services. If more units of goods and services are desired because of a change in circumstance or need, the dollar amount of a flexible budget can increase.

Fixed budgets are simple to prepare and administer and are more understood than flexible budgets and are important for legislation control to limit the discretion of executives and their subordinates. Flexible budgets are more realistic when changes in quantities of goods or services provided directly affect resource availability and need change in outlay pattern.

Executive or Legislative

Budgets are also sometimes categorized by the preparer. Budget preparation is usually an executive‘s function, though the legislature may revise the budget prior to approval. In some instances the legislative branch may prepare budge, possibly subject to executive veto. *Executive budgets* are, as the name implied, budgets originated from the executive branch and *Legislative budgets* from the legislation branch.

2.6. Approaches to Budgeting

There are different types of budgetary approaches which differ to each other in their emphasis on planning, control and evaluation. These approaches fall in to two categories: Modern and Traditional

2.6.1. Modern (Rational) Approaches to budgeting

The modern approaches to budgeting are sometimes called rational. That is because they all advocate thinking carefully about the relationship of inputs, with a special concern for the outputs. Outputs are the goods or services actually provided; inputs are the resources that go in providing those goods or services. Thinking carefully also involves analyzing the costs and benefits of alternative methods of achieving objectives. The ―big-picture,‖ the idea that lawmaking bodies should focus on broad policy objectives rather than details of spending for particular departments is emphasized. Long term, ultimate goals are stressed rather than annual budget requests. Attention is directed to continual evaluation of services which are being performed. The different modern approaches are considered; each one is explained briefly, below.

2.6.1.1. Performance Budgeting

Performance budget is a budget that bases expenditures primarily up on measurable performance of activities and work programs. It focuses on the outputs generated by the department or organizational unit, rather than looking primarily at the cost of the inputs. In this type budgets attempt will be made to relate the input of governmental resources to the output of governmental services. To provide the legislative body with a reasonable justification for its budget requests, each department must do some clear thinking about what it is trying to do and how best to do it.

The performance budget is mainly concerned with only one year at a time. Basically, the process of making the budget may be summarized as follows:

1. The governmental entity decides what type of services to offer.
2. The entity decides how many units of the service to offer.
3. The cost of one unit of the service is calculated.
4. The budget is determined by multiplying units of service by the cost per unit.

For example, a prison holds 1,000 inmates. The cost of keeping a prisoner is estimated at $5,000 per year. The budget for the prison for 2009 then would be $5,000,000 for a year. However, if the prison actually incarcerated 800 prisoners in 2009, then the budget would be reduced to $4,000,000, and the head of the prison would be expected to return the extra $1,000,000.

Advantage

1. It emphasis on inclusion of narrative description of each proposed activity with in the proposed budget
2. Organization of the budget by activities, with requests supported by estimates of costs and accomplishments in the quantitative terms and
3. Its emphasis on the need to measure output and input

Limitations

This approach is fundamentally sound but has the following drawbacks

1. Many government services and activities do not appear readily measurable in meaningful output units or unit cost terms
2. This style makes data gathering difficult and impossible 3. Need highly qualified skill man power

2.6.1.2. Planning-Programming-budgeting (PPB)

PPB emphasizes broad policy goals, strategies and objectives, rather than details of spending. In looking at these broad goals and objectives, it considers long-range plans. In those longrange plans both ultimate goals and intermediate objectives must be explicitly stated. After formulating the long-range plans, it then evaluates costs and benefits of different ways of meeting the goals and objectives. It also emphasized the government‘s overall program, rather than a specific department. For instance, both the Ministry of Health and the Ministry of Education might have some sort of AIDS program – one for treatment and one for education. If the idea of PPB were adopted, both of these programs would be looked at together to see they complemented each other in meeting the government‘s overall objectives.

Distinctive characteristics of PPB

1. It focuses on identifying the fundamental objectives of the government and then relating all

activities to them
2. Future year implications are explicitly identified
3. All pertinent costs are considered
4. Systematic analysis of alternatives is performed
5.

Advantages

1. Unlike performance and traditional budgeting which based principally on historical data and focus in single period, PPB emphasizes on long range planning in which (i) ultimate goals and intermediate objectives must be explicitly stated and (ii) the costs and benefits of major alternative courses to achieve these goals and objectives are to explicitly evaluated
2. It assumes that all programs are to be evaluated annually, so that poor ones may be weeded out and new ones added
3. It can be adapted to any level

Limitations

1. It is quite difficult to formulate a meaningful, explicit statement of a government's goals and objectives that can be agreed by all the concerned
2. Official change matters on its effectiveness
3. Need highly qualified personnel
4. Objective measurement is difficult

2.6.1.3. Zero-Base-Budgeting (ZBB)

ZBB is one method of continually evaluating programs and services. The primary idea of ZBB is that each program must justify its existence every year. No program is assumed to be continuing from one year to the next. In this approach, the starting point for the budget each year is zero. First the program itself must be justified, then different ways of carrying out the program are examined and the best is chosen.

Advantages

It requires annual revision of all programs, activities and expenditures. This helps to

1. Save money by identifying outdated programs and unnecessary high levels of services
2. Concentrate the attention of officials on the costs and benefits of services 3. cause a search for new ways of planning and evaluation 4. provide better justification for the budget 5. improve the decisions of executives and legislative bodies

Limitations

1. It requires a great deal of paper work, staff time and effort to identify and rank decision units and packages
2. It is difficult to obtain the data to compute costs of alternative methods of achieving objectives and of alternative levels of services

Practical Usefulness of the Modern Approaches

All of these modern approaches are theoretically sound. They have very good ideas about improving performance and analyzing existing programs, which may be used in budgeting. However, they ignore two practical realities of budgeting. One is that the budget process itself is very political. Those who contribute to the budget process are often not objective, and sometimes try to manipulate the process for their own gain. Each of the above approaches may be easily manipulated in the political process. The second practical reality they ignore is the need for a very high level of skill, understanding, time, and paperwork to implement these approaches. Carrying out any of these modern budget approaches consumes many scarce resources by itself.

2.6.2. Traditional Approach to Budgeting

For the reasons stated above, the modern approaches have not been adopted as widely as might be expected. The traditional approach, called object-of-expenditure (OOE) is still the most widely used. The objective of the OOE budget has an expenditure control orientation. It is to simply list expected expenditures, and then say how much is required for each one. This approach involves three facets:

1. First, subordinate agencies submit budget requests to the chief executive in terms of the type of expenditures to be made. These requests include the number of people to be hired in each specified position and salary level and the specific goods or services to be purchased during the upcoming period.
2. Next, the chief executive compiles and modifies the agency budget requests and submits an overall request for the organization to the legislature in the same object – of - expenditure terms
3. Finally, the legislative body usually makes line - item appropriations, possibly after revising the requests, along object - of – expenditure lines.

As an example of OOE let us take a university department.

Department of Science

Salaries	
1 Department Head	24,000
4 Professors	72,000
3 Lecturers	36,000
1 Secretary	6,000
Total Salaries	**138,000**
Supplies	
Paper	5,000
Chalk	1,000
Other Mise.Supplies	1,000
Total Supplies	**7,000**

Equipment	
Computer	12,000
Printer	5,000
Total Equipment	**17,000**
Total Science Department	**162,000**

The detail information required in the budget will depend on how much control the budget authority wants to exercise over the department head. The level of detail in the budget shown above illustrated a fairly high degree of control. If less control were exercised by the authority and more flexibility given to department head, the approved budget could look like this:

Department of Science

Salaries	138,000
Supplies	7,000
Equipment	17,000
Total Science Dept.	**162,000**

In this case, for example, the department head has the flexibility to allocate the salary budget as he/she sees fit, rather than listing each position required.

If the budget authority wanted to give the department head maximum flexibility, the approved budget would look like this:

Department of Science **$472,000**

In this last case, as long as the department head stayed within total figure, he/she would have great in management. For example, if he/she decided during the year that the department could get along without a secretary, but would rather have a second computer, then he/she could make that decision him/herself. Without this flexibility, he/she would have to wait until the next year‘s budget to make the change.

Advantages

1. It is simple for preparation and understanding
2. It allows a great deal of control over expenditure, and
3. It fits with practical realities.

Limitations

1. It is overly control centered, to the detriment of the planning and evaluation process
2. It provides only list of proposed personnel to be hired or goods to be purchased for decision makers. It is only decision makers that are familiar with the departments function and activities do understand the justification

3. It is long range planning, program justification, and outputs achieved are not necessarily formally considered. In other words, it doesn‘t encourage asking of the questions, “Why are we really spending this money?” or, “What are we getting for the money we are spending?” or, “Could this objective be better met by another means?”

Many, if not most, governmental entities, in fact, actually use an Incremental process in preparing an OOE budget. This means that they simply take last year‘s budget expenditures and add or subtract an arbitrary percentage to each line based on various internal and/or external considerations. In spite of its weaknesses however, it is the most common approach.

End of chapter questions

1. Describe the governmental activities of a state or local government and identify the measurement focus and basis of accounting used in accounting and financial reporting for these activities.
2. Describe the business-type activities of a state or local government and explain how and why accounting and financial reporting for business-type activities differ from those for governmental activities.
3. Describe the fiduciary activities of a state or local government and explain how accounting and financial reporting for fiduciary activities differ from those for governmental and business-type activities.
4. What organizations does the governmental reporting entity include? Define primary government. How does a component unit differ from the primary government?
5. “If a discrete presentation is used for the financial data of a component unit in the statement of net assets of a governmental financial reporting entity, there is no need for the component unit to issue a separate financial report.” Is this statement true or false? What other method may be allowed to include a component unit’s financial information with that of the reporting entity?
6. What are the three categories of funds prescribed by GASB standards and which fund types are included in each? Do the three fund categories correspond precisely with the three activity categories described in Chapter If not, how do they differ?
7. Explain what is meant by the phrase, “A fund is a fiscal and an accounting entity.”
8. Which fund category uses the modified accrual basis of accounting? What are the recognition rules for revenues and expenditures under the modified accrual basis of accounting?
9. Amber City borrowed $1,000,000 secured by a 5-year mortgage note. The cash from the note was used to purchase a building for vehicle and equipment maintenance. Show how these two transactions should be recorded in the General Fund and governmental activities general journals.

10. Explain the criteria for determining if a governmental or enterprise fund must be reported as a major fund. What other funds should or may be reported as major funds?

CHAPTER THREE

ACCOUNTING FOR GENERAL AND SPECIAL REVENUE FUNDS

Learning Objectives

After studying this chapter, you should be able to:

- Explain how general fund differ from special revenue fund and how operating revenues and expenses related to governmental activities are classified and reported in the government-wide financial statements.
- Distinguish, at the fund level, between Revenues and Other Financing Sources and between Expenditures and Other Financing Uses.
- Explain how revenues and expenditures are classified in the General Fund.
- Explain how budgetary accounting contributes to achieving budgetary control over revenues and expenditures, including such aspects as:

  Recording the annual budge
  Accounting for revenues.
  Accounting for encumbrances and expenditures.
  Accounting for allotments.

3.1.Nature of General and Special Revenue Funds

Special revenue funds are established to account for general governmental financial resources that are restricted by law or contractual agreements to specific purpose (s) and special revenue funds are exist for the life of restriction. For example, they may be used to account for federal (state) grants which are restricted as to purpose or to account operating activities of libraries and other services supported by special taxes. Another example might be when a tax or other revenue source is restricted to a specific purpose by a legislative body; its use assists in demonstrating compliance with that purpose.

General Fund account for unrestricted resources and resources not requiring accounting elsewhere. The General fund exists from inception of the government throughout the government`s life unlike that of special revenue funds which exist as long as the government has resources dedicated to specific purposes.

Resources of the *General Fund and special revenue funds* are expended each year and are commonly replenished for current operating purposes such as for salaries, supplies, and contractual services; routine capital outlay such as for vehicles and equipment; and for routine debt services such as for capital leases and equipment notes payable. Resources which are significant in amounts which are to be expended for large capital projects or debt services are usually transferred from the General Fund or special revenue funds to *capital projects funds and debt service funds*, respectively and then expended from those funds.

Assume that the town council approved the creation of a new Supplies Fund, an internal service fund, effective January 1, 2005, to provide most operating and office supplies used by departments accounted for in the General Fund. The new fund was created by transferring the current inventory of supplies amounting $61,500, and $30,000 in cash from the General Fund, general government function.

Required: Prepare the necessary journal entries for General Fund.

Solution

<u>General Fund</u>

(1) Other Financing Uses—Inter-fund Transfer Out	91,500	
Inventory of supplies		61,500
Cash		30,000

<u>Other Financing Uses Ledger:</u>

General Government 91,500

<u>General Fund</u>

(2) Reserve for Inventory of supplies	61,500	
Fund Balance		61,500

Total inflows and outflows for the operating statement accounts of the governmental funds are reported each period in a **statement of revenues, expenditures, and fund balances.**

Both **revenues and other financing sources** are temporary accounts that **increase** fund balance at year-end when closing entries are made. Similarly, **expenditures and other financing uses** are temporary accounts that **decrease** fund balance when closing entries are made. GASB standards emphasize, however, that other financing sources (uses) should be distinguished from revenues and expenditures.

GASB standards require that the operating statement accounts of a governmental fund such as the General Fund be recognized on the **modified accrual basis of accounting.**

Available means that the revenue or other financing source is expected to be collected during the current period or soon enough thereafter to pay current period obligations. In the case of property taxes, GASB requires expected collection **within 60 days** after the end of the current fiscal year for the taxes to be recognized as a current-period revenue. Thus, if a portion of the current tax levy is not expected to be collected within 60 days, it would be recorded in the current period as a credit to **Deferred Revenues** (a current liability).

In the following year, **Deferred Revenues** would be debited and **Revenues** would be credited. For all other categories of revenues, as well as other financing sources, governmental units have the discretion to determine the length of time used to define available (generally not more than

90 days after the current fiscal year-end) but must disclose their policy in the notes to the financial statements.

Table Relationship between Budgetary and Operating Statement Accounts

Budgetary Accounts		**Operating Statement Accounts**		**Budgetary Status**
Account Title	**Normal Balance**	**Account Title**	**Normal Balance**	
Estimated Revenues	Debit	**Revenues**	Credit	Net balance indicates deficit (excess) of operating (actual) vs. budgeted revenues.
Estimated Other Financing Sources	Debit	**Other Financing Sources**	Credit	Net balance indicates deficit (excess) of actual OFS vs. budgeted OFS.
Appropriations	Credit	**Expenditures**	Debit	Appropriations minus the sum of Expenditures and Encumbrances indicate remaining or overspent expenditure authority.
Estimated Other Financing Uses	Credit	**Other Financing Uses**	Debit	Net balance indicates the amount of remaining or overspent interfund transfer authority.
Encumbrances	Debit	NA	NA	See Appropriations line above. An encumbrance has a normal debit balance because it is a commitment to make expenditure and often is considered the same as expenditure for budgetary purposes.

NA = Not applicable, since there is no corresponding operating statement account.
OFS = Other Financing Sources

Budget and Budgetary Accounts

The fact that budgets are legally binding upon administrators has led to the integration of budgetary accounts into the general ledgers of the General Fund and special revenue funds; and all other funds required by state laws to adopt a budget. GASBS 34 requires that a budget to actual comparison schedule be provided for the General Fund and for each major special revenue fund for which a budget is legally adopted. GASBS 34 recommends that these schedules be provided as required supplementary information (RSI)**,** which should be placed immediately following the notes to the financial statements. GASBS 34 provides the option, however, for governments to report the budgetary comparison information in a budgetary comparison statement, a statement of revenues, expenditures, and changes in fund balances —budget and actual, which would then be part of the basic financial statements. Thus, according to GASBS 34, a budgetary comparison can be in the form of a basic financial statement or required supplementary information schedule**.**

GASB require, at a minimum, the presentation of both the originally adopted and final amended budgets and actual amounts of inflows, outflows, and balances.

In order to achieve budgetary control, the following budgetary control accounts are needed in the General Fund (and other funds for which a budget is adopted):

- ❖ **Estimated Revenues-** different sources revenue for the governmental unit expected to be collected during the year. It is an account maintained to show the amount of revenue that will be collected in future. Major revenue source classes commonly used are:

- Taxes
- Special Assessments
- Licenses and Permits
- Intergovernmental Revenues
- Charges for Services
- Fines and Forfeits

Miscellaneous Revenues (including interest earnings, rents and royalties, contribution in lieu of taxes from the government`s enterprise fund activities, escheats, and contributions and donations from private enterprises).

- **Appropriations-**An authorization granted by law to make expenditures and to incur obligations for specific purpose.
- **Encumbrances-** An account used to record the estimated amount of purchase orders or contracts
- **Estimated Other Financing Sources-**amount of financial resources estimated to be received during the period from inter fund transfer.
- **Estimated Other Financing Uses –** amount of financial resources estimated to be disbursed for other funds.

Subsidiary ledger accounts should be provided in whatever detail is required by law or for sound financial administration to support each of the control accounts.

The normal balance of Budgetary and Operating Statement Accounts can be summarized as follows.

Budgetary Accounts		**Operating Statement Accounts**	
Account Title	**Normal Balance**	**Account Title**	**Normal Balance**
Estimated Revenues	Debit	**Revenues**	Credit
Estimated Other Financing Sources	Debit	**Other Financing Sources**	Credit
Appropriations	Credit	**Expenditures**	Debit
Estimated Other Financing Uses	Credit	**Other Financing Uses**	Debit
Encumbrances	Debit		

Recording the budget

- At the beginning of the budget period, the estimated revenue control account is debited for the total amount of revenues expected to be recognized as provided in the revenue budget where as the credit will be fund balance.

  Estimated revenue ------------------xx

  Fund balance -----------------------xx
- The accounting entry to record the legally approved appropriations budget is a debit to fund balance and a credit to appropriations.

  Fund balance ---------------------------xx

  Appropriation ---------------------xx
- Budgeted inter fund transfer may be recorded as

  Fund balance ------------xx

  Estimated other financing uses ------------- xx

- ✓ The estimated revenues account and estimated other financing source accounts may be considered as pseudo asset account, because it reflects revenues expected to be received by general fund during the fiscal year.
- ✓ Appropriations account and estimated other financing use may be considered as a pseudo liability account, because it reflects legislative body's commitment to expend.

Illustration: Assume the following are the amounts that have been legally approved as the budget for the general fund of a certain governmental unit for the fiscal year ending December 31, 2008.

Estimated revenue		Appropriations	
Taxes --------------------------------	882,500	General gov't ----	1,150,000
Intergovernmental revenue -----	200,000	Public safety -----	212,000
License and permit --------------	195,000	Totals----------------	**1,362,000**
Tota ---------------------------------	**1,277,500**		

Estimated other financing uses (EOFU)

Operating transfer out to other funds ---------------------274,500

Required: Show in general form the entries that would be necessary to record the budget assume it is legally approved at the beginning of the year; show the subsidiary ledger as well.

Solution

1. Estimated revenue ----------------------------1,277,500

    Fund balance -----------------------------------1,277,500

    (To record general ledger)

    Revenue ledger (subsidiary ledger): Dr

    Tax --882,500

    Intergovernmental revenue ----------------------------200,000

    License and permit ------------------------------------195,000

2. Fund balance ------------------------------------1362,000

    Appropriation --1,362,000

    (To record the general ledger)

    Appropriation ledger (subsidiary): Cr

    General government ------------------------------------- 1,150,000

    Public safety ---212,000

3. Fund balance ------------------------------------274,500

    EOFU --274,500

    (To record the general ledger)

Other financing use ledger (subsidiary): Cr

Operating transfer out to other funds -------------------274,500

4. **Combined entry**

    Estimated revenue --------------------------------1,277,500

    Fund balance ------------------------------------- 359,000

    Appropriations --1,362,000

EOFU --- 274,500

Accounting for subsequent collection of Revenues

- To establish accountability for revenues and permit budgetary control, actual revenues should be recognized in the general ledger accounts of governmental funds by **credits to the Revenues account** (offset by **debits to receivable accounts for revenues that are accrued or by debits to Cash for revenues recognized when received in cash).** The general ledger Revenues account is a control account supported by Revenues subsidiary ledger accounts kept in exactly the same details as kept for the Estimated Revenues subsidiary ledger accounts.

  When revenues are collected in cash, the journal entry would be:

Cash	xxx	
Revenues		xxx

Classification of Estimated Revenues and Revenues

The primary classification of governmental revenue is by **fund.** Within each fund, the major classification is by source. Within each major source class, it is desirable to have as many secondary classes as needed to facilitate revenue budgeting and accounting.

Major revenue source classes commonly used are these:

- Taxes (ad-valorem and self-assessing)
- Special Assessments
- Licenses and Permits
- Intergovernmental Revenues
- Charges for Services
- Fines and Forfeitsand Miscellaneous Revenues (including interest earnings, rents and royalties, contribution in lieu of taxes from the government`s enterprise fund activities, escheats, and contributions and donations from private enterprises).

A. Taxes (including property, sales, income and other taxes; penalties and interest on delinquent taxes)

Taxes are of particular importance because (1) they provide a large portion of the revenue of governmental units on all levels and (2) they are compulsory contributions to the cost of government, whether the affected taxpayer approves or disapproves of the taxes.

Property taxes are based on value in proportion to the assessed valuation of real or personal property. Property taxes are a mainstay of financing for many local governments but are not used as a source of revenue by many state governments or by the federal government.

The valuation of each parcel of taxable real property, and of the taxable personal property owned by each taxpayer, is assigned by a process known as **property assessment.**

The tax rate is set by one of two widely different procedures:

(1) The government simply multiplies the assessed valuation of property in its jurisdiction by a flat rate—either the maximum rate allowable under state laws or a rate determined by policy—or

Gross Tax Levy = Statutory or Legislatively x Assessed Valuation of Taxable Property

Approved Tax Rate (either real property or personal property)

(2) The property tax is treated as a **residual source of revenue.**

Gross Tax Levy = $\dfrac{\text{Amount of Revenue Required from Property Taxes}}{\text{Estimated Collection Portion of the Levy}}$

Recording Property Tax Levy

Property tax revenue is an example of non-exchange revenue—one in which the government receives value without directly giving equal value in exchange. For imposed non-exchange revenues, a receivable should be debited when there is an enforceable claim, as in the case of a property tax levy, and revenue should be credited in the year for which the tax was levied.

When property taxes are levied, the usual journal entry in the General Fund or special revenue funds (or other governmental funds) and Governmental Activities at government-wide level would be as follows:

General Fund

Tax Receivable—Current---------------------------xxx
Estimated Uncollectible Current Taxes-------- xx
Revenues--- xx

Governmental Activities

Taxes Receivable—Current------------------------ xxx
Estimated Uncollectible Current Taxes----- xx
General Revenues---------------------------- xx

When taxes levied are collected in the current period, the following entry is made in both the General Fund and governmental activities journal:

General Fund and Governmental Activities:

Cash ------------------------------------ xxx
Taxes Receivable—Current------- xxx

When property taxes levied were legally due before the end of the year, any balance of taxes receivable at year-end is properly classified as **delinquent taxes** rather than current. The related **allowance for estimated uncollectible taxes** should also be transferred to the delinquent classification. The entry to accomplish the reclassification would be:

General Fund and Governmental Activities

Taxes Receivable—Delinquent------------------------- xxx
Estimated Uncollectible Current Taxes---------------- xx
Taxes Receivable—Current---------------------- xxx
Estimated Uncollectible Delinquent Taxes----- xx

Delinquent taxes are subject to interest and penalties. When interest and penalties on delinquent taxes are accrued, the following entries are necessary in General Fund and Governmental Activities.

General Fund

Interest and Penalties Receivable on Taxes-----------------xxx (total)
Estimated Uncollectible Interest and Penalties------ xx
Revenues-- xxx (expected to be collected)

Revenues Ledger

Interest and Penalties on Delinquent taxes------------------------------ xxx

Governmental Activities

Interest and Penalties Receivable on Taxes------------------------------------ xxx

Estimated Uncollectible Interest and Penalties--------------------------- xx

General Revenues— Interest and Penalties on Delinquent Taxes------ xxx

Delinquent taxes are subject to interest and penalties that must be paid at the time the tax bill is paid. It is possible for a government to record the amount of penalties at the time the taxes become delinquent. Interest may be computed and recorded periodically to keep the account on the accrual basis; it must also be computed and recorded for the period from the date of last recording to the date when a tax payer pays delinquent taxes.

When delinquent taxes as well as related interest and penalties are collected, the journal entry in General Fund and Government-wide level is:

General Fund and Governmental Activities:

Cash-- xxx

Taxes Receivable—Delinquent----------------- xx

Interest and Penalties Receivable on Taxes--- xx

Write-off of Uncollectible Delinquent Taxes

When delinquent taxes and related interest and penalties on delinquent taxes are write-off, the entry in both the General Fund and governmental activities would be:

General Fund and Governmental Activities

Estimated Uncollectible Delinquent Taxes----------- xxx

Estimated Uncollectible Interest and Penalties ----- xx

Tax Receivable—Delinquent--------------------- xxx

Interest and Penalties Receivable on Taxes----- xx

When delinquent taxes are written off, the tax bills are retained in the files in case it becomes possible to collect the amounts in the future. If collections of written-off taxes are made, it is highly desirable to return the tax bills to general ledger control by making an entry that is the reverse of the write-off entry.

Accounting for General Long-term Liabilities and Debt Service

Sales Taxes, Income Taxes, and Gross Receipts TaxesGASB standards provide that revenue from sales taxes, income taxes, and gross receipts taxes are be recognized, net of estimated refunds, in the accounting period in which underlying transactions (e.g., sales and earnings) occur.

Example: The Village of Darby`s budget calls for property tax revenues for the fiscal year ending December 31, 2008, for $2,660,000. Village records indicate that, on average, 2 percent of taxes levied are not collected. The county tax assessor has assessed the value of taxable property located in the village at $135,714,300.

Required:

(a) Record the tax levy for 2008 in the General Fund. (Ignore subsidiary detail and entries at the government-wide level). Record credits to Revenues of $2,660,000 and Estimated uncollectible current taxes of $54,286.

(b) Assume by December 31, 2008, $2,540,000 of the current property tax levy had been collected. Record the amounts collected and reclassify the uncollected amount as delinquent. Interest and penalties of 6 percent were immediately due on the delinquent taxes, but the finance director estimates that 10 percent will not be collectible. Record the interest and penalties receivable. (Round all amounts to the nearest dollar).

B. Licenses and Permits

Commonly found among licenses and permits include items such as vehicle licenses, amusement licenses, business and occupational licenses, liquor licenses, marriage licenses, animal licenses, building permits, street and curb permits, zoning variances, etc. regardless of the governmental level or the purpose of a license or permit, the revenue it produces is ordinarily accounted for when cash is received.

The journal entry at the time of collection would be:

Cash	xxx	
Revenues		xxx

Intergovernmental revenues include grants and other financial assistance. These may be *government–mandated non-exchange transactions* (for example, certain state sales taxes required by law to be shared with local governments) or *voluntary non-exchange transactions* (for example, federal and state grants for which local governments compete).

C. Charges for Services

A few of the many revenue items included in this category are court costs; special police service; solid waste collection charges; street, sidewalk, and curb repairs; receipts from parking meters; library use fees (but not fines); and tuition.Charges for services should be recognized as revenue when measurable and available if that is prior to the collection of cash.

D. Fines and Forfeits

Revenue from fines and forfeits includes fines and penalties for commission of statutory crimes and for neglect of official duty; forfeitures of amounts held as security against loss or damage, or collections from bonds or sureties placed with the government for the same purpose; and penalties of any sort, except those levied on delinquent taxes. Library fines are included in this category. Revenues from fines and forfeits may be recognized when received in cash if accrual is not practicable.

E. Miscellaneous Revenues

These are revenues that do not fall into one of the other categories, such as:

- proceeds from the sale of government assets (if immaterially small in amount; other financing source otherwise)
- Some items of miscellaneous revenues, such as interest earnings on investments, might well be accrued, but mostly they are accounted for when received in cash. Also, interest earnings that are significant in amount may be reported as a separate classification.
- investment income, Accrue if the amount is known prior to the receipt of cash

3.2.Tax Anticipation Notes Payable

Revenues from property taxes are often collected during one or two months of the year. Expenditure demands may occur more or less uniformly during the year. A local bank may extend a lien of credit in the form of tax anticipation notes to meet short-term cash needs since the notes will be backed by the power of lien over taxable properties.

When money is borrowed in tax anticipation notes, the necessary entries in both General Fund and governmental activities are:

General Fund and Governmental Activities

Cash	xxx	
Tax Anticipation Notes		xxx

Repayment of Tax Anticipation Notes

Just as borrowing the money did not involve the recognition of revenue, the repayment of the principal is merely the extinguishment of debt of the General Fund and is not expenditure. *Payment of interest*, however, must be recognized as *the expenditure of an appropriation* because it requires a reduction in the fund balance of the fund.

Assume on April 1, 2008, the city of Mekelle signs a 60-day, $300,000 tax anticipation note, discounted at 6 percent per annum.

Required: Record the necessary entries in both the General Fund and governmental activities at government-wide level.

General Fund

Cash	297,000	
Expenditures—2008 (6% x $300,000 x 60/360)	3,000	
Tax Anticipation Notes Payable		300,000

Governmental Activities

Cash	297,000	
Expense—Interest on Tax Anticipation Notes	3,000	
Tax Anticipation Notes Payable		300,000

a) Assume the city of Mekelle repaid the 60-day, $300,000 tax anticipation note on the due date. Record the entries in both General Fund and governmental activities at government-wide level.

General Fund and Governmental Activities

Tax Anticipation Notes Payable	300,000	
Cash		300,000

Assume during fiscal year 2008, the Town of Mekelle has collected revenues in cash from the sources shown below.

Licenses and permits	$100,000
Fines and forfeits	151,000
Charges for services	7,000
Miscellaneous revenues	1,200

The journal entry in **General Fund and governmental activitiesat government-wide level** would be:

General Fund:

Cash 259,200
Revenues 259,200

Revenues Ledger:

Licenses and permits	$100,000
Fines and forfeits	151,000
Charges for services	7,000
Miscellaneous revenues	1,200

Of the preceding revenues, licenses and permits, fines and forfeits, and charges for services are appropriately recorded as **program revenues at the government-wide level**. Licenses and permits are attributed to the general government function. Fines and forfeits were assessed by the Public Safety function in the amount of $91,000 and by the Public Works function in the amount of $60,000. Charges for services were received from customers of the Parks and Recreation function. Miscellaneous revenues cannot be identified with a specific program and thus are recorded as general revenues at the government-wide level. Based on this information the entry that should be made in the journal for governmental activities would be:

Governmental Activities:

Cash	259,200	
Program Revenues—General Government—Charges for Services		100,000
Program Revenues—Public Safety—Charges for Services		91,000
Program Revenues—Public Works—Charges for Services		60,000
Program Revenues—Parks and Recreation—Charges for Services		7,000
General Revenues—Miscellaneous		1,200

An appropriation is a legal authorization for administrators to incur on behalf of the governmental unit liabilities in the amounts specified in the appropriation ordinance or statue, for the purposes set forth in that ordinance or statue, during the period of time specified. An**appropriation** is considered ***expended*** when the authorized liabilities have been incurred. Because penalties are imposed by law on an administrator who incurs liabilities for any amount in excess of that appropriated, or for any purpose not covered by an appropriation, or who incurs liabilities after the authority to do so has expired, prudence dictates that each purchase order and each contract be reviewed before it is signed to determine that a valid and sufficient appropriation exists to which the expenditure can be charged when goods or services are received.

An **encumbrance**is an estimated amount recorded for purchase orders, contracts, or other expected expenditures chargeable to an appropriation.

❖ Encumbrance accounts are affected when an order is placed and when the goods or services are received. When the order is placed, the journal entry would be as follows:

Encumbrance's *xxx*
Reserve for Encumbrances *xxx*

- When goods or services for which encumbrances have been recorded are received and the suppliers` invoices are approved for payment, the accounts should record the fact that appropriations have been expended, not merely encumbered, and that an actual liability, not merely an expended liability, exists. The journal entry would be:

Reserve for Encumbrances	xxx	
Encumbrance's		xxx
Expenditures	xxx	
Vouchers Payable		xxx

The estimated and actual amounts differ causes no accounting difficulties as long as goods or services are received in the same fiscal period as ordered.

The encumbrance procedure is not necessary for every type of expenditure transaction. For example, although salaries and wages of governmental employees must be chargeable against valid and sufficient appropriations in order to give rise to legal expenditures, many governmental units do not find it necessary to encumber the departmental personal services appropriations for estimated payrolls of recurring, relatively constant amounts. Departments having payrolls that fluctuate greatly from one season to another may follow the encumbrance procedure to make sure the personal service appropriation is not over expended.

Reserve for Encumbrances, sometimes called **Outstanding Encumbrances**, is not a control account: the balance of the account at the balance sheet date is reported as a **reservation of fund balance.**

Assume purchase orders and contracts in the following estimated amounts were issued by Johnson City chargeable against these 2008 appropriations:

General government	$100,000
Public safety	400,000
Public works	150,000
Total	$650,000

Required: Show the necessary entry in general journal form to record the issuance of purchase orders and contracts. (Show entries in subsidiary ledger accounts as well as general ledger accounts.)

Classification of Expenditures and Appropriations

According to GASB Transfer, Revenue, Expenditure, and Expense Account Classifications Principle, expenditures should be classified by (1) fund, (2) function or program, (3) organization unit, (4) activity, (5) character, and (6) object.

Classification by Fund

The primary classification of governmental expenditures is by fund, since a fund is the basic fiscal and accounting entity of a governmental unit. Purposes served by fund classification—identify which fiscal and accounting entity was affected.

Classification by Function or Program

The GASB distinguishes between functions and programs in the following manner:

Functions group related activities that are aimed at accomplishing a major service or regulatory responsibility. **Programs group activities**, operations, or organizational units that are directed to the attainment of specific purposes or objectives.

Examples of common functional classification are the following:

- General Government, Public safety, Highways and Streets, Health and Welfare and Culture and Recreation

Purposes served by function or program classification—assists in budgeting resources for carrying out major areas of service activities or goals.

Classification by Character

Classification by character, as defined by the GASB, is based on the fiscal period that benefits from a particular expenditure. A common classification of expenditures by character recognizes three groups:

✓ Current expendituresCapital outlays andDebt service

Purposes served by character classification—assist in evaluating which period is benefited by expenditure: past, current, or future.

Classification by Organization Unit

Classification of expenditures by organizational unit is considered essential to management control, assuming the organizational structure or given governmental unit provides clear lines of responsibility and authority. Some examples of organizational units that might be found in a city are these:

❖ Police Department, Fire Department, Building Safety Department, Public Works Department, City Attorney, City Clerk, Personnel Department and Parks and Recreation Department.

Purposes served by organization unit classification—Assists in enhancing managerial control over departments and divisions, and responsibility accounting.

Classification by Activity

An **activity** is a specific and distinguishable line of work performed by an organization unit. For example, within the public works department, activities such as the following may be performed:

- Solid waste collection—residential, Solid waste collection—commercial, Solid waste disposal—landfill and Solid waste disposal—incineration

Purposes Served by Activity Classification—assists in assessing performance on specific lines of work and determining cost of activities

Classification by Object

The **object of expenditure** is the thing for which the expenditure was made. Object classes may be viewed as subdivisions of character classifications. One scheme of object classification includes the following major classes:

❖ Personal services, Supplies, Other services and charges, Capital outlays and Debt service.

Purposes served by object classification—Assists in determining how much was expended for specific things, such as personnel and equipment.

3.3.Interim Financial Statements

Periodically during a year it is desirable to prepare financial statements for the information of administrators and members of the legislative branch of the governmental unit.

Interim Balance Sheet

Balance sheet equation at an interim point during the year (e.g., end of first quarter):

Assets + Budgetary Resources = Liabilities + Available Appropriations + Reserved Fund Balances + Unreserved Fund Balance

Budgetary resources—are the amount of unrealized estimated revenues to date (estimated revenues minus actual revenues).

Available Appropriations—is the amount of appropriations that has not yet been expended or encumbered. It is one component of Fund Equity at an interim point during the year.

The interim balance sheet reflects the balances of both actual and budgetary accounts. Instead of Assets, which those familiar with accounting for profit-seeking entities would expect, the caption must be Assets and Resources because the excess of Estimated Revenues over Revenues is not an asset as of the balance sheet date but does indicate the amount that will be added to assets when legally budgeted revenues are recognized. Similarly, the caption is not Equities, or Liabilities and Capital, or another title commonly found in financial reports of profit-seeking entities but Liabilities and Budgeted Fund Equity.

The Liability section is consistent with that of profit-seeking entities, but the next section discloses the three subdivisions of the Fund Equity. The first presents the amount appropriated for the year, less the amount of appropriations that have been expended during the year to date and less the amount of appropriations that have been encumbered by purchase orders and contracts outstanding at balance sheet date, the net is the amount that legally may be expended or encumbered during the remainder of the budget year. The second subdivision discloses the portion of budgeted fund equity that is not available for appropriation because expected liabilities exist (or certain assets will not be converted into cash in the normal operations of the fund). The remaining subdivision, Fund Balance, discloses that portion of the budgeted fund equity available for appropriation. Accordingly, in financial statement presentation, the word Unreserved or the phase Available for Appropriation is sometimes used in place of Fund Balance. Fund Balance, in an interim balance sheet, is the excess of the sum of actual assets and budgeted resources over the sum of actual liabilities, available appropriations, and reserves for assets not available for appropriation; in short, it has both actual operating and budgetary aspects at an interim point in time.

Operating Transactions and Interim General Fund Balance Sheet

Example: The City of Macon`s General Fund had the following post-closing trial balance at April 30, 2007, the end of its fiscal year:

	Debits	**Credits**
Cash	$97,000	
Taxes Receivable-Delinquent	583,000	
Estimated Uncollectible-Delinquent Taxes		$189,000
Interest and penalties Receivable	26,280	
Estimated Uncollectible Interest and Penalties		11,160

Inventory of Supplies	16,100	
Vouchers Payable		148,500
Due to Federal Government		59,490
Reserve for Inventory of Supplies		16,100
Fund Balance		298,130
	$722,380	**$722,380**

During the six months ended October 31, 2007, the following transactions, in summary for, with subsidiary ledger detail omitted, occurred:

1. The budget for FY 2008 provided for General Fund estimated revenues totaling $3,170,000 and appropriations totaling $3,100,000.

2. The country council authorized a temporary loan of $300,000 in the form of a 120-day tax anticipation note. The loan was obtained from a local bank at a discount of 6 percent per annum (debit Expenditures for discount).

3. The property tax levy for FY 2008 was recorded. Net assessed valuation of taxable property for the year was $43,000,000, and the tax rate was $5 per hundred. It was estimated that 4 percent of the levy would be uncollectible. Classify this tax levy as current.

4. Purchase orders and contracts in the amount of $1,027,000 were issued to vendors and others.

5. Current taxes of $1,034,000, delinquent taxes of $340,000, and interest and penalties of $13,240 were collected. Because of taxpayers` delinquencies in payment of the first installment of taxes, additional penalties of $15,230 were levied but had not yet been collected.

6. Total payroll for the first six months of the year was $481,070. Of that amount, the following amounts were withheld: $36,800 for employees` FICA tax liability, $61,200 for employees` federal income tax liability, and $20,000 for state taxes; the balance was paid in cash.

7. The employer`s FICA tax liability amounted to $36,800.

8. Revenues from sources other than taxes were collected in the amount of $335,000.

9. Amounts due to the federal government as of April 30 and amounts withheld for federal and state withholding taxes during the year were vouched.

10. Purchase orders and contracts encumbered in the amount $890,800 were filled at a net cost of $894,900, which was vouchered.

11. Cash of $1,099,060 was paid on vouchers payable, and credit for purchases discount earned was $8,030 (credit Expenditures).

12. The tax anticipation note of $300,000 was repaid.

Required: A. Record in general journal form the effect of the transactions for the six months ended October 31 on the General Fund and governmental activities. You need not record subsidiary ledger debits and credits.

B.Prepare a General Fund interim balance sheet.

Solution

ROMULUS COUNTY
JOURNAL ENTRIES FY 2005

		Debits	Credits
	General Fund:		
(1)	Estimated revenues	3,170,000	
	Appropriations		3,100,000
	Fund balance		70,000
	General Fund:		
(2)	Cash	294,000	
	Expenditures—2005	6,000	
	Tax anticipation notes payable		300,000
	(Computation of discount: $300,000 x .06 x 1/3 year = $6,000.)		
	Governmental Activities:		
	Cash	294,000	
	Interest expense	6,000	
	Tax anticipation notes payable		300,000
	General Fund:		
(3)	Taxes receivable—current	2,150,000	
	Estimated uncollectible current taxes		86,000
	Revenues		2,064,000
	(COMPUTATIONS: $43,000,000 ASSESSED VALUATION X $5.00 TAX RATE PER $100 = $2,150,000 GROSS LEVY; $2,150,000 GROSS LEVY X .04 = $86,000 ESTIMATED UNCOLLECTIBLE.)		
	Governmental Activities:		
	Taxes receivable—current	2,150,000	
	Estimated uncollectible current taxes		86,000
	General revenues—property taxes		2,064,000
	General Fund:		
(4)	Encumbrances—2005	1,027,000	
	Reserve for encumbrances—2005		1,027,000
	General Fund and Governmental Activities:		
(5)	Cash	1,387,240	
	Taxes receivable—current		1,034,000
	Taxes receivable—delinquent		340,000
	Interest and penalties receivable		13,240
	General Fund:		
	Interest and penalties receivable	15,230	
	Revenues		15,230
	Governmental Activities:		

		Debits	Credits
	Interest and penalties receivable	15,230	
	General revenues – interest on taxes		15,230
	General Fund:		
(6)	Expenditures—2005	481,070	
	Due to federal government		98,000
	Due to state government		20,000
	Cash		363,070
	Governmental Activities:		
	Expenses —(itemize functions)	481,070	
	Due to federal government		98,000
	Due to state government		20,000
	Cash		363,070
	General Fund:		
(7)	Expenditures—2005	36,800	
	Due to federal government		36,800
	Governmental Activities:		
	Expenses —(itemize functions)	36,800	
	Due to federal government		36,800
	General Fund:		
(8)	Cash	335,000	
	Revenues		335,000
	Governmental Activities:		
	Cash	335,000	
	Revenues —(itemize sources)		335,000
		Debits	**Credits**
	General Fund and Governmental Activities:		
(9)	Due to federal government	194,290	
	Due to state government	20,000	
	Vouchers payable		214,290
	General Fund:		
(10)	Reserve for encumbrances—2005	890,800	
	Encumbrances—2005		890,800
	Expenditures—2005	894,900	
	Vouchers payable		894,900
	Governmental Activities:		
	Expenses —(itemize functions)	894,900	
	Vouchers payable		894,900
	General Fund:		
(11)	Vouchers payable	1,107,090	
	Cash		1,099,060

Expenditures—2005		8,030
Governmental Activities:		
Vouchers payable	1,107,090	
Cash		1,099,060
Expenses —(itemize functions)		8,030
General Fund and Governmental Activities:		
(12) Tax anticipation notes payable	300,000	
Cash		300,000

***b*. Romulus County**

General Fund

Interim balance sheet, October 31, 2004

Assets and resources

Cash	$ 351,110	
Taxes receivable—current	$1,116,000	
Less: estimated uncollectible	86,000	1,030,000
Taxes receivable—delinquent	243,000	
Less: estimated uncollectible	189,000	54,000
Interest and penalties receivable	28,270	
Less: estimated uncollectible	11,160	17,110
Inventory of supplies		16,100
Total assets		1,468,320
Estimated revenues	3,170,000	
Less: revenues	2,414,230	755,770
Total assets and resources		

3.4.Accounting for Payroll

Payroll accounting is similar for a governmental fund and a for-profit entity, except Expenditures rather than Expenses are recorded.

- ✓ Debit Expenditures for full amount of payroll and credit liabilities for withholdings from employees pay; credit cash for the amount paid to employees.
- ✓ Record expenditures for the employer`s payroll costs, including employer`s share of FICA and credit a liability for federal government.
- ✓ Encumbrances usually are not recorded for recurring expenditure such as payroll.

Example: Assume the gross pay of employees of General Fund departments for the month of January 2008 amounted to $252,000. The Town does not use the encumbrance procedure for payrolls. Deductions from gross pay for the period amount to $19,278 for employees` share of FICA tax; $25,200, employees` federal withholding tax; and $5,040, employees` state withholding tax. The first two will, of course, have to be remitted by the Town to the federal government, and the last item will have to be remitted to the state government. The gross pay is chargeable to the appropriations in the General Fund as indicated by the Expenditures Ledger debits. Assuming that the liability for net pay is vouchered, the entry in the General Fund is:

General Fund:

Expenditures—2008	252,000	
Vouchers Payable		202,482
Due to Federal Government		44,478
Due to State Government		5,040

Expenditures Ledger:

General Government	35,040
Public Safety	156,120
Public Works	29,160
Health and Welfare	19,080
Parks and Recreation	12,600

In addition, the following entry would be required to record the payroll transaction in the governmental activities general journal at the government-wide level, using the **accrual basis** (expenses rather than expenditures):

Governmental Activities:

Expenses—General Government	35,040	
Expenses—Public Safety	156,120	
Expenses—Public Works	29,160	
Expenses—Health and Welfare	19,080	
Expenses—Parks and Recreation	12,600	
Vouchers Payable		202,482
Due to Federal Government		44,478
Due to State Government		5,040

Recording the salaries and wages expenses in the manner shown above permits reporting direct expenses by function. If a government prefers to also record the expenses by natural classification (that is, as salaries and wages expense), it will be necessary to add additional classification detail: for example, Expenses—General Government—Salaries and Wages.

Payments of the vouchers for the net pay results in the following entry in both the General Fund and governmental activities journals:

General Fund and Governmental Activities

Vouchers Payable	202,482	
Cash		202,482

In as much as the town is liable for the employer`s share of FICA taxes ($19,278) and for contributions to additional retirement plans established by state law (assumed to amount to $5,400 for the pay period ended), it is necessary that the town`s liabilities for its contributions be recorded. These obligations were provided for in the Appropriations budget under the account Contributions to Retirement Plans.

General Fund:

Expenditures—2008	24,678

Due to Federal Government		19,278
Due to State Government		5,400

Expenditures Ledger:

Contributions to Retirement Plans 24,678

Additional entry is also required to record the payroll expense on the accrual basis at the government-wide level.

Governmental Activities:

Expenses—General Government	3,430	
Expenses—Public Safety	15,289	
Expenses—Public Works	2,856	
Expenses—Health and Welfare	1,869	
Expenses—Parks and Recreation	1,234	
Due to Federal Government		19,278
Due to State Government		5,400

3.5.Accounting for Inventories of Supplies

Two acceptable methods of accounting for expenditure relating to inventory are used. If governmental unit is large enough to have sizeable inventories of consumable supplies that are used by a number of departments, it is generally recommended that the purchasing, warehousing, and distribution functions be centralized and managed by an internal service fund.

Governments that account for their supplies within the General Fund can use either the ***purchases method or the consumption method.***

1) Purchase Method

Using *purchases method, expenditures for supplies equals the total amount purchased for the year***,** even if the amount of supplies consumed is less than the amount purchased. Thus, the purchases method is consistent with the *modified accrual basis of accounting* used by the General Fund and other governmental funds. The purchases method is generally associated with a *periodic inventory system*, so the balance of the Inventory of Supplies account is increased or decreased as necessary at year-end to agree with the valuation based on a physical count. In addition, a Reserve for Inventory of Supplies account, having a credit balance equal in amount to the balance of the inventory account, is required to indicate that the inventory reported on the balance sheet is not available for spending.

2) Consumption Method

The consumption method is consistent with the *accrual basis of accounting*, as resources (i.e., supplies) consumed in providing services is the essence of an expense. Thus, GASB standards require the use of the consumption method for government-wide and proprietary fund reporting. Using this method, the General Fund recognizes *expenditures equal to the amount of supplies consumed during the year* rather than the amount purchased. Accordingly, budgetary appropriations for supplies are based on estimated consumption rather than estimated purchases. When using the consumption method, reporting of a reservation of fund balance is optional, though recommended.

Example: To illustrate and contrast the consumption and purchases methods, assume the following information for supplies purchases and usage of a certain city for its 2008 fiscal year.

Balance of inventory, January 1, 2008---------------------------------- $55,000
Purchases during 2008--- 260,000
Supplies available for use-- 315,000
Less: Balance of inventory, December 31, 2008----------------------- 65,000
Supplies consumed during 2008-- **$250,000**

Consumption Method

Generally, the consumption method is used with a *perpetual inventory system*; however, because the purchases method is commonly used for General Fund accounting, many governments must convert their purchases information to the consumption basis for governmental activities at the government-wide level. Accordingly, the following examples show consumption method journal entries using both perpetual and periodic inventory control procedures, omitting subsidiary details for simplicity.

Assuming a perpetual inventory system is used, the summary entry to record purchases for the year in the accounts of the General Fund and a governmental activity at the government-wide level is:

General Fund and Governmental Activities:

Inventory of Supplies---------------------- 260,000
Cash------------------------------------ 260,000

The actual consumption (usage) is recorded by the following entries:

General Fund:

Expenditures 250,000
Inventory of Supplies 250,000

Governmental Activities:

Expenses—(Function or program detail omitted) 250,000
Inventory of Supplies 250,000

Observe that these two entries result in expenditures/expenses equal to the amount of supplies consumed ($250,000) and a net increase of $10,000 in the balance of the Inventory of Supplies account during 2008. In addition, if the General Fund opts to report a reserve of fund balance, it would make the following entry:

General Fund:

Fund Balance 10,000
Reserve for Inventory of Supplies 10,000

Unless a physical inventory reveals inventory loss (or gain), no adjusting entry is required at year-end at the government-wide level.

If the city uses a periodic inventory system, but reports inventories under the consumption method in both the General Fund and governmental activities, the following entries are required. To record purchases of supplies for the year, assuming that for budgetary control purposes the city records expenditures for each purchase of supplies (encumbrance entries and subsidiary detail omitted for simplicity):

General Fund:

Expenditures 260,000
Cash 260,000

At year-end, the city`s General Fund adjusting entries will be:

Inventory of Supplies	10,000	
Expenditures		10,000
Fund Balance	10,000	
Reserve for Inventory of Supplies		10,000

The appropriate year-end adjusting entry at the government-wide level depends upon the way inventories are recorded during the year. If purchases during the year debited to Inventories of Supplies, then the adjusting entry will require a debit to expenses and credit to the inventory account. If, on the other hand, the city records expenses at the government-wide level during the year as purchases are made, the adjusting entry will require a debit to inventory and a credit to expenses for the $10,000 increase in inventory that occurred in 2008. Assuming purchases are recorded initially as expenses, the entries that would be required for governmental activities at the government-wide level are:

To record purchases during the year:

Governmental Activities:

Expense (function or program detail omitted)	260,000	
Cash		260,000

The required governmental activities adjusting entry is:

Inventory of Supplies	10,000	
Expenses (function or program detail omitted)		10,000

Purchase Method

Under purchase method, the summary entry in the general Fund to record supplies purchased during the year, assuming all supplies purchased from external vendors and all invoices have been paid, is (encumbrance entries and subsidiary detail omitted for simplicity):

General Fund

Expenditures (function or program detail omitted)	260,000	
Cash		260,000

At year-end, a physical inventory revealed that $65,000 of inventory remained on hand. The entry to record the $10,000 increase in inventory and the corresponding reservation of fund balance is given below:

General Fund

Inventory of Supplies	10,000	
Reservation for inventory of supplies		10,000

(Note: **Reservation of fund balance for inventory** and other reasons applies only to governmental funds that are subject to legal budgetary control. Thus, this entry is unnecessary at the government-wide level.)

In all of these examples, the entries in the General Fund are somewhat more complex because of the need to adjust the Reserve for Inventory of Supplies account at the fund level. One can expect that the GASBS 34 requirement to report inventories using the consumption method at the government-wide level may lead to increased use of this method for the General Fund as well.

Closing Entries

At fiscal year-end, all temporary accounts, both operating and budgetary, must be closed to Fund Balance. Many state and local governments record the difference between budgeted inflows and outflows to a Budgetary Fund Balance account. As a result, the closing process typically involves a simple reversal of the budgetary entry, as amended, with a separate closing entry to close temporary operating accounts to the **Unreserved Fund Balance** account. Since we use a single Fund Balance account for the sake of simplicity, any sequence of of entries and combination of accounts should yield the desired result that all temporary accounts have their balances transferred to the balance sheet account, Fund Balance.

Thus, any combination of entries that close all temporary accounts to Fund Balance is acceptable. The following processes are recommended:

- ✓ Reverse the original and revised budgetary accounts (Estimated Revenues, Estimated Other Financing Sources, Appropriations, Estimated Other Financing Uses, and Encumbrances)
- ✓ Close operating statement accounts (Revenues, Other Financing Sources, Expenditures, and Other Financing Uses) in a second entry, debiting or crediting Fund Balance as necessary to balance the entry.

Example: At the end of a fiscal year, budgetary and operating statement control accounts in the general ledger of the General Fund of Jane City had the following balances: Appropriations**,** **$**6,224,000**;** EstimatedOther Financing Uses, $2,776,000; Estimated revenues $7,997,000;
Encumbrances, $0; Expenditures, $6,192,000; Other financing uses, $2,770,000; Revenues, $8,022,000**.** Appropriations included the authorization to order a certain item at a cost not to exceed $64,700; this was not ordered during the year because it will not be available until late in the following year.

Required:

Show in general journal form the entry needed to close all of the preceding accounts that should be closed as of the end of the fiscal year.

Appropriations	6,224,000	
Estimated other financing uses	2,776,000	
Revenues	8,022,000	
Estimated revenues		7,997,000
Expenditures		6,192,000
Other financing uses		2,770,000
Fund balance		63,000

(Under the conditions given, the $64,700 item should not be treated as an encumbrance. It would need to be provided for the appropriations budget for the next fiscal year.)

3.6.Accounting for Allotments

In some jurisdictions, it is necessary to regulate the use of appropriations so only specified amounts may be used from month to month or from quarter to quarter. The purpose of such control *is to prevent expenditure of all or most of the authorized amount early in the year without providing for unexpected requirements arising later in the year***.** A common device for regulating expenditures is the use of allotments. An **allotment** may be described as an internal allocation of funds on a periodic basis usually agreed upon by the department heads and the chief executive.

- Allotments may be formally recorded in ledger accounts. This procedure might begin with the budgetary entry, in which Unallotted Appropriations would replace Appropriations.

The entry to record amounts formally allotted (for example, for the first period) would be:

Unallotted Appropriations	xxx	
Allotments		xxx

Amounts allotted for each function are shown in the subsidiary ledger entries.

- Expenditures should be recorded periodically as invoices are received by using departments or divisions. Under this procedure, Expenditures, Allotments, and unexpended Unallotted Appropriations are all closed to Fund Balance at year-end.

Accounting for Interfund Transactions and Transfers: Interfund Activity

Reciprocal Interfund Activity

Internal exchange transactions—those involving the sales and purchases of goods and services in a reciprocal exchange transaction between two funds. These transactions are termed interfund services provided and used and interfund loans.

Interfund loans are sometimes made from one fund to another with the intent that the amount be repaid. If the loan must be repaid during the current year or soon thereafter, the lending fund should record a current receivable, and the borrowing fund should record a current liability.

Example: Assume that the General Fund makes a short-term loan in the amount of $100,000 to the Central Stores Fund, an internal service fund.

General Fund:

Interfund Loans receivable—Current	100,000	
Cash		100,000

Internal Service Fund:

Cash	100,000	
Interfund Loans Payable—Current		100,000

If this interfund loan did not require repayment for more than one year, the word "Noncurrent" should be used rather than "Current" to signify the noncurrent nature of the loan. As shown in the following entries, **Noncurrent** is added to each of the interfund loan receivable/payable accounts to indicate that the loan is not payable during the current year or soon thereafter.

General Fund:

Interfund Loans receivable—Noncurrent	100,000	
Cash		100,000

Internal Service Fund:

Cash	100,000	
Interfund Loans Payable—Noncurrent		100,000

Because the **noncurrent interfund loan receivable** represents assets that are not available for the current year`s appropriation in the General Fund, the Fund balance account should be reserved for this amount, as was done for encumbered amounts and ending inventories of supplies.

General Fund:

Fund Balance	100,000	
Reserve for Noncurrent Interfund Loans Receivable		100,000

CHAPTER FOUR
ACCOUNTING FOR GENERAL LONG TERM ASSETS AND CAPITAL PROJECT FUND

After studying this chapter, you should be able to:

- Describe the nature and characteristics of general capital assets
- Account for general capital assets, including: acquisition, depreciation and disposition
- Explain the purpose, characteristics and typical financing sources of a capital projects fund
- Prepare journal entries for a typical capital project, both at the fund level and within the governmental activities category at the government-wide level
- Prepare financial statements for capital projects

4.1. Natures and Accounting for General Capital Assets(General Long Term Assets)

Long-lived assets used by activities financed by the General Fund or other governmental funds are called general capital assets. General capital assets should be distinguished from capital assets that are specifically associated with activities financed by proprietary and fiduciary funds. Capital assets acquired by proprietary and fiduciary funds are accounted for by those funds.

Acquisitions of general capital assets that require major amounts of money ordinarily cannot be financed from General Fund or special revenue fund appropriations. Major acquisitions of general capital assets are commonly financed by issuance of long-term debt to be repaid from tax revenues or by special assessments against property deemed to be particularly benefited by the long-lived asset. Other sources for financing the acquisition of long-lived assets include grants from other governments, transfers from other funds, gifts from individuals or organizations, capital leases, or a combination of several of these sources.

If money received from these sources is restricted, legally or morally, to the purchase or construction of specified capital assets, it is recommended that a capital projects fund be created to account for resources to be used for such projects. When deemed useful, capital projects funds may also be used to account for the acquisition of major general capital assets, such as buildings, under a capital lease agreement. Leases involving equipment are more commonly accounted for by the General Fund.

Accounting for general capital assets

Only proprietary funds routinely account for capital assets (property, plant, equipment, and intangibles) used in their operations. Fiduciary funds may use capital assets for the production of income, in which case they also account for property, plant, and equipment within the fund. Since governmental funds account only for current financial resources, these funds do not account for capital assets acquired by the funds. Rather, general capital assets purchased or constructed with governmental fund resources are recorded in the governmental activities general ledger at the government-wide level.

Governmental Accounting Standards Board (GASB) standards require that general capital assets be recorded at historical cost or fair value at time of receipt if assets are received by donation. **Historical cost** includes acquisition cost plus ancillary costs necessary to put the asset into use.
Ancillary costs may include items such as freight and transportation charges, site preparation costs, and set-up costs. If the cost of a capital asset was not recorded when the asset was acquired and is unknown when accounting control over the asset occurred, it is acceptable to record an estimated cost.

Under the GASB reporting model, general capital assets are reported in the Governmental Activities column of the statement of net assets, net of accumulated depreciation, when appropriate. Any rational and systematic depreciation method is allowed. Depreciation is not reported for inexhaustible assets such as land and land improvements, non-capitalized collections of works of art or historical treasures, and infrastructure assets that are accounted for using the *modified approach.* The term amortization rather than depreciation is used when referring to intangible assets.

Management should maintain an inventory record for each asset, or group of related assets, that exceeds the minimum dollar capitalization threshold established by the government. Inventory records help achieve accountability and should provide all information needed for planning an effective maintenance program, preparing budget requests for replacements and additions, providing for adequate insurance coverage, and fixing the responsibility for custody of the assets.

Even though general capital assets are acquired for the production of general governmental services rather than for the production of services that are sold, reporting depreciation on general capital assets may provide significant benefits to users and managers alike. Reporting depreciation expense as part of the direct expenses of functions and programs in the Governmental Activities column of the government wide statement of activities helps to determine the full cost of providing each function or program.
Depreciation expense on capital assets used in the operations of a government grant–financed program is often an allowable cost under the terms of a grant. In addition, depreciation expense may provide useful information to administrators and legislators concerned with the allocation of resources to programs, departments, and activities. To a limited extent, a comparison of the accumulated depreciation on an asset with the cost of the asset may assist in budgeting outlays for replacement of capital assets.

Classification of General Capital Assets

As discussed previously in this chapter, general capital assets typically are those acquired using the financial resources of a governmental fund. Many of these assets, however, are not used exclusively in the operations of any one fund, nor do they belong to afund

Land

The cost of land acquired by a government through purchase should include not only the contract price but also such other related costs as taxes and other liens assumed, title search costs, legal fees, surveying, filling, grading, draining, and other costs of preparing for the use intended. Governments are frequently subject to damage suits in connection with land acquisition, and the amounts of judgments levied are considered capital costs of the property acquired. Land acquired through forfeiture should be capitalized at the total amount of all taxes, liens, and other claims surrendered plus all other costs incidental to acquiring ownership and perfecting title. Land acquired through donation should be recorded on the basis of appraised value at the date of acquisition; the cost of the appraisal itself should not be capitalized, however.

Buildings and Improvements Other than Buildings

If a definition of assets classified as buildings is needed, they may be said to consist of those structures erected above ground for the purpose of sheltering persons or property. Improvements other than buildings consist of land attachments of a permanent nature, other than buildings, and include, among other things, walks, walls, and parking lots.

The determination of the cost of buildings and improvements acquired by purchase is relatively simple, although some peripheral costs may be of doubtful classification. The price paid for the assets constitutes most of the cost of purchased items, but legal and other costs plus expenditures necessary to put the property into acceptable condition for its intended use are proper additions. The same generalizations may be applied to acquisitions by construction under contract; that is, purchase or contract price plus positively identified incidentals, should be capitalized.

The determination of the cost of buildings and improvements obtained through construction by some agency of the government (sometimes called force account construction) is slightly more difficult. In these cases, costs should include not only all direct and indirect expenditures of the fund providing the construction but also materials and services furnished by other funds.

The value of buildings and improvements acquired by donation should be established by appraisal. As in the case of land, one reason for setting a value on donated buildings and improvements is to aid in determining the total value of capital assets used by the government and for reports and comparisons. However, more compelling reasons exist for setting a value on buildings and certain improvements: the need for obtaining proper insurance coverage and the need to substantiate the insurance claim if loss should occur. Finally, one should not lose sight of the fact that the cost of donated general capital assets is also required to be reported in the Governmental Activities column of the government-wide financial statements.

Equipment, or Machinery and Equipment

Machinery and equipment are usually acquired by purchase. Occasionally, however, machinery and equipment may be constructed by the government, perhaps financed by an internal service fund. In such cases, the same rules will apply as for buildings and improvements constructed by governmental employees. The cost of machinery and equipment purchased should include items conventional under business accounting practice: purchase price, transportation costs if not included in purchase price, installation cost, and other direct costs of readying for use. Cash discounts on machinery and equipment purchased should be treated as a reduction of costs.

Donated equipment should be recorded in the same manner and for the same reasonsas donated buildings and improvements.

Construction Work in Progress

Construction Work in Progress is the account needed to record construction expenditures accumulated to the end of the fiscal year on projects financed by capital projects funds. As described later in this chapter, construction expenditures by capital projects funds are ordinarily closed to Fund Balance at the end of each year, but the amounts are not capitalized in the funds financing the construction. Instead, the amounts to be capitalized are debited to the account Construction Work in Progress in the governmental activities general journal at the government-wide level.

Infrastructure Assets

Infrastructure assets are capital assets, such as highways, streets, sidewalks, storm drainage systems, and lighting systems that are stationary in nature and normally can be preserved for a longer life than most other capital assets. The GASBS 34 reporting model ushered in a new era in infrastructure accounting and reporting by requiring that all state and local governments report the cost of their infrastructure assets in the government-wide statement of net assets. Unless a government adopts the modified approach discussed below, it must also report depreciation expense for infrastructure assets in its government-wide statement of activities. Under the previous standards, most governments opted not to report their investment in infrastructure

assets because they believed the immovable and nontransferable nature of such assets made financial information about them of limited value for stewardship or decision making purposes. In its basis for conclusions in GASBS 34, the GASB argued that failure to recognize the benefits associated with investment in capital assets (including infrastructure) in the statement of net assets, while recognizing the long-term debt incurred to acquire the capital assets, would result in a misleading net assets deficit.

GASB further argued that the cost of using capital assets (in the form of a depreciation) should properly be included in determining the full costs of conducting governmental programs. Under the modified approach, a government can elect not to depreciate certain eligible infrastructure assets, provided that two requirements are met.

The two requirements are:

(1) The government manages the eligible infrastructure assets using an asset management system that includes

a. an up-to-date inventory of eligible assets,
b. condition assessments of the assets and summary of results using a measurement scale, and
c. estimates each year of the annual amount needed to maintain and preserve the eligible assets at the condition level established and disclosed by the government, and

(2) The government documents that the eligible infrastructure assets are being preserved approximately at (or above) the condition level established and disclosed (see item 1,(c) above).

What constitutes adequate documentation requires professional judgment. At a minimum, the government must provide documentation that (1) complete condition Assessments are made at least every three years and (2) the three most recent condition assessments provide reasonable assurance that the eligible infrastructure assets are being preserved at or above the established condition level. If requirements are met and adequate documentation is maintained, all expenditures incurred to preserve the eligible infrastructure assets should be expensed in the period incurred.

Additions and improvements to the eligible assets should be capitalized. As long as the conditions are met, there is evidence that the eligible assets have an indefinite useful life and thus do not need to be depreciated. If the government subsequently fails to maintain the assets at or above the established and disclosed condition level, it must revert to reporting depreciation for its infrastructure assets and discontinue its use of the modified approach.

Intangible Assets

Intangible assets are defined by the GASB as capital assets that lack physical substance, have a useful life of more than one reporting period, and are nonfinancial in nature. Examples of government intangible assets include patents, copyrights, easements, water rights, and computer software. The GASB standards allow for recognition of intangible assets if the asset is separable or if the asset arises from contractual or other legal rights.

An asset would be considered separable from the government if, for example, it could be sold, transferred, or exchanged, either individually or in combination with a related asset, liability, or contract. Because intangible assets are considered general capital assets, all guidance related to general capital assets is applicable.

General Capital Assets Acquired under Capital Lease Agreements

As will be explained in some detail in Chapter 5, state and local governments generally have limits on the amount of long-term debt they may issue. Consequently, governments that are reaching their legal debt limit often use leases to acquire capital assets.

FASB Statement No. 13 (SFAS 13) defines and establishes accounting and financial reporting standards for a number of forms of leases, only two of which, operating leases and capital leases, are of importance in governmental accounting.

GASB standards accept the SFAS 13definitions of these two forms of leases andprescribe accounting and financial reporting for lease agreements of state and local governments. If a particular lease meets any one of the following classification criteria, it is a **capital lease**.

1. The lease transfers ownership of the property to the lessee by the end of the leaseterm.
2. The lease contains an option to purchase the leased property at a bargain price.
3. The lease term is equal to or greater than 75 percent of the estimated economic life of the leased property.
4. The present value of rental or other minimum lease payments equals or exceeds 90 percent of the fair value of the leased property less any investment tax credit retained by the lessor.

If no criterion is met, the lease is classified as an ***operating lease*** by the lessee. Rental payments under an operating lease for assets used by governmental funds are recorded by the using fund as expenditures of the period. In many states, statutes prohibit governments from entering into obligations extending beyond the current budget year. Because of this legal technicality, governmental lease agreements typically contain a "fiscal funding clause," or cancellation clause, which permits governmental lessees to terminate the agreement on an annual basis if funds are not appropriated to make required payments. GASB standards specify that lease agreements containing fiscal funding or cancellation clauses should be evaluated. If the possibility of cancellation is judged remote, the lease should be disclosed in financial statements and accounts in the manner specified for capital leases.

As an example of accounting for the acquisition of general capital assets under a capital lease agreement, assume that a government signs a capital lease agreement to pay $10,000 on January 1, 2010, the scheduled date of delivery of certain equipment to be used by an activity accounted for by a special revenue fund. The lease calls for annual payments of $10,000 at the beginning of each year thereafter; that is, January 1, 2011, January 1, 2012, and so on, through January 1, 2019. There will be 10 payments of $10,000 each, for a total of $100,000, but GASB standards require entry in the accounts of the present value of the stream of annual payments, not their total. Since the initial payment of $10,000 is paid at the inception of the lease, its present value is $10,000. The present value of the remaining nine payments must be calculated using the borrowing rate the lessee would have incurred to obtain a similar loan over a similar term to purchase the leased asset. Assuming the rate to be 10 percent, the present value of payments 2 through 10 is $57,590. The present value of the 10 payments is, therefore, $67,590. GASB standards require a governmental fund (including, if appropriate, a capital projects fund) to record the following entry at the inception of the capital lease:

	Debits	Credits
Special Revenue Fund:		
Expenditures	67,590	
Other Financing Sources—Capital Lease Agreements.		67,590

The corresponding entry in the governmental activities general journal at the government-wide level to record the equipment and long-term liability under the capital lease is as follows:

Governmental Activities:		
Equipment	67,590	
Capital Lease Obligations Payable		67,590

***Acquisition of general capital assets(GLA)* -Illustrative Entries**

Acquisition of general capital assets requires a debit to the appropriate governmental activities asset account and a credit to Cash or a liability account. Thus, if office equipment is purchased for the treasurer's office from General Fund resources, the following journal entries would be made in the general journals for the General Fund (ignoring encumbrances) and governmental activities at the government-wide level:

General Fund:

Expenditures 450

Vouchers Payable. 450

Governmental Activities:

Equipment 450

Vouchers Payable. 450

Assuming Vouchers Payable is paid shortly after the equipment acquisition, Vouchers Payable will be debited and Cash will be credited, both in the General Fund and the governmental activities journal at the government-wide level. General capital assets acquired with capital projects fund resources would be recorded in essentially the same manner as if they had been acquired by the General Fund. If construction of a general capital asset is in progress at the end of a fiscal year, construction expenditures to the date of the financial report should be capitalized in the governmental activities ledger. These capital asset entries will be illustrated later in this chapter in the discussion of capital projects fund transactions.

Accounting for the disposal of general capital assets

Accounting for the disposal of general capital assets is relatively simple unless cash or other assets are involved in the liquidation. Accounting for an asset disposal requires elimination of the capital asset and accumulated depreciation accounts and recognition of a gain or loss, as appropriate.

Assuming a building that cost $100,000 and with $80,000 of accumulated depreciation is retired without revenue or expenditure to the General Fund, the following entry in the governmental activities general journal would be required:

Governmental Activities:

Loss on Disposal of Building 20,000
Accumulated Depreciation—Buildings. 80,000
Buildings 100,000

Property records for the building should receive appropriate notations about the transaction and then be transferred to an inactive file.

In the event that cash is disbursed or received in connection with the disposal of general capital assets, the Cash account would be debited or credited as part of the entry to remove the book value of the capital asset, and a gain or loss would be recorded, as appropriate. Assuming that in the preceding example the General Fund incurred $3,000 for the demolition of the building, an entry in the following form should be made on the General Fund books:

General Fund:

Expenditures 3,000
Vouchers Payable 3,000

The corresponding entry that should be made at the government-wide level is:

Governmental Activities:

Loss on Disposal of Building 23,000
Accumulated Depreciation—Buildings 80,000
Buildings 100,000
Vouchers Payable 3,000

If cash is received from the sale of a general capital asset, some question may arise as to its disposition. Theoretically, the cash should be directed to the fund that provided the asset, but this may not always be practicable. If the asset was provided by a capital projects fund, the contributing fund may have been liquidated before the sale occurs. Unless otherwise prescribed by law, disposition of the results of a sale will be handled as decided by the legislative body having jurisdiction over the asset and will be recorded in the manner required by the accounting system of the recipient fund.

Commonly, proceeds of sales of general capital assets are budgeted as Estimated Other Financing Sources in the General Fund. In such cases, when sales actually occur, the General Fund debits Cash (or a receivable) for the selling price and credits Other Financing Sources—Proceeds of Sales of Assets.

Required Disclosures about Capital Assets

GASB standards require certain disclosures about capital assets in the notes to the basic financial statements, both the general capital assets reported in the Governmental Activities column and those reported in the Business-type Activities column of the government-wide financial statements. In addition to disclosure of their general policy for capitalizing assets and for estimating the useful lives of depreciable assets, governments should provide certain other disclosures in the notes to the financial statements.

These disclosures should be divided into the major classes of capital assets of the primary government (as discussed in the following section) and should distinguish between general capital assets and those reported in business-type activities. Capital assets that are not being depreciated are disclosed separately from those assets that are being depreciated.

Required disclosures about each major class of capital assets include:

1. Beginning-of-year and end-of-year balances showing accumulated depreciation separate from historical cost.
2. Capital acquisitions during the year.
3. Sales or other dispositions during the year.
4. Depreciation expense for the current period with disclosure of the amounts charged to each function in the statement of activities.
5. Disclosures describing works of art or historical treasures that are not capitalized and explaining why they are not capitalized. If collections are capitalized, they should be included in the disclosures described in items 1 through 4.

4.2. CAPITAL PROJECT FUND

The reason for creating a fund to account for capital projects is the same as the reason for creating special revenue funds—to provide a formal mechanism to enable administrators to ensure revenues and other financing sources dedicated to a certain purpose are used for that purpose and no other, as well as to enable administrators to report to creditors and other grantors of capital projects fund resources that their requirements regarding the use of the resources are being met.

Capital projects funds differ from General Funds in that a capital projects fund exists only for the duration of the project for which it is created. In some jurisdictions, governments are allowed to account for all capital projects within a single capital projects fund. In other jurisdictions, laws require each project to be accounted for by a separate capital projects fund. Even in jurisdictions that permit the use of a single fund, managers may prefer to use separate funds to enhance control over individual projects. In such cases, a fund is created when a capital project or a series of related projects is legally authorized; it is closed when the project or series is completed.

A major source of funding for capital projects funds is the issuance of long-term debt. In addition to debt proceeds, capital projects funds may receive: grants from other governmental units, proceeds of dedicated taxes, transfers from other funds, gifts from individuals or organizations, or a combination of several of these sources.

Characteristics of capital projects:

- Involve long-lived assets (e.g., buildings, roads and bridges, etc.)
- Usually involve a construction project
- Usually require long-range planning and extensive financing
- Have a project-life focus, rather than a year-to-year focus

Two types of capital projects:

- General (public benefit)

  Examples: public buildings; roads, highways and bridges; park improvements; etc.
- Special assessment (private benefit)

  Examples: street improvements, curbs,
  sidewalks, street lighting, sewage, etc.
  Deemed to benefit citizens in a
  specified benefit district

The successful accomplishment of a capital project may be brought about in one or more of the following ways:

- *Outright purchase from fund cash.*
- *By construction, utilizing the government's own workforce.*
- *By construction, utilizing the services of private contractors.*
- *By capital lease agreement.*

Illustrative Transactions — Capital Projects Funds

GASB standards require the use of the same basis of accounting for capital projects funds as for the other governmental fund types. Proceeds of debt issues should be **recognized** by a capital projects fund at the time the issue is **sold** rather than the time it is authorized because authorization of an issue does not guarantee its sale. Proceeds of debt issues should be recorded as **Proceeds of Bonds or Proceeds of Long-Term Notes rather than as Reven**ues**, and they should be reported in the Other Financing Sources** section of the statement of revenues, expenditures, and changes in fund balance. Similarly, tax revenues raised by the General Fund or a special revenue fund and transferred to a **capital projects fund are recorded as Interfund Transfers In and reported in the Other Financing Sources** section of the operating statement**. Taxes raised specifically for a capital projects fund would be recorded as revenues of that fund,** as would special assessments to be used for the construction of assets that will be of particular benefit to certain property owners. **Grants, entitlements, or shared revenues received by a capital projects fund from another government are considered revenues of the capital projects fund. I**nterest earned on investments of the capital projects fund is also considered revenue if the interest is available for expenditure by the capital projects fund. If, by law, the interest must be used for service of long-term capital debt, the interest should be transferred to the appropriate debt service fund.

Assume that the town council of the Town of Brighton authorized an issue of $1,200,000 of 6 percent bonds as partial financing of a fire station expected to cost approximately $1,500,000; the $300,0000 additional financing was to be contributed by other governments. The project, to utilize land already owned by the town, was completed partly by a private contractor and partly by the town`s own workforce. Completion of the project was expected within the current year. The following transactions occurred in 2008 (for economy of time and space, disregard vouchering of liabilities).

1. The $1,200,000 bond issue, which had been approved by voter referendum, was officially approved by the town council.

No formal entry is required to record voter and town council approval. A memorandum entry may be made to identify the approved project and the means of financing it.

2. The sum of $50,000 was borrowed on a short-term basis from the National Bank for defraying engineering and other preliminary expenses.

Fire Station Capital Projects Fund and Governmental Activities:

Cash	50,000	
Short-Term Notes Payable		50,000

3. Total purchase orders and other commitment documents issued for supplies, materials, items of minor equipment, and labor required for the part of the project to be performed by the town`s employees amounted to $443,000.

Fire Station Capital Projects Fund:

Encumbrances	443,000	
Reserve for Encumbrances		443,000

Since the authorization is for the project, not for a budget year, it is unnecessary to include 2008, or any other year, in the account titles.

Governmental Activities:

Not required

4. A contract was signed for certain work to be done by a private contractor in the amount of $1,005,000.

Fire Station Capital Projects Fund:

Encumbrances	1,005,000	
Reserve for Encumbrances		1,005,000

5. Special engineering and miscellaneous costs that had not been encumbered were paid in the amount of $48,000. These costs are deemed to be properly capitalized as part of the fire station.

Fire Station Capital Projects Fund:

Construction Expenditures	48,000	
Cash		48,000

Governmental Activities:

Construction Work in Progress	48,000	
Cash		48,000

Accounting for a governmental fund focuses on the inflows and outflows of the current financial resources on the modified accrual basis; accounting for governmental activities focuses on the inflows and outflows of economic resources, including capital assets, on the accrual basis used in accounting for business organization.

6. When the project was approximately half finished, the contractor submitted a billing requesting payment of $495,000.

Fire Station Capital Projects Fund:

Reserve for Encumbrances	495,000	
Encumbrances		495,000
Construction Expenditures	495,000	
Contracts Payable		495,000

Governmental Activities:

Construction Work in Progress	495,000	
Contracts Payable		495,000

7. Payment in full was received from the other governments that had agreed to pay part of the cost of the new fire station.

Fire Station Capital Projects Fund:

Cash	300,000	
Revenues		300,000

Governmental Activities:

Cash	300,000	
Program revenues−Capital Grants and Contributions−Public safety		300,000

8. The National Bank loan was repaid with interest amounting to $1,000.

Fire Station Capital Projects Fund:

Interest Expenditures	1,000	
Short-Term Notes Payable	50,000	
Cash		51,000

Governmental Activities:

Expenses-Interest on Notes Payable	1,000	
Short-Term Notes Payable	50,000	
Cash		51,000

GASB standards prohibit capitalization of interest incurred during construction as part of the cost of general capital assets. However, interest is capitalized as part of self-constructed capital assets recorded in proprietary funds.

9. On June 15, 2008, the Town of Brighton issued at par bonds with a par value of $1,200,000 and dated June 15, 2008. Thus, there was no accrued interest as of the date of issue.

Fire Station Capital Projects Fund:

Cash	1,200,000	
Other Financing Sources−Proceeds of Bonds		1,200,000

Governmental Activities:

Cash	1,200,000	
Bonds Payable		1,200,000

10. The contractor's initial claim was fully verified and paid (see Transaction 6)

Fire Station Capital Projects Fund and Governmental Activities:

Contracts Payable	495,000	
Cash		495,000

11. Total disbursements for all costs encumbered in Transaction 3 amounted to $440,000.

Fire Station Capital Projects Fund:

Reserve for Encumbrances	443,000	
Encumbrances		443,000
Construction Expenditures	440,000	
Cash		440,000

Governmental Activities:

Construction Work in Progress	440,000	
Cash		440,000

Although the encumbrance's entry only affects the capital projects fund, the disbursement affects both the capital projects fund and governmental activities at the government-wide level.

12. Billing for the balance owed on the construction contract was received from the contractor.

Fire Station Capital Projects Fund:

Reserve for Encumbrances	510,000	
Encumbrances		510,000
Construction Expenditures	510,000	
Contracts Payable		510,000

Governmental Activities:

Construction Work in Progress	510,000	
Contracts Payable		510,000

13. Inspection revealed only minor imperfections in the contractor`s performance, and on correction of these, the liability to the contractor was paid.

Fire Station Capital Projects Fund and Governmental Activities:

Contracts Payable	510,000	
Cash		510,000

14. All requirements and obligations related to the project having been fulfilled, the operating statement accounts were closed in the capital projects fund.

Fire Station Capital Projects Fund:

Revenues	300,000	
OFSs−Proceeds of Bonds	1,200,000	
Construction Expenditures		1,493,000
Interest Expenditures		1,000
Fund Balance		6,000

Required:

a. Prepare journal entries to record the preceding information in the general ledger accounts for the Fire Station Capital Projects Fund and governmental activities general journal at the government-wide level.
b. Prepare a statement of revenues, expenditures, and changes in fund balance for the period.

Since the project has been complete, it is appropriate to terminate the capital projects fund. The only remaining asset of the fund after the 13 transactions illustrated is **Cash** in the amount of $6,000. State laws often require that assets no longer needed in a capital projects fund be transferred to the fund that will service the debt incurred for the project, a debt service fund. Transfers of this nature are called **inter fund transfer**s and are reported as **other financing uses** by the **transferor fund** and **other financing sources** by the **transferee fund** in the **statement of revenues, expenditures, and changes in fund balance.**

The entries to record the transfer and termination of the Town of Brighton Fire Station Capital Projects Fund accounts are:

Fire Station Capital Projects Fund:

OFUs-Interfund Transfers out	6,000	
Cash		6,000
Fund Balance	6,000	
OFUs-Interfund Transfers Out		6,000

Similar entries would be required to record the inter fund transfers in by the debt service fund. No entry is required at the government-wide level since the transfers occurs within the governmental activities category.

The cost of fire station constructed by the Town of Brighton is recorded in the governmental activities general journal at the government-wide level. Because all capitalizable costs have previously been recorded as **construction work in progress** during the period of construction, the only entry required is to reclassify the amount in that account to the Building account, as shown in the following entry.

Governmental Activities:

Buildings	1,493,000	
Construction work in progress		1,493,000

Town of Brighton
Fire Station Capital Projects Fund
Statement of Revenues, Expenditures, and Changes in Fund Balance
For the Year Ended December 31, 2008

Revenues:		
From other governments		$300,000
Expenditures:		
Construction ($48,000+$495,000+$440,000+$510,000)	$1,493,000	
Interest	1,000	1,494,000
Excess of revenues over (under) expenditures		(1,194,000)
Other financing sources (uses):		
Proceeds of bonds	1,200,000	
Interfund transfer out	(6,000)	1,194,000
Excess of revenues and other financing sources/uses over expenditures		−0−
Fund Balance, January 1, 2008		−0−
Fund Balance, December 31, 2008		**−0−**

Bond Premium, Discount, and Accrued Interest on Bonds Sold

The premium should be amortized, using the effective-interest method, over the life of the bonds, the amount of amortization being the difference between the actual cash paid for interest and the calculated amount of effective interest expense for the period. Banks sometimes require borrowers to maintain **compensating balances,** which are deposit requirements set at between 10 and 20 percent of the loan amount. Compensating balances raise the effective interest rate on bank loans.

Similarly, when bonds are sold between interest payment dates the party buying the bonds must pay upfront the amount of interest accrued from the date of the bonds (the starting date for purposes of calculating interest) to the date the bonds are actually sold, as part of the total price of the bonds. Thus, assuming two months of interest have already accrued by the sale date, the two months of interest that bondholders pay at the sale date yields the equitable result that they earn a net four months of interest, although they will receive a full six months of interest only four months after the sale date.

Conceptually in a governmental fund, accrued interest sold should be credited to Interest Expenditure and be offset against the six-month interest expenditure recorded on the first interest payment date following the sale of the bonds. In practice, however, accrued interest sold is generally recorded as a Revenue of the Debt Service Fund. This practice simplifies budgetary control by permitting the government to budget appropriations for and record expenditure for the full six months of interest that must be paid on the first interest payment date. At the government-wide level, however, cash received on the sale date for accrued interest would be credited either as Accrued Interest Payable or Interest Expense, as in business accounting.

It may happen that the issuing government receives one check from the underwriters for the total amount of the par plus the premium. If procedures of that government indicate that it is desirable to record the entire amount in the Capital Projects Fund, the following entries are appropriate (using assumed amounts):

Capital Projects Fund:

Cash 1,509,000

Other Financing Sources—Proceeds of Bonds 1,500,000

Due to Other Funds 9,000

This entry accounts for the bond premium as a liability of the Capital Projects Fund because it must be remitted to the Debt Service Fund. In the Debt Service Fund, an entry would be made to debit Due from Other Funds and credit Other Financing Sources—*Premium on Bonds Sold.* Some accountants credit Premium on Bonds rather than Due to Other Funds in the Capital Projects Fund, particularly if the disposition of the premium is still to be determined on the sale date. Some accountants also include the amount of the premium as part of the credit to Other Financing Sources—Proceeds of Bonds in the Capital Projects Fund. If this latter procedure is used, it is necessary to make a second entry debiting Other Financing Uses—Interfund Transfers Out and crediting Due to Other Funds.

In those jurisdictions in which it is legal for bonds to be sold initially at a discount, using the amounts assumed in the entry above, except the debt proceeds are less than the face amount of the bonds, the entry might be:

Capital Projects Fund:

Cash 1,491,000

Discount on Bonds 9,000

Other Financing Sources—Proceeds of Bonds 1,500,000

Crediting Other Financing Sources—Proceeds of Bonds for $1,500,000 carries the implication that, if necessary, the discount is expected to be counterbalanced at a future date by receipt of money from another source. When money from another source has been provided, or it has been determined that no money from another source will be provided, the discount would be written off against Proceeds of Bonds. When the money from another source is received, the Capital Projects Fund should debit Cash and credit either Revenues or another financing source, depending on the source of the money. When it is known in advance that the discount will not be made up by transfers from other sources, an entry debiting Cash and crediting Other Financing Sources—Proceeds of Bonds, each for par value less discount, should be made.

Retained Percentages

It is a common to require contractors on large-scale contracts to give **performance bonds**, providing for indemnity to the government for any failure on the contractor's part to comply with terms and specification of the agreement. Before final inspection of a project can be completed, the contractor firm may have moved its workforce and equipment to another location, thus making it difficult to remedy possible objections to the firm's performance. Also, the shortcoming alleged by the government may be of a controversial nature with the contractor unwilling to accede to the demands of the government. Results of legal action in such disagreements are not predictable with certainty.

To provide more prompt adjustment on shortcomings not large or convincing enough to justify legal action and not recoverable under contractor's bond, as well as those the contractor may admit but not be in a position to rectify, it is common practice to withhold a portion of the contractor's remuneration until final inspection and acceptance have occurred. The withheld portion is normally a contractual percentage of the amount due on each segment of the contract.

In the Town of Brighton illustration, the contractor submitted a bill for $495,000, which, on preliminary approval, was recorded previously in the Fire Station Capital projects fund as follows:

Construction Expenditures………………………………………..	495,000	
Contracts Payable ……………………………………………..		495,000

Assuming that the contracts provide for retention of **5 percent**, current settlement on the billing would be recorded as follows:

Capital Projects Fund:

Contracts Payable ……………………………………………….	495,000	
Cash…………………………………………………….		470,250
Contracts Payable- Retained Percentage (5%x$495,000)…		24,750

This same entry would also be made in the governmental activities general journal at the government-wide level.

Alternatively, the intention of the government to retain the percentage stipulated in the contract could be recorded at the time the progress billing receives preliminary approval. In that event, the credit to Contracts Payable in the first entry in this section would be $470,250, and the credit to **Contracts Payable-Retained Percentage** in the amount of $24,750 is made at that time. The second entry, therefore, would be a debit to Contracts Payable and a credit to Cash for $470,250.

On final acceptance of the project, the retained percentage is liquidated by a payment of cash. In the event that the government that recorded the retention finds it necessary to spend money on correction of deficiencies in the contractor's performance, the payment is charged to **Contracts Payable-Retained Percentage.** If the cost of correcting deficiencies exceeds the balance in the Contracts Payable-Retained Percentage account, the excess amount is debited to **Construction Expenditures** in the Fire Station Capital Projects Fund and to **Buildings** (or other appropriate capital asset account) in the governmental activities general journal.

Chapter end Exercises

1. What are general capital assets? How are they reported?
2. Explain what disclosures the GASB requires for capital assets in the notes to the financial statements.
3. What is the difference between using the modified approach to accounting for infrastructure assets and depreciating infrastructure assets? Under the modified approach, what happens if infrastructure assets are not maintained at or above the established condition level?
4. How does one determine whether a particular lease is a capital lease or an operating lease? What entries are required in the general journals of a governmental fund and governmental activities at the government-wide level to record a capital lease at its inception?
5. Compare the reporting of intangible assets under GASB and FASB standards.
6. What is the purpose of a capital projects fund? Give some examples of projects that might be considered capital projects.
7. If a capital project is incomplete at the end of a fiscal year, why is it considered desirable to close Encumbrances and all operating statement accounts at year-end? Why is it desirable to reestablish the Encumbrances account as of the first day of the following year?
8. Which expenditures of a capital projects fund should be capitalized to Construction Work in Progress? Is Construction Work in Progress included in the chart of accounts of a capital projects fund? If not, where would it be found?
9. The county replaced its old office building with a new structure. Rather than destroy the old office building, the county decided to convert the old building and use it as a storage facility. Why would the old office building need to be evaluated for impairment? If it was decided the building was impaired, what would be the most appropriate method for estimating the degree of impairment?

CHAPTER FIVE
Accounting for General Long Term Liabilities and Debt Service Fund

Learning Objectives

After studying this chapter, 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.
- 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.

5.1. General Long Term Liabilities

The use of long-term debt is a traditional part of the fiscal policy of state and local governments, particularly for financing the acquisition of general capital assets. Although some governments have issued taxable debt, the interest earned on most debt issued by state and local governments is exempt from federal taxation and, in some states, from state taxation. The tax-exempt feature enables governments to raise large amounts of capital at relatively **low cost.**

General long-term liabilities are those that arise from activities of governmental funds and that are not reported as fund liabilities of a proprietary or fiduciary fund. General long-term liabilities are reported as liabilities in the Governmental Activities column of the government wide statement of net assets but are not reported as liabilities of governmental funds.

Long-term liabilities include obligations arising out of financing activities, such as the issuance of bonds and notes, and capital leases. In addition, long-term liabilities can arise out of the operating activities of governments. Examples of long-term liabilities related to operating activities include claims and judgments, compensated absences, pensions and other post-employment benefits, and obligations related to landfills and pollution remediation. The primary focus of this chapter is general long-term liabilities arising from financing activities.

When studying this chapter, the reader is reminded that governmental fund types (General, special revenue, capital projects, debt service, and permanent funds) account for only short-term liabilities to be paid from fund assets. The proceeds of long-term debt may be placed in one of these fund types (usually a capital projects fund), the long-term liability itself must be recorded in the governmental activities accounting records at the government-wide level. Proprietary funds and perhaps certain private-purpose trust funds account for both long-term debt serviced by the fund and short-term debt to be repaid from fund assets.

As we just observed, major capital additions are commonly financed through bond or other debt issues. Another fund type, the **debt service fund,** is used to account for financial resources that are intended to provide payments of interest and principal as they come due. Debt service funds are not created for debt issues where the activities of proprietary funds are intended to generate sufficient cash to make interest and principal payments.

If taxes or special assessments are levied specifically for payment of interest and principal on long-term debt, those taxes are recognized as **revenues of the debt service fund**. More commonly, undesignated taxes are levied by the General Fund and transferred to a debt service fund to repay debt. In that case, the taxes are recorded as revenues by the General Fund and as transfers to the debt service fund. Because the amounts of bond issues and the associated capital projects are often approved by the voters, bond premiums and unexpended capital project resources are generally required by state law to be transferred to debt service funds.

5.2. Debt Service Fund

When long-term debt has been incurred for capital or other purposes, revenues must be raised in future years to make debt service payments. Debt service payments include both periodic interest payments and the repayment of debt principal when due. Revenues from taxes that are restricted for debt service purposes are usually recorded in a ***debt service fund***, as are subsequent expenditures for payments of interest and principal. A debt service fund is used only for debt service activities related to general long-term liabilities—those reported in the Governmental Activities column of the government-wide statement of net assets. Debt service related to long term liabilities reported in proprietary and fiduciary funds is reported in those funds, not in a debt service fund.

5.2.1. Types Of Governmental Bonds

There are different types of long-term debt issued by governmental entities. Among these, the following two are most frequently used: ***bond and notes***.

Bonds—a written promise to pay a specified sum of money, called the face value or principal amount, at a specified date or dates in the future, called the maturity dates, together with periodic interest at a specified rate. Note that the difference between a note and a bond is that the latter *runs for a longer period of time and requires greater legal formality***.** Bonds are classified in to: serial and term bonds.

A. Types of Serial Bonds

Several decades ago, governmental issues of long-term debt commonly matured in total on a given date. In that era, bond indentures often required the establishment of a “sinking fund,” sometimes operated on an actuarial basis. Some sinking fund term tax-supported bond issues are still outstanding, but they are dwarfed in number and amount by serial bond issues in the principal matures in installments.

Serial bonds—are bonds in which the principal of which is **repaid in periodic installments** over the life of the issue. Four types of serial bond issues are found in practice: **regular, deferred, annuity, and irregular.**

1. If the total principal of an issue is repayable in a specified number of equal annual installments over the life of the issue, it is a **regular serial bond issue.**
2. If the first installment is delayed for a period of more than one year after the date of the issue but thereafter installments fall due on a regular basis, the bonds are known as **deferred serial bonds.**
3. If the amount of annual principal repayments is scheduled to increase each year by approximately the same amount that interest payments decrease (interest decreases, of course, because the amount of outstanding bonds decreases) so that the total debt service remains reasonably level over the term of the issue, the bonds are called **annuity serial bonds.**
4. **Irregular serial bonds** may have any pattern of repayment that does not fit the other three categories.

Debt Service Accounting for Regular Serial Bonds

Assume the bonds issued by the Town of Brighton as partial financing for the fire station construction project are regular serial bonds maturing in equal annual amounts over 20 years are registered as to interest and principal. The total face value of the issue was $1,200,000; all bonds in the issue bear interest of 6 percent per year, payable semiannually on June 15 and December 15. The bonds were dated June 15, 2008, and sold on that date at par. During 2008 the only expenditure the debt service fund will be required to make will be the interest payment due December 15, 2008, in the amount of $36,000 ($1,200,000 x 0.06 x ½ year). Assuming that revenues to pay the first installment of bonds due on June 15, 2009, and both interest payments due in 2009 will be raised in 2009 from a special sales tax, the budget for 2008 need only provide resources in the amount of the 2008 interest expenditure. The entry to record the budget for the year ended December 31, 2008, including $6,000 residual equity to be transferred from the Fire Station Capital Projects Fund, is:

Serial Bond Debt Service Fund:

Estimated Revenues	30,000	
Estimated Other Financing Sources	6,000	
Appropriations		36,000

The above entry has no effect at the government-wide level since the budget entries are made only in governmental funds.

If sales tax revenues in the amount of $31,200 were collected in cash for debt service, the entry is:

Serial Bond Debt Service Fund:

Cash 31,200
 Revenues 31,200

The corresponding entry in the governmental activities general ledger at the government-wide level is:

Governmental Activities:

Cash 31,200
 General Revenues—Sales taxes—Restricted for Debt Service 31,200

The $6,000 residual equity of the Fire Station Capital Projects Fund was transferred to the debt service fund. The entry required in the latter fund is:

Serial Bond Debt Service Fund:

Cash 6,000
 Other Financing Sources—Interfund Transfers In 6,000

Note: Governmental activities at the government-wide level are unaffected since the transfer is between two funds within the governmental activities category.

On December 15, 2008, when the first interest payment is legally due, the debt service fund records the expenditure of the appropriation and the corresponding entry is made to record interest expense at the government-wide level:

Serial Bond Debt Service Fund:

Expenditures—Bond Interest 36,000
 Interest Payable 36,000

Governmental Activities:

Expenses—Interest on Long-Term Debt 36,000
 Interest Payable 36,000

Checks totaling $36,000 are written to the registered owners of these bonds. The entries to record the payment in the debt service fund and governmental activities general journal are:

Serial Bond Debt Service Fund and Governmental Activities:

Interest Payable 36,000
 Cash 36,000

As of December 31, 2008, an adjusting entry would be made to accrue one-half of a month`s interest expense on the accrual basis at the government-wide, as would be the case in accounting for business organizations. Interest expenditure is recognized in the period when due in the debt service fund and is not accrued at the end of the accounting period.

Governmental Activities:

Expenses—Interest on Long-term Debt 3,000
 Accrued Interest Payable 3,000

All budgetary and operating statement accounts are closed by the following entry:

Serial Bond Debt Service Fund:

Revenues 31,200
Other Financing Sources—Interfund Transfers In 6,000
Appropriations 36,000
 Estimated Revenues 30,000

Estimated Other Financing Sources		6,000
Expenditures—Bond Interest		36,000
Fund Balance		1,200

In addition, all temporary accounts of the governmental activities general ledger would be closed at year-end. Because that ledger has many temporary accounts besides those related to debt service, its closing entry is not illustrated here.

Second-Year Transactions

In the second year of the Serial Bond Debt Service Fund, the fiscal year ending December 31, 2009, the following journal entries would be required.

The special sales tax for debt service estimated to produce revenues of $135,000 for the year. From these revenues, two interest payments (the interest due on June 15, 2009, and December 15, 2009) of $36,000 and $34,200 (1200000-60000*0.06*0.5), respectively, and a principal redemption payment of $60,000 due on June 15, 2009, must be paid. The entry required at January 1, 2009, to record the budget for FY 2009.

Serial Bond Debt Service Fund:

Estimated Revenues	135,000	
Appropriations		130,200
Fund Balance		4,800

During the year, actual revenues from the special sales tax were $134,100. The following entries summarize these collections:

Serial Bond Debt Service Fund:

Cash	134,100	
Revenues		134,100

Governmental Activities:

Cash	134,100	
General Revenues—Sales Taxes—Restricted for Debt Service		134,100

On June 15, 2009, interest of $36,000 and the first redemption of principal in the amount of $60,000 ($1,200,000 ÷20 years) were paid to bondholders of record, as shown below:

Serial Bond Debt Service Fund:

Expenditures—Bond Principal	60,000	
Expenditures—Bond Interest	36,000	
Cash		96,000

Governmental Activities:

Bonds Payable	60,000	
Expenses—Interest on Long-Term Debt	33,000	
Accrued Interest Payable	3,000	
Cash		96,000

The semiannual interest payment due on December 15, 2009, was paid on schedule, as reflected in the following entries, based on a remaining principal of $1,140,000 at 6 percent interest per annum.

Serial Bond Debt Service Fund:

Expenditures—Bond Interest	34,200	
Cash		34,200

On December 31, 2009, interest expense and interest payable were accrued in the amount of $2,850 ($1,140,000 x 0.06 x 1/12 x ½):

Governmental Activities:

Expenses—Interest on Long-Term Debt	2,850	
Accrued Interest Payable		2,850

All temporary accounts of the debt service fund were closed on December 31, 2009, as shown below.

Serial Bond Debt Service Fund:

Revenues	134,100	
Appropriations	130,200	
Fund Balance	900	
Estimated Revenues		135,000
Expenditures—Bond Interest		70,200
Expenditures—Bond Principal		60,000

In subsequent years, the pattern of journal entries will be the same as that of the preceding entries, except that actual sales taxes realized will vary from year to year and the amount of interest will decline each year as the principal is reduced.

B. Debt Service Accounting for Term Bonds

Term bond issues mature in their entirely on a given date, in contrast to **serial bonds,** which mature in installments. Required revenues of term bond debt service funds may be determined on an **"actuarial"** basis or on less sophisticated bases designed to produce approximately level contributions during the life of the issue.

Assume that the Town of Brighton has a term bond issue amounting to $1,500,000 with a 20-year life. The term bonds bear semiannual interest at a nominal (or stated) annual rate of 5 percent, payable on January 1 and July 1. Revenues and other financing sources of this particular debt service fund are assumed to be property taxes levied directly for this debt service fund and earnings on investments of the debt service fund. The amount of the tax levy is computed in accord with annuity tables on the assumption that revenues for principal repayment will be invested and will earn 6 percent per year, compounded semiannually. Actuaries are usually conservative in their assumptions because they are concerned with a long time span. Using either the annuity tables found in most intermediate accounting texts or a calculator, one will find that the future amount of $1 invested at the end of each period will amount to $75.4012587 at the end of 40 periods, if the periodic compound interest is 3 percent (as specified in this example). Since the amount needed for bond repayment at the end of 40 six-month periods is $1,500,000, the tax levy for bond principal repayment must yield $1,500,000 divided by 75.401259, or $19,893.57, at the end of each six-month period throughout the life of the bonds. Tax revenue must be sufficient to cover each bond interest payment of $**37,500** ($1,500,000, the face of the bonds, x 5 percent, the annual nominal interest rate, x ½ year) plus the two required additions of $**19,893.57** for sinking fund investment, for total revenue of $**114,787.14** per year.

$$A=R\left[\frac{(1+i)^n-1}{1}\right]=\underline{\underline{\mathbf{75.401259}}}\text{,}\quad \mathbf{1500{,}000/75.4012259=}\underline{\underline{\mathbf{19893.57}}}$$

Assuming the bonds were issued in the preceding fiscal year on January 1, 2007, and actual additions and actual earnings were both exactly as budgeted, the Term Bonds Debt Service Fund of the Town of Brighton would have the following trial balance as of December 31, 2007.

	Debits	Credits
Cash	$37,500.00	—
Investments	40,383.95	—
Fund Balance	—	$77,883.95
Totals	$77,883.95	$77,883.95

For every year of the life of the issue, the budget for the Term Bonds Debt Service Fund of the Town of Brighton, reflecting the conditions just described above, will include two required additions of $19,893.57 each for investment for eventual principal repayment, and two amounts of $37,500 each for interest payment, for a total of $114,787.14. The budget will also include earnings on debt service fund investments computed in accord with actuarial requirements. For 2008, the second year of the Term Bonds Debt Service Fund`s operation, the actuarial assumption is that the fund will earn 6 percent per year, compounded semiannually; the required earnings for the year amount to **$3,056.19.**

The computation is (all amounts rounded to nearest cent):

Year	Period	Addition at End of Period3	Percent per Period	Balance at End of Period
2007	1	$19,893.57	$-0-	$19,893.57
	2	19,893.57	596.81	40,383.95
2008	3	19,893.57	1,211.52	61,489.04
	4	19,893.57	1,844.67	83,227.28

The balance at the end of period 2 is the total of investments and the total of fund balance in this case since actuarial assumptions were met exactly in 2007. The sum of the interest for period 3 and period 4 is **$3,056.19**, the required earnings for the second year.

Therefore, Estimated Revenues is debited for $117,843.33 ($114,787.14 + $3,056.19). The appropriations budget would include only the amounts becoming due during the budget year, $75,000 (two interest payments, each amounting to $37,500).

The entry to record the budget for fiscal year 2008 follows:

Term Bond Debt Service Fund:

Estimated Revenues	117,843.33	
Fund Balance		42,843.33
Appropriations		75,000

If the debt service fund is to accumulate the amount needed to retire the term bond issue at maturity, both additions and earnings must be received, and invested, in accord with the actuarial assumptions. Therefore, the tax levy for this fund must yield collections in the first six months totaling $57,393.57, at least, so that $19,893.57 can be invested and $37,500 can be paid in interest to bondholders, both as of the end of the first six-month period. Collections during the second six months must also total $57,393.57, to the penny, in either six-month period. If collections are less than that amount in either period, it should be obvious that this fund would have to borrow enough to make the required investments; there is no question that the interest would have to be paid when due.

Assuming that collection experience of the Town of Brighton indicates that a tax levy in the amount of $120,000 is needed in order to be reasonably certain that collections during each six-month period will equal the needed amount, the entries to record the levy and the expected uncollectible amounting to $3,000 are as follows:

Term Bond Debt Service Fund:

Taxes Receivable—Current	120,000	
Estimated Uncollectible Current Taxes		3,000
Revenues—Property Taxes		117,000

Governmental Activities:

Taxes Receivable—Current	120,000	
Estimated Uncollectible Current Taxes		3,000
General Revenue—Property Taxes—Restricted for Debt Service		117,000

The required interest payment was made on January 1, 2008, as reflected in the following entries:

Term Bond Debt Service Fund:

Expenditures—Bond Interest	37,500	
Cash		37,500

Governmental Activities:

Accrued Interest Payable	37,500	
Cash		37,500

Note: Interest expense and interest payable were accrued at the government-wide level for the second six months of FY 2007, but not in the debt service fund as the interest was not yet due on December 31, 2007.

Actual tax collections during the first six months of FY 2008 were $57,400. The following entries would be required in the journals of both the debt service fund and governmental activities to record the collections and subsequent addition to sinking fund investments at June 30, 2008.

Term Bond Debt Service Fund and Governmental Activities:

Cash	57,400	
Taxes Receivable—Current		57,400

Investments	19,893.57	
Cash		19,893.57

Entries shown below record the addition of $1,261.99 of interest on June 30, 2008, which is added to the Investments account. Note that the actual interest earned during this six-month period is $50.47 more than the estimated earnings of $1,211.52 for the period because the actual earnings rate for the period was slightly higher than the 6 percent per annum rate used in actuarial computations.

Term Bond Debt Service Fund:

Investments	1,261.99	
Revenues—Investment Earnings		1,261.99

Governmental Activities:

Investments	1,261.99	
General Revenues— Investment Earnings—Restricted for Debt Service		1,261.99

The interest payment of $37,500 due on July 1, 2008, was made as scheduled, as shown in the following entries:

Term Bond Debt Service Fund:

Expenditures—Bond Interest	37,500	
Cash		37,500

Governmental Activities:

Expenses—Interest on Long-Term Debt	37,500	
Cash		37,500

During the second six months of the year, property tax collections for debt service on the term bonds totaled $58,000 and the required addition to the sinking fund Investments account was made on December 31, 2008, as shown below:

Term Bond Debt Service Fund and Governmental Activities:

Cash	58,000	
Taxes Receivable—Current		58,000
Investments	19,893.57	
Cash		19,893.57

At December 31, 2008, interest of $37,500 on the term bonds was accrued at the government-wide level for the second six months of the year.

Governmental Activities:

Expenses—Interest on Long-Term Debt	37,500	
Accrued Interest Payable		37,500

Interest earnings on sinking fund investments for the second six-months of the year were recorded in the amount of $1,883.10, as shown below:

Term Bond Debt Service Fund:

Investments	1,883.10	
Revenues—Investment Earnings		1,883.10

Governmental Activities:

Investments	1,883.10	
General Revenues—Investment Earnings—Restricted for Debt Service		1,883.10

Taxes levied for 2008 but not collected during the year become delinquent as of December 31; the balance of the Estimated Uncollectible Current Taxes account is reviewed and determined to be reasonable. The following entry is made in the journals of both the Term Bond Debt Service Fund and governmental activities at the government-wide level to record the reclassification of the property tax accounts as delinquent.

Term Bond Debt Service Fund and Governmental Activities:

Taxes Receivable—Delinquent	4,600	
Estimated Uncollectible Current Taxes	3,000	
Taxes Receivable—Current		4,600
Estimated Uncollectible Delinquent Taxes		3,000

All budgetary and operating statement accounts of the Term Bond Debt Service Fund were closed at December 31, 2008, as shown below.

Term Bond Debt Service Fund:

Revenues—Property Taxes	117,000	
Revenues—Investment Earnings	3,145.09	
Appropriations	75,000	
Estimated Revenues		117,843.33
Expenditures—Bond Interest		75,000
Fund Balance		2,301.76

CHAPTER SIX

ACCOUNTING FOR PROPRIETARY FUND

Learning Objectives

After studying this chapter, you should be able to:

1. Distinguish between the purposes of internal service funds and enterprise funds.

2. Describe the characteristics of proprietary funds, including those unique to internal service and enterprise funds.

3. Explain the financial reporting requirements, including the differences between the reporting of internal service and enterprise funds in the government-wide and fund financial statements.

4. Describe accounting procedures and prepare journal entries and financial statements for an internal service fund.

6.1. Introduction

Proprietary funds**,** describes funds that are used to account for activities similar to those often engaged in by profit-seeking businesses. That is, users of goods or services provided by a proprietary fund are charged amounts at least sufficient to cover the costs of providing the goods or services. Thus, in the pure case, proprietary funds are self-supporting.

Proprietary funds use the economic resources measurement focus and the accrual basis of accounting. Because revenues and *expenses* (not expenditures) are recognized on the accrual basis, financial statements of proprietary funds are similar in many respects to those of business organizations.

Fixed assets used in fund operations and long-term debt serviced from fund revenues are recorded in the accounts of each proprietary fund. Depreciation on fixed assets is recognized as an expense, and other accruals and deferrals common to business accounting are recorded in proprietary funds. The use of accrual accounting permits financial statement users to observe whether proprietary funds are operated at a profit or a loss. The accrual basis of accounting requires revenues to be recognized when earned and expenses to be recognized when goods and services are used.

Two types of funds are classified as proprietary funds: enterprise funds and internal service funds.

6.2. Accounting for Enterprise funds

Enterprise funds provide, on a user charge basis, services to the public and some cases to other activities of governmental unit at a profit. Financial statements are required for proprietary funds: a Statement of Net Assets (or Balance Sheet); a Statement of Revenues, Expenses, and Changes in Fund Net Assets; and a Statement of Cash Flows.

The most common examples of governmental enterprises are public utilities, notably water and sewer utilities. Electric, transportation systems, airports, sea ports, toll bridges, municipal golf courses, parking lots, parking garages, lotteries, municipal sports stadiums, and public housing projects are examples.

Encumbrance's accounts are not used in enterprise fund. Enterprise funds are to be reported using the economic resources measurement focus and accrual basis of accounting. Fixed assets and long-term debt are included in the accounts. Governmental enterprises often issue debt, called **revenue bonds,** that is payable solely from the revenues of the enterprise. These bonds are recorded directly in the accounts of the enterprise fund.

If payment is to be paid from enterprise revenues, these general obligation bonds would also be reflected in the accounts of enterprise funds. Like commercial businesses, operating profits are necessary to establish adequate working capital, provide for expansion of physical facilities, and retire debt. **Example:**

TOWN AWASA ENTERPRISE FUND
Statement of Revenue, Expenses and Change In Retained Earnings
For The Year Ended Dec31, 2012

Operating Revenues		
Charges for sales and services		$ 260,000
Operating Expenses:		
Personal service	41,000	
Contractual services	47,000	
Supplies	10,500	
Material	37,500	
Heat, light and power	7,000	
Deprecation	22,500	
Payment in lieu of property taxes	20,000	
Total operating expenses		185,500
Operating income		$ 74,500
Non-Operating Revenues (Expenses)		
Operating grants	17,500	
Interest revenue	6,000	
Rent	4,000	
Interest expense	(30,000)	
Total non operating revenue (expense)		(2500)
Income before operating		72,000
Operating transfer out		(5000)
Net income		67,000
Retained earnings beginning year		161,000
Retained earnings end of year		$228,000

6.3. Accounting for Internal Service Funds

Activities that produce goods or services to be provided to other departments or other governmental units on a cost-reimbursement basis are accounted for by internal service funds Internal service funds recognize revenues and expenses on the accrual basis. They account for fixed assets used in their operations and for long-term debt to be serviced from revenues generated from their operations, as well as for all current assets and current liabilities.

❖ Establishment and Operation of Internal Service Funds

The establishment of an internal service fund is normally subject to legislative approval. The original allocation of resources to the fund may be derived from a transfer of assets of another fund, such as the General Fund or an enterprise fund, intended as a transfer not to be repaid or as a loan that is in the nature of a long-term advance to be repaid by the internal service fund over a period of years. Because internal service funds are established to improve the management of resources, they should be operated and accounted for on a business basis. For example, assume that administrators request the establishment of a fund for the purchasing, warehousing, and issuing of supplies used by a number of funds and departments.

A budget should be prepared for the internal service fund (but not recorded in the accounts) to demonstrate that fund management has realistic plans to generate sufficient revenues to cover the cost of goods issued and such other expenses, including depreciation, that the governing body intends fund operations to recover.

Illustrative Case--- Supplies Fund

1. The town Water Utility Fund was provided long-term inter-fund advance $ 130,000. The advance would to be repaid in 20 equal annual installments, with no interest. The receipt of the transfer in and the liability to the Water Utility Fund would be recorded in the Supplies Fund accounts in the following manner.

Supplies Fund:

Cash	130,000	
Inter fund loan from water utility -current		6,500
Inter fund loan from water utility -non-current		123,500

Governmental Activities:

Cash	130,000	
Internal Balances		130,000

2. Assume that early in 2012, a satisfactory warehouse building is purchased for $95,000; $25,000 of the purchase price is considered as the cost of the land. Necessary warehouse machinery and equipment was purchased for $25,000. Delivery equipment was purchased for $10,000. If the purchases are made for cash, the acquisition of the assets would be recorded in the books of the Supplies Fund as follows

Supplies Fund:

Land	25,000

Building	70,000	
Machinery and Equipment—Warehouse	25,000	
Equipment—Delivery	10,000	
Cash		130,000

Governmental Activities:

Land	25,000	
Building	70,000	
Equipment	35,000	
Cash		130,000

3. During 2012, it is assumed that supplies are received and related invoices are approved for payment for $192,600; the entry needed to record the asset and the liability is as follows

Supplies and Governmental Activities:

Inventory of supplies	192,600	
Voucher payable		192,600

4. Construction project on which costs totaled $220,000 were completed and the assets placed in the service

Governmental Activities:

Utility plant in service	220,000	
Construction work in process		220,000

CHAPTER SEVEN
ACCOUNTING FOR FIDUCIARY FUNDS

Learning Objectives

After studying this chapter, you should be able to:

1. Explain how fiduciary funds are used to report on the fiduciary activities of a government.

2. Distinguish among agency funds and trust funds (private-purpose, investment, and pension).

3. Describe the uses for and characteristics of agency funds.

4. Explain the activities of and accounting and financial reporting for commonly

used agency funds.

7.1. Introduction

Fiduciary activities benefit other individuals, organizations, or governments, rather than the reporting government. For this reason, Governmental Accounting Standards Board (GASB) standards exclude the reporting of fiduciary activities in the government-wide financial statements. However, fiduciary activities are reported in the fiduciary fund financial statements, the focus of this chapter.

Fiduciary funds are used to account for those activities in which a government holds assets as an agent or trustee. To account for these *private-purpose fiduciary activities agency funds, investment trust funds, private-purpose trust funds, and pension trust funds are used*. Resources that are held in trust for the benefit of the government's own programs or its citizenry should be accounted for using a governmental fund rather than a fiduciary fund. Such public-purpose trusts should be accounted for as special revenue funds if the resources are expending able for the trust purpose or as permanent funds if the trust principal is permanently restricted. In law, there is a clear distinction between an agency relationship and a trust relationship.

In accounting practice, the legalistic distinctions between trust funds and agency funds are not of major significance. The important and perhaps the sole consideration from an accounting standpoint is what can and what cannot be done with the fund's assets in accordance with laws and other pertinent regulations. The name of a particular fund is not a reliable criterion for determining the correct accounting basis for trust and agency funds.

Trust funds differ from agency funds principally in ***degree:*** Trust funds often exist over a longer period of time than an agency fund, represent and develop vested interests of a beneficiary to a greater extent, and involve more complex administration and financial accounting and reporting. Agency funds are used only if a government holds resources in a purely custodial capacity for others. As noted,

specific accounting procedures and limitations depend on the enactment that brought about creation of a particular trust or agency fund, plus all other regulations under which it operates.
Regulations include pertinent statutes, ordinances, wills, trust indentures, and other instruments of endowment, resolutions of the governing body, statements of purposes of the fund, kinds and amounts of assets held, and others. This aggregate of factors helps determine the transactions in which a fiduciary fund may and should engage.

7.2. Accounting For Agency Funds

GASB standards identify *agency funds* as one of the four types of fiduciary funds. **Agency funds** are used to account for assets held by a government acting as an agent for one or more other governments or for individuals or private organizations. Assets that are held in an agency fund belong to the party or parties for which the government acts as agent. Therefore, *agency fund assets are offset by liabilities equal in amount; no fund equity exists.* GASB requires agency fund assets and liabilities to be recognized on the accrual basis. Revenues and expenses are not recognized in the accounts of agency funds, however.

Unless use of an agency fund is mandated by law, by GASB standards, or by decision of the governing board, an agency relationship may be accounted for within governmental and/or proprietary funds. For example, local governments act as agents of the federal and state governments in the collection and remittance of employees' withholding taxes, retirement contributions, and social security taxes. In the absence of contrary legal requirements or administrative decisions, it is perfectly acceptable to account for the withholdings, and the remittance to federal and state governments, within the funds that account for the gross pay of the employees, as is shown by the

Agency Fund for Special Assessment Debt Service

Do you recall that GASB standards specify that a government that has *no* obligation to assume debt service on special assessment debt in the event of property owners' default but does perform the functions of billing property owners for the assessments, collecting installments of assessments and interest on the assessments, and *from the collections,* paying interest and principal on the special assessment debt, should account for those activities by use of an agency fund.

To illustrate *agency fund* accounting for special assessment debt service activities. When the assessments in the amount of $480,000, payable in 10 equal installments, were levied on benefited property owners, the following journal entry was made in the agency fund.

Assessments Receivable—Current 48,000
Assessments Receivable—Deferred 432,000
Due to Special Assessment Bondholders—Principal 480,000

All current assessments receivable were collected (see Entry 2) along with $24,000 of interest (5 percent on the previous unpaid receivable balance). any amounts not collected by the due date should be reclassified as Assessments Receivable—Delinquent.

Cash 72,000

Assessments Receivable—Current 48,000

Due to Special Assessment Bondholders—Interest 24,000

Special assessment bond principal in the amount of $48,000 and interest in the amount of $24,000 were paid during the current year.

Due to Special Assessment Bondholders—Principal 48,000

Due to Special Assessment Bondholders—Interest 24,000

Cash 72,000

The second installment of assessments receivable was reclassified at year-end from the deferred category to the current category.

Assessments Receivable—Current 48,000

Assessments Receivable—Deferred 48,000

This pattern of journal entries will be repeated during each of the remaining nine years until all special assessment bonds are retired.

7.3. Accounting For Trust Funds

Historically, trust funds have been created to account for assets received by the government in a trust agreement in which the assets are to be invested to produce income to be used for specified purposes (generally cultural or educational). The majority of such trusts benefit the government's own programs or its citizenry.

7.3.1. Investment Pools

Effective management of investments (and in some cases, idle cash) often is enhanced by placing the investments of the funds in a pool under the control of the treasurer or a professional investment manager, either within the treasurer's office or in a financial institution such as a bank or investment firm. If the investment pool is an *internal* investment pool (participating funds are all within the same government) an agency fund may be used to account for the investments in the pool. However, each participating fund is required, for financial reporting purposes, to report its proportionate share of pooled cash and investments as fund assets, and the assets and liabilities of the agency fund are not reported in the government's external financial statements. For internal management purposes, it may be useful for participating funds to use the account title *Equity in Pooled Cash and Investments*, the account title used in the illustrative journal entries shown later in this section.

If the investment pool has external participants (other governments or organizations outside the government administering the pool), an **external investment pool** is used. GASB standards require that an **investment trust fund** be used to account for the assets, liabilities, net assets, and changes in net assets corresponding to the equity of the *external* participants. The accounting for investment trust funds uses an economic resources measurement focus and the accrual basis of accounting.

Typically, the administering government also participates in the pool; however, its equity is considered *internal* and is not reported in the financial statements of the investment trust fund. Instead, the net assets and changes in net assets relating to the internal portion of the pool are presented in the financial statements of each participating fund and in the governmental activities and business-type activities of the sponsoring government's government-wide financial statements.

7.3.2. Private-Purpose Trust Funds

The fair value of assets placed in trust under a trust agreement is referred to as the *principal* or *corpus* of the trust. If the principal of the trust must be held intact (nonexpendable) to produce income, the trust is often called an *endowment*. The income from the assets of an endowment may be used only for the purposes specified by the trust . Not all trusts require that the principal be held intact. Some trusts allow the principal to be spent (expended) for the purpose specified by the trust. Additionally, not all trusts make distinctions between the use of principal and income.

For example, loan funds operated as trust funds usually require that both the principal and income be held intact, whereas public retirement systems are trusts whose principal and income are both expended for specified purposes.

Trust funds are also classified as public or private. *Public trust funds* are those who are principal or income, or both, must be used for some public purpose. The beneficiaries of *private trust funds* are private individuals, organizations, or other governments.

A fund established for the purpose of holding performance deposits of licensees under a government's regulatory activities is an example of a private trust fund. A fund used to account for escheat property arising from the estate of persons who die intestate without any known heirs is another example of a private trust fund. Because most trusts administered by governments are created for public purposes (for example, to maintain parks and cemeteries or to acquire art for public buildings), they are considered governmental rather than fiduciary activities under GASB standards. Thus, nonexpendable public-purpose trusts are accounted for as permanent funds and expendable public-purpose trusts are accounted for as special revenue funds.

7.3.3. Pension Funds

This section provides an overview of the accounting and reporting requirements for pension plans, as well as the governmental employers that sponsor such plans.

Pension plans are of two general types, *defined contribution plans* and *defined benefit plans.* A **defined contribution plan** specifies the amount or rate of contribution, often a percentage of covered salary that the employer and employees must contribute to the members' accounts in the pension plan. The level of benefits payable upon retirement is determined by the total amount of contributions to a member's account, earnings on investments, and allocations of forfeited contributions of other members credited to the account. Because future benefits are neither formula neither based nor guaranteed, the risk associated with defined contribution plans rests primarily with employees; the employer's responsibility essentially ends once the required contribution is made. Such plans ordinarily are *not* administered on an actuarial basis; therefore, accounting and financial reporting requirements for both the plan and the employer are straightforward and present few complications. Essentially, the plan reports the fair value of pension assets and any liability for accrued plan benefits; the employer reports expenditures/expenses for the amount contributed to the plan. Both the plan and the employer are required to provide in the notes to the financial statements a brief description of the plan, classes of employees covered, plan provisions, contribution requirements, significant accounting policies for the plan, and concentrations of investments in any one organization that exceed 5 percent or more of plan net assets.

A **defined benefit plan** provides a specified amount of benefits based on a formula that may include factors such as age, salary, and years of employment. Determining the present value of projected pension benefits involves numerous factors, such as employee mortality, employee turnover, salary progression, and investment earnings.

To ensure that plan assets will be adequate to cover future benefits, professional actuaries are engaged to calculate the present value of benefits and the required contributions that must be made by employers and, in some cases, employees. The basic assumptions underlying actuaries' projections may change over time, giving rise to periodic revisions in the required contributions. Because of the need to rely extensively on actuaries' estimates, it is not surprising that accounting for defined benefit plans is much more complex than for defined contribution plans. The remainder of this section provides a summary overview of the accounting and financial reporting requirements for defined benefit pension plans.

Chapter EIGHT

Accounting for other Not for Profit entities

8.1. Characteristics of the Not-For-Profit Sector

This chapter focuses primarily on NPOs referred to as **voluntary health and welfare organizations (VHWO)** or **human service organizations,** such as the American Cancer Society, Girl Scouts, and Boy Scouts. These organizations receive contributions from the public at large and provide health and welfare services for a nominal or no fee. There are many other kinds of not-for-profit organizations, such as cemetery organizations, civic organizations, fraternal organizations, labor unions, libraries, museums, cultural institutions, performing arts organizations, political parties, private schools, professional and trade associations, social and country clubs, research and scientific organizations, and religious organizations. These organizations are classified by Internal Revenue Code Sections.

The National Center for Charitable Statistics (NCCS) of the Urban Institute developed a National Taxonomy of Exempt Entities (NTEE) that divides the largest set of tax-exempt entities, Internal Revenue Code Sec. 501(c)(3) and (c)(4) organizations, into 10 functional categories (arts, culture, and humanities; education and research; environment/animals; health; human services; international/foreign affairs; public/society benefit; religion related; mutual/membership benefit; and others) and 26 major group areas.

Distinguishing between for profit, not for- profit, and *governmental/nongovernmental* is more useful. "Governmental" not for- profit organizations may receive tax revenue or be owned or controlled by a government but are not governments.

Examples of entities that receive special tax revenue include ***libraries and transportation authorities***. Governments often control museums, cemeteries, development authorities, housing authorities, public hospitals, public colleges and universities, and other public benefit corporations. Some such organizations are reported as a department or unit of a general purpose government.

8.2. GAAP for Nongovernmental NPO

The Financial Accounting Standards Board (FASB) assumed primary responsibility for providing guidance on generally accepted accounting principles for not for- profit entities in 1979. The Governmental Accounting Standards Board (GASB) is responsible for governmental organizations including governmental not-for-profit organizations. These lines of responsibility were formally established by the AICPA's *SAS No. 69*, commonly known as "the GAAP hierarchy." Governmental not-for-profit organizations should apply the standards established by the GASB rather than the FASB's standards applicable to nongovernmental NPOs. This chapter focuses on nongovernmental not-for profit entities.

The AICPA, the FASB, and the federal Office of Management and Budget (OMB) have made a concerted effort to standardize the accounting, financial reporting, and auditing rules for the diverse set of entities in the not-for-profit sector and reduce the inconsistencies across segments of this sector. The FASB has completed four of its five not-for-profit agenda items designed to reduce inconsistencies across NPOs: depreciation, contributions, financial reporting display, and investments. The remaining item focuses on financially interrelated entities and was separated into issues related to intermediaries addressed in *SFAS No. 136* and combinations of not-for-profit organizations, which continues to be on the FASB's technical agenda (at the time of publication).

Congress revised the Single Audit Act in 1996 to cover both governmental and not-for-profit entities, and OMB is now applicable to governments, not-for-profit organizations, and health care entities.

8.3. Financial Reporting and Accounting for NGOs

As stated in Chapter 1, the FASB's objectives of financial reporting for not-for-profit agencies are to provide information useful in

- ✓ Making resource allocation decisions,
- ✓ Assessing services and ability to provide services,
- ✓ Assessing management stewardship and performance, and
- ✓ Assessing economic resources, obligations, net resources, and changes in them.

Common phrases heard today when speaking of financial reporting of any organization include accountability and transparency to stakeholders. Stakeholders of NPOs that use not-for-profit financial statements include donors, grantors, members, lenders, consumers, and others who provide resources to NPOs.

Financial Reporting

FASB *Statement No. 117* establishes standards for financial reporting that require, as a minimum, that NPOs present a statement of financial position, a statement of activities, and a statement of cash flows that present financial information for the entity as a whole. Comparative financial statements are encouraged but not required. Prior to *SFAS No. 117*, NPO financial reporting focused on groups of funds rather than aggregated financial statements for the entity as a whole, making it difficult to assess the financial position and results of operations of individual NPOs and to compare the performance of similar organizations. In addition to reporting financial information for the entity as a whole, *SFAS No. 117* permits NPOs to present additional disaggregated information, such as fund information, that may be useful to internal management, donors, and others.

Statement of Financial Position

This statement, also known as a balance sheet, shows total assets, total liabilities, and the difference, **net assets,** for the organization as a whole.

Unrestricted net assets arise from contributions for which either no donor restrictions exist or the restrictions have expired, revenues for services provided, and most investment income. Unrestricted net assets can be further segregated into board-designated and other categories. **Board-designated net assets** are unrestricted net assets appropriated or set aside by the governing board rather than an external donor and are sometimes subtitled "investments" and "net equity in capital."

Temporarily restricted net assets result from contributions on which the donor imposes restrictions as to purpose (how the asset may be used) or time (when the asset may be used). When the restrictions are met, these net assets are “released from restrictions” and reported as increases in unrestricted net assets.

Permanently restricted net assets are assets for which the donor stipulates that the assets be held in perpetuity but allow the organization to spend any income earned by investing those assets. These gifts are also called **endowments** and are nonexpendable.

Endowments may take the form of *pure* or *permanent* endowments, *term* endowments, or *quasi*-endowments. Term endowments are classified as temporarily restricted net assets because as the term expires, the assets can be used at the discretion of the NPO. Quasi-endowments or “funds functioning as endowments” are those in which the board designates that funds be set aside; however, since the board can reverse that decision, this form of endowment is classified as an unrestricted net asset. Permanently restricted net assets may also be in the form of artwork, land, or other assets that must be used for a certain purpose and may not be sold. Information on temporarily and permanently restricted net assets can be reported on the face of the statement of financial position or disclosed in the notes to the financial statements.

Illustrative Transactions—Voluntary Health and Welfare Organizations

Preceding sections of this chapter point out the fact that NPOs vary greatly regarding the kinds of program services provided and the sources of support and revenue utilized. Accordingly, the transactions and accounting entries presented in this section should be taken as illustrative of those considered appropriate for an organization that offers counseling, adoption, and foster home care; they are not necessarily typical of other NPOs. The transactions illustrated in this section are assumed to pertain to the year 2011 of a hypothetical organization called the Community Family Service Agency, Inc. The trial balance of the Community Family Service Agency, Inc., as of December 31, 2010, is shown on the next page.

The trial balance as of December 31, 2010, indicates that the capital assets (land, building, and equipment) are temporarily restricted, either explicitly by the donor or by an organization policy implying that donated capital assets will be restricted for the term of their useful life, or, in the case of land, for some specified period of time. An amount equal to depreciation expense is reclassified from temporarily restricted to unrestricted net assets each year. Donors of temporarily restricted gifts for programs, plant, or future periods have also restricted the specific asset or investments, in addition to net assets.

1. Contributions received in 2010 but specified by donors for unrestricted use in 2011 were transferred from the temporarily restricted to the unrestricted net asset class, as shown.

a. Net Assets Released—Expiration of Time Restrictions—Temporarily Restricted . . . . ………………………………………………………… .5,125

Net Assets Released—Expiration of Time Restrictions—Unrestricted . . . 5,125

2. Pledges receivable resulting from the 2011 fund drive were recorded. Pledges of $69,500 were unrestricted; in addition, pledges of $16,500 were donor restricted for a special outreach project to be undertaken in 2011.

a. Contributions Receivable—Unrestricted 69,500
Contributions—Unrestricted 69,500

b. Contributions Receivable—Temporarily Restricted 16,500
Contributions—Temporarily Restricted—Program 16,500

3. Cash collected for unrestricted pledges totaled $68,500; collection of accounts receivable amounted to $2,200. Cash collected for restricted pledges made this year totaled $16,500. Cash in the amount of $9,200 was collected for pledges given during a building fund drive in the preceding year.

a. Cash 70,700
Contributions Receivable—Unrestricted 68,500
Accounts Receivable . . . . . . …. 2,200

b. Cash 16,500
Contributions Receivable—Temporarily Restricted 16,500

c. Cash 9,200
Contributions Receivable—Temporarily Restricted 9,200

4. The organization sponsored a bazaar to raise funds for the Special Outreach Project. Direct costs of $3,000, not considered peripheral or incidental in nature, incurred for this event were paid in cash; the event yielded cash contributions of $10,000.

a. Cash 10,000
Contributions—Temporarily Restricted—Program 10,000

b. Direct Costs—Special Outreach Project—Program 3,000
Cash 3,000

5. The FY 2011 allocation from the United Way of Fairshare Bay amounted, in gross, to $317,000. Related fund-raising expenses to be borne by the Community Family Service Agency totaled $13,200; the net allocation was received in cash.

a. Cash 303,800
Fund-Raising Support Expenses 13,200
Contributions—Unrestricted . . . . …. 317,000

6. Salaries expense for the year totaled $265,000, employee benefits expense totaled $51,000, and payroll taxes expense was $20,300. As of year-end, $15,100 of these expenses were unpaid; the balance had been paid in cash.

a. Salaries Expense 265,000
Employee Benefits Expense 51,000
Payroll Taxes Expense 20,300
Cash . . . . …. 321,200
Accounts Payable and Accrued Expenses 15,100

7. Expenses incurred for the Special Outreach Project were professional fees, $17,000; supplies, $4,500; and printing and publications, $1,600. All amounts were paid in cash.

a. Professional Fees Expense 17,000
Supplies Expense 4,500
Printing and Publications Expense 1,600
Cash 23,100

8. Expenses for program services and supporting services were professional fees, $43,000; supplies, $7,800; telephone, $9,800; postage and shipping, $7,800; occupancy, $23,900; rental and maintenance of equipment, $8,700; printing and publications, $7,900; travel, $22,000; conferences, conventions, and meetings, $13,800; specific assistance to individuals, $30,000; membership dues, $700; awards and grants to national headquarters, $5,500; costs of sales to the public, $900; and miscellaneous, $4,200. All expenses were credited to accounts payable and accrued expenses.

a. Professional Fees Expense 43,000
Supplies Expense 7,800
Telephone Expense 9,800
Postage and Shipping Expense 7,800
Occupancy Expense 23,900
Rental and Maintenance of Equipment Expense 8,700
Printing and Publications Expense 7,900
Travel Expense 22,000
Conferences, Conventions, and Meetings 13,800
Specific Assistance to Individuals 30,000
Membership Dues . . . .….. 700
Awards and Grants to National Headquarters 5,500
Cost of Sales to the Public . . . .…. . . 900
Miscellaneous Expense . . . .….. 4,200
Accounts Payable and Accrued Expenses . . . .….. 186,000

9. Unrestricted support and revenue were received in cash during 2011 from the following sources: legacies and bequests, $15,000; membership dues from individuals, $1,000; program service fees, $55,000; investment income, $2,900; and miscellaneous, $1,500. In addition, $250 of net incidental revenue was collected in cash from advertisers for the Special Outreach Project.

Cash 75,650
Contributions—Unrestricted 15,000
Membership Dues . . . . …. 1,000
Program Service Fees 55,000
Investment Income—Unrestricted 2,900
Miscellaneous Revenue 1,500
Contributions—Temporarily Restricted—Program 250

10. Sales to the public amounted to $1,000 gross for the year. None of this amount was collected by year-end.

Accounts Receivable 1,000
Sales to the Public 1,000

11. Accounts payable and accrued expenses paid in cash during 2011 totaled $182,864.
Accounts Payable and Accrued Expenses 182,864
Cash 182,864

12. Contributions received in cash in 2011 amounted to $20,000, of which $10,000 was specified by donors for use in 2012, $6,000 was temporarily restricted for a program, and $4,000 was temporarily restricted for plant.

Cash 20,000
Contributions—Temporarily Restricted—Time 10,000
Contributions—Temporarily Restricted—Program 6,000
Contributions—Temporarily Restricted—Plant 4,000

13. Interest of $4,540 and $6,500 on the principal of the mortgage were paid. Shortterm investments that were restricted for plant were sold at par, $5,000; the proceeds were used to purchase equipment. The organization’s policy is that there is an implied restriction on plant assets and that this restriction is satisfied as the assets are used (measured by depreciation expense).

a. Miscellaneous Expense 4,540
Mortgage Payable 6,500
Cash 11,040

b. Cash 5,000
Short-Term Investments—Temporarily Restricted—Plant 5,000

c. Equipment—Temporarily Restricted 5,000
Cash 5,000

14. Interest received in cash on short-term investments restricted for the plant amounted to $1,390. Interest received in cash on investments of endowment funds amounted to $12,780. This income was not restricted by the donor.

a. Cash 1,390
Investment Income—Temporarily Restricted—Plant 1,390

b. Cash 12,780
Investment Income—Unrestricted 12,780

15. The Community Family Service Agency paid its national affiliates in accord with the affiliation agreements; the amount of the payment in 2011 was $8,574.
Payments to Affiliated Organizations 8,574
Cash 8,574

16. At the end of the year, a local family donated $100,000 in cash to be held in perpetuity with any investment income or gains and losses (realized or unrealized) to be used at the discretion of management.
Cash 100,000
Contributions—Permanently Restricted 100,000

End-of-the-Year Adjusting Journal Entries

17. A physical count of supplies, valued at the lower of cost or market, indicated the proper balance sheet value should be $19,100, a decrease of $3,995 during the year. Prepaid expenses at year-end were $3,600; the decrease of $317 is chargeable to postage and shipping expense.

a. Supplies Expense 3,995

Supplies 3,995

b. Postage and Shipping Expense 317

Prepaid Expense . . . .… 317

Text and reference books

Text Book:

- Accounting for Governmental and Non-Profit Entities, 15th edition, by Wilson, Kattelus, Hay. McGraw-Hill/Irwin Inc., USA, 2010 or recent edition

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