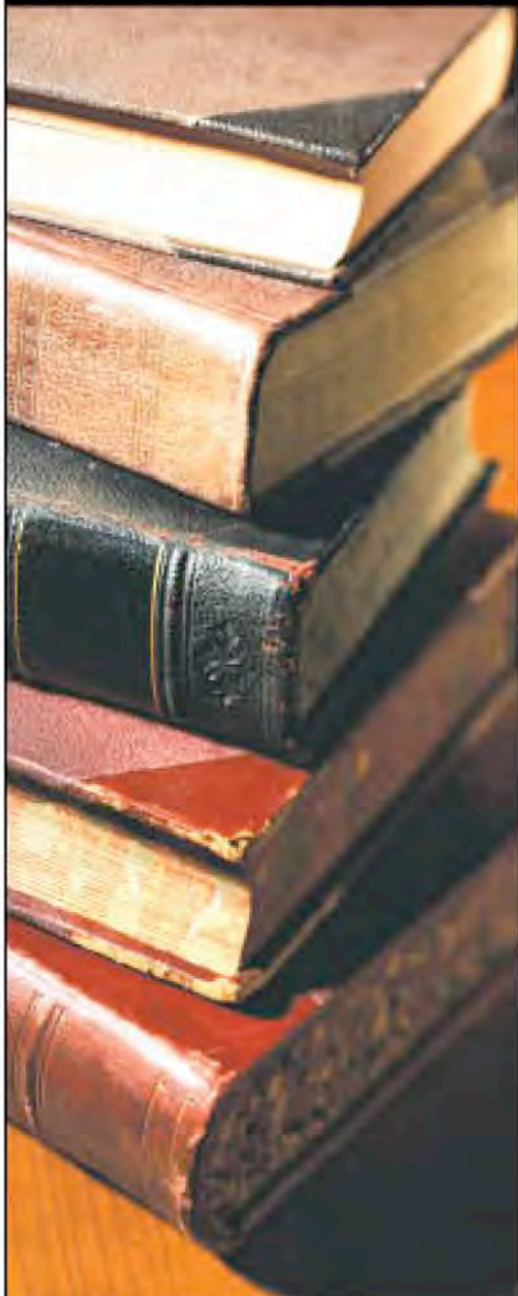
Professional Education Services, LP



Quality education offered by PES...

Basic Governmental Accounting Concepts Including Fund Accounting

Course #7055/QAS7055

Course Material

Professional Education Services, LP

The Professional's Choice for CPE. sm

4208 Douglas Blvd. · Suite 50 · Granite Bay, CA 95746

To Order: 1-800-998-5024 · Customer Service: 1-800-990-2731 · Fax: 916-791-4099

www.mypescpe.com · www.pescpe.com · www.pesqascpe.com · www.eacpe.com

Basic Governmental Accounting Concepts Including Fund Accounting (Course #7055/QAS7055)

Table of Contents

Program publication date 10/17/13

Chapter 1: Basic Governmental Accounting Concepts

This chapter focuses on some of the underlying accounting principles and concepts that underlie all governmental accounting and financial reporting. In order to understand governmental financial statements, the reader needs to understand these basic concepts. Specifically, this chapter addresses the following areas:

- Understanding the different bases of accounting
- Understanding what measurement focuses are used by governments
- Defining and understanding the nature of assets
- Defining and understanding the nature of liabilities
- Defining and understanding the nature of net assets

In reading this chapter, keep in mind that a government reports different types of financial information within different types of specific financial statements. For example, a government's "fund" financial statements will report fund balances while its "government-wide" financial statements will report net assets. Both represent the difference between the assets and liabilities presented on each financial statement. The important point of this chapter is to obtain an overview of many concepts.

UNDERSTANDING THE DIFFERENT BASES OF ACCOUNTING

Nonaccountants tend to think, understandably, that there is only one way that organizations record transactions. If a government buys something and then pays the bill, one would expect that all governments universally would record that transaction or event the same way, at the same time. Not so; in fact, the same government, within its same set of financial statements, may record that simple purchasing and bill-paying transaction in as many as three different ways. Please resist the temptation to close this course, and read on as to how this could possibly be the case.

The simplest way to understand the concept of "basis of accounting" is to view the basis of accounting as determining when a particular transaction will be recorded in the financial statements. In order to understand this concept, three different bases of accounting will be examined – the cash basis, the accrual basis, and the modified accrual basis. A fourth basis – the budgetary basis – may also be used by certain governments when they prepare budgets that do not use generally accepted accounting principles. Only the accrual basis and the modified accrual basis are actually used in preparing governmental financial statements that are in accordance with GAAP for governments. Generally accepted accounting principles for governments do require, in certain cases, that certain budget-to-actual comparison information accompany the financial statements, using whatever basis of accounting was used to prepare the government's budget (i.e., the budgetary basis). The cash basis of accounting is not acceptable for use in a government's financial statements prepared in accordance with GAAP, but learning about the cash basis of accounting will certainly help in understanding the accrual basis and modified accrual basis and perhaps even the budgetary basis.

Cash Basis of Accounting

As stated earlier, the cash basis of accounting is not an acceptable basis of accounting for preparing governmental financial statements in accordance with GAAP. So why look at the cash basis first? Because it is the easiest to understand and will help you to understand the other accounting bases.

Under the cash basis of accounting, revenues are recorded when cash is received. Expenses are recorded when cash is paid out. For example, a government purchases office supplies from a neighborhood office supply store, Clips. The supplies are ordered on January 1, received on January 15, and paid for on January 31. Under the cash basis of accounting, no accounting entries are recorded until January 31, when the office supplies are actually paid for. For an example on the revenue side, assume a town's real estate tax for the town's fiscal year, which begins July 1, is levied on June 10 (just before the end of the fiscal year) and is due on July 15. If a taxpayer pays his or her tax bill on July 13, then that is the date the real estate tax revenue is recorded under the cash basis of accounting. If the taxpayer pays his or her tax early, say June 20 in the prior fiscal year, the real estate tax revenue would be recorded in the prior fiscal year (the one that ends on June 30, ten days after the receipt of the real estate tax) under the cash basis of accounting.

Again, from an accounting perspective, recording transactions on the cash basis could not be simpler. When are transactions recorded? Transactions are recorded when cash is received and when cash is disbursed. If the cash basis were acceptable for preparing governmental financial statements in accordance with GAAP, this course would end here, because that would be about all you would need to know about governmental accounting. Since it is not, read on.

Accrual Basis of Accounting

The accrual basis of accounting is what is used in preparing the government-wide financial statements as well as the types of fund financial statements for what are termed proprietary funds, meaning that they closely resemble a business-type activity. Accordingly, understanding the accrual basis of accounting is important for understanding a government's financial statements prepared in accordance with GAAP.

Under the accrual basis of accounting, transactions are recorded when they occur, irrespective of when actual cash is received or paid. Revenues are recorded when earned or when the government has the right to receive the revenue. Expenses are recorded when incurred. Some examples will help clarify these concepts.

Continuing the examples started in the cash basis of accounting discussion, for the purchase of office supplies, the transaction actually occurs when the government receives the office supplies. That is when it has a legal obligation (i.e., a liability) to pay the supplier. So, under the accrual basis of accounting, the expense (and a corresponding liability) is recorded on January 15, the date that the supplies are received and the government owes the supplier the money for those supplies. For those readers who guessed that the transaction occurred on January 1, when the supplies were ordered, the distinction is that there is no real obligation on January 1 on the part of the government. The order might be canceled prior to delivery, the supplier may be out-of-stock of the items ordered, and so forth. A "budgetary" entry wherein the government might record an "encumbrance" on the date of the order to reserve the budgetary spending authority that it will ultimately use to pay for the supplies is not an accounting entry for purposes of recording an expense. An encumbrance is not the equivalent of an expense for accounting purposes.) Note that when the supplies are paid for, the financial statements of the government will reflect payment of cash (it will have less cash) and the payment of the liability (it will no longer have a liability to the supplier).

To continue the earlier examples for the accrual basis for revenues, the goal would be to match the real estate tax revenue with the year to which it relates. In other words, the real estate tax payment that was received in advance – on June 20 – would not be recognized as revenue until the fiscal year that begins on the following July 1, since that is the year to which it relates.

Let us supplement this example with one that is not tax-based. If a governmental water utility bills its customers based on the actual water used (assume that all customers have water meters), revenue is recognized by the governmental water utility when the customer actually uses the water. Let us again assume a fiscal year that ends on June 30. A meter reader visits a customer on July 10 and reads the customer's meter to measure the water used by the customer from June 11 (the date of the last meter reading) to July 10. The water utility bills the customer on July 15 based on the July 10 meter reading. The customer pays the bill on July 31. When would the governmental water utility recognize the revenue from the water sales to this customer based on this meter reading on the accrual basis of accounting? The answer is that the revenue is split over two fiscal years. Revenue is recognized from June 11 through June 30 for the water sales that occurred during that period in the fiscal year that ended on June 30. Water sales that occurred from July 1 through July 10 will be recognized as revenue in the fiscal year that began on July 1. Since a meter reading was not available on June 30, this utility would likely use a simple method of prorating the total month's bill between the two fiscal years. It would allocate the total monthly revenue over the number of days in the previous fiscal year that ended June 30 (20 days) and the number of days in the next fiscal year (10 days). The date of the bill and the date that the customer pays the bill are not relevant in this example for purposes of determining when the revenue is recognized.

In comparing governmental accounting to nongovernmental entities, the reader should know that the accrual basis of accounting is the only accounting basis that is acceptable for commercial enterprises and not-for-profit organizations in preparing those organizations' financial statements in accordance with generally accepted accounting principles.

Modified Accrual Basis of Accounting

The modified accrual basis of accounting is used by funds that are considered "governmental funds" (these are the funds that are not considered proprietary, or business-type, funds which use the accrual basis of accounting described earlier) in the fund financial statements. The modified accrual basis of accounting is never used in the preparation of the government-wide financial statements.

The modified accrual basis of accounting can be thought of as falling somewhere between the cash basis of accounting and the accrual basis of accounting. In other words, transactions are generally recognized when they occur (similar to the accrual basis of accounting), but the timing of the ultimate cash receipt or cash disbursement may have an impact on when the transaction is recorded (similar to the cash basis of accounting.)

Many of the differences between the modified accrual basis of accounting and the accrual basis of accounting concern the timing of when revenue is recognized. Under the modified accrual basis of accounting, revenues are recognized (i.e., recorded in the financial statements as revenue) when they are susceptible to accrual. To be susceptible to accrual, revenues need to be both measurable and available. In determining whether revenues are measurable, the government does not have to know the exact amount of the revenue in order for it to be subject to accrual. As long as a reasonable estimate of the revenue can be made, this criterion will be met. The available criterion is a bit more complicated. Available means that the revenue is collectible within the current accounting period or soon enough thereafter to pay liabilities of the current period. This criterion results in the recording of only those revenues within a fiscal year that are received within a relatively short period of time after the close of the fiscal year.

For real estate taxes, the susceptible to accrual criterion, based on the availability of the funds, is defined in GAAP as being 60 days after the close of the fiscal year. Going back to the real estate tax example discussed previously, the modified accrual basis of accounting would result in the same amount of real estate tax being recognized as revenue as with the accrual basis of accounting. The June 20 payment would not be recognized until the subsequent fiscal year and the July 13 payment is recognized within the fiscal year that it was paid. Let us change the facts to assume that this July 13 payment is not received until September 13 of the following fiscal year. So, for the June 30, 20X1 fiscal year-end, the tax payment related to that year that was due on July 1, 20X0, is not received until September 13, 20X1. Under the accrual basis of accounting, the revenue would be recognized in the fiscal year ending on June 30, 20X1, irrespective of the fact that it was received more than 60 days after the end of the fiscal year when it was due. Under the modified accrual basis of accounting, the September 13, 20X1 tax payment does not meet the susceptible to accrual criterion – it is not considered available since it was received more than 60 days after the fiscal year-end of June 30, 20X1. Using the modified accrual basis of accounting, the September 13, 20X1 payment will not be recognized as revenue until the fiscal year that ends on June 30, 20X2. This is despite the fact that the real estate tax relates to the town's fiscal year that ended on June 30, 20X1.

Budgetary Basis of Accounting

The budgetary basis of accounting refers to the accounting principles that a government uses to prepare its budget for its main operating fund, the general fund, as well as certain other funds called special revenue funds. Sometimes governments use generally accepted accounting principles to prepare their budgets for these funds, in which case the budgetary basis of accounting would be the same as the basis of accounting required for fund financial reporting for these funds, which would be the modified accrual basis of accounting.

When the budgetary basis of accounting for budget preparation is not the same as the GAAP basis of accounting for these funds, a government has latitude, generally set by the local laws governing the government's budget process, as to what accounting principles it will use to prepare its budget. Sometimes the cash basis of accounting is adopted as the budgetary basis. Sometimes the cash basis of accounting, modified for certain specific ways certain types of transactions are accounted for, is adopted as the budgetary basis. Other times, governments may take the modified accrual basis of accounting and modify the accounting for certain types of transactions and adopt that basis of accounting as the budgetary basis. Since the budgetary basis is something specifically set by governments, there is no way that a course such as this can describe what the budgetary basis is for governments in general. In other words, if the budgetary basis adopts a GAAP basis of accounting, then the budgetary basis equals the GAAP basis. If the budgetary basis is other than GAAP, the accounting principles used to prepare a government's budget will vary from GAAP.

Why is the budgetary basis of accounting important? Generally accepted accounting principles are requiring budget-to-actual comparison information to be presented when the accounting principles used to prepare these budget and actual numbers are not in accordance with GAAP.

UNDERSTANDING WHAT MEASUREMENT FOCUSES ARE USED BY GOVERNMENTS

If the basis of accounting describes when transactions are recorded, the measurement focus can be viewed as defining what transactions are recorded. There are two different measurement focuses that are used in the preparation of financial statements for governments. They are the economic resources measurement focus and the current financial resources measurement focus. The economic resources measurement focus is used in the preparation of the government-wide financial statements and in the fund financial statements by funds that undertake business-type activities. These types of funds are called proprietary funds. The current financial resources measurement focus is used in the fund financial statements by funds that are called governmental funds. For simplicity, think of the governmental funds (general fund, special revenue, capital projects, and debt service are examples) as those funds other than the proprietary funds.

Economic Resources Measurement Focus

The economic resources measurement focus is based on whether an entity is economically better off or worse off as a result of the events and transactions that occurred during the fiscal period being reported. This measurement focus results in a broader range of transactions being recorded than does the current financial resources measurement focus. Think of it this way: Does a transaction or event affect the economic condition of an entity? If it does, record it, irrespective of whether the current or noncurrent, financial or nonfinancial resources of an entity are affected. The economic resources measurement focus described here is essentially the same measurement focus used by commercial organizations and not-for-profit organizations.

Transactions and events that improve the economic position of an entity are reported as revenues or gains. Transactions and events that diminish the economic position of an entity are reported as expenses or losses. Because the economic resources measurement focus reflects transactions regardless of whether they affect current financial resources, both long-term assets (such as capital assets) and long-term liabilities (such as the liability for long-term bonds) are reflected on the statement of financial position under the economic resource measurement focus. Accordingly, the government-wide financial statements and the fund financial statements for proprietary funds report long-term assets and long-term liabilities because they are prepared using the economic resources measurement focus.

Current Financial Resources Measurement Focus

The current financial resources measurement focus is used only in the fund financials by funds that are governmental funds, which basically are the funds that are not proprietary funds. (For simplicity, a group of funds called fiduciary funds are being left out of this discussion.)

Financial statements prepared using the current financial resources measurement focus, as its name implies, reflect changes in the financial resources available in the near future as a result of transactions and events of the fiscal period being reported. Increases in spendable resources are reported as revenues or other financing sources and decreases in spendable resources are reported as expenditures or other financing uses.

Since the current financial resources measurement focus is on the financial resources available in the near future, the operating statements and balance sheets of governmental funds in the fund financial statements reflect transactions and events that involved current financial resources: for instance, those assets that will be turned into cash and spent and those liabilities that will be satisfied with those current financial resources. In other words, long-term assets and those assets that will not be turned into cash to satisfy current liabilities are not reflected on the balance sheets of governmental funds in the fund financial statements. At the same time, long-term liabilities (those that do not require the use of current financial resources to pay them) will not be recorded on the balance sheets of governmental funds.

Practical Example

Say that a government purchases a new computer (a capital asset) for $10,000 that is expected to last five years. After the five years, the computer will be discarded and not sold as scrap. Under the economic resources measurement focus, the computer would be recorded as an asset on the statement of financial position (synonymous with balance sheet) at $10,000. Each year the computer will be depreciated, reducing the asset recorded by $2,000 ($10,000 divided by the five-year estimated useful life) and depreciation expense of $2,000 is recorded. On the date of purchase, there is no economic change in the organization. It traded $10,000 in cash for a $10,000 computer. There is no effect on the statement of activities (think of this as the income statement) because there is no change in the economic condition of the organization. It gave up cash and received a computer in return. In subsequent years, the economic condition of the organization is worse off because the computer has fewer years of useful life remaining. Accordingly, the statement of activities reflects an expense each year equal to $2,000 of depreciation expense.

> Now look at this transaction under the current financial resources measurement focus. On the date of purchase, the governmental fund has $10,000 less in current financial resources because it gave up $10,000 in cash (a current financial resource) and traded it for a computer, which is not a current financial resource because it is not expected to be turned into cash to pay this fund's bills. The operating statement (think of this as the income statement) of the governmental fund will show an expenditure of $10,000 to reflect that, in terms of current financial resources, the governmental fund is $10,000 worse off than it was before the computer purchase. It gave up $10,000 of its cash and did not receive a current financial resource in return. Since there are no other impacts on current financial resources relating to this computer, the governmental fund's financial statements would not reflect any other transactions in subsequent years relating to this computer.

The remaining sections of this chapter discuss the nature of various asset, liability, and net asset amounts typically found in governmental financial statements. If the previous sections were understood, the reader will understand that different assets and liabilities are recorded on the government-wide financial statements than on the fund financial statements when there are governmental funds being reported. The following discussion pertains to amounts recorded on the government-wide financial statements – that is, assuming the accrual basis of accounting and the economic resource measurement focus are being used. This discussion will also pertain, in general, to the financial statements of proprietary funds.

DEFINING AND UNDERSTANDING THE NATURE OF ASSETS

Let us start by looking at the GAAP definition of an asset. The GASB provides a useful definition of assets (and other financial statement elements) that will be examined below.

GASB Concepts Statement No. 4, "Elements of Financial Statements" (GASBCS 4), defines assets in the following way: "Assets are resources with present service capacity that the government presently controls." And all this time you thought that assets were stuff that you owned! The fact is, the GASB definition is meant to provide a broader context to assets, rather than a narrower definition that only implies ownership. For example, if a government prepays its liability for an insurance premium for the following year, it really does not own anything as a result of that prepayment. However, the prepayment is a resource of the government which will be insured during the following year without having to pay an insurance premium in that year. Thinking of assets as including things that the organization owns as well as other types of resources that it is entitled to will help the reader understand what types of items are considered assets.

Note also that assets are measured in financial statements as of a point in time, that is, as of the date of the statement of net assets, which is sometimes referred to as the balance sheet. For example, if the government's fiscal year-end is June 30, its statement of net assets will report its assets as of that date. Assets are also presented in the statement of net assets in their order of liquidity, which means the assets that can be converted the most readily into cash are reported first.

Some of the types of assets often found on a government's statement of financial position are

- Cash
- Cash equivalents
- Investments
- Taxes receivable
- Accounts receivable
- Grants and other receivables
- Inventories
- Capital assets
- Prepaid expenses

Cash

Cash is a fairly obvious asset. It represents the funds in the government's bank accounts. The presentation of cash represents the book balances of the bank accounts, not the amounts reported on the bank statements. The book balances are similar to what individuals keep as balances in their own checkbooks, that is, checks that have been written and deducted from the balance but that have not yet cleared the bank. Similarly, deposits that have been received but have not yet cleared the bank are also included in the balance.

The cash amount reported on the statement of financial position should include

- *All demand bank accounts that the government has, including those for general disbursements, payroll imprest accounts, separate accounts for wire transfers, and so forth.* (One cash balance is reported on the financial statements representing the aggregation of all of these accounts.)
- *All petty cash accounts that are maintained by the government*

The "cash" caption on the statement of net assets should not include the following, which should be disclosed as separate lines on the statement of net assets:

- *Cash that is restricted by some legally enforceable instrument.* Generally, this would include cash maintained in debt service reserve accounts required to be maintained by the related debt instruments. Restricted cash is usually shown as a separate line item in the statement of net assets to make it clear to the reader that it is not available to pay the government's current bills.
- *Cash that is received and held as a security deposit that will be returned to the provider at the end of some agreement.* For example, if a government rents a part of its office space to another organization and holds a $1,000 security deposit that it collects from the renter, that security deposit cash should not be included in the cash balance of the government on the statement of net assets.

Cash Equivalents

The term cash equivalents refer to investments that are so close to being realized as cash that they are viewed essentially as the equivalent of cash. The definition of what is considered a cash equivalent originated in the rules for preparing statements of cash flows. These rules for determining what can be considered a cash equivalent were promulgated by GASB Statement No. 9, “Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Accounting” (GASBS 9). These requirements define cash equivalents as short-term, highly liquid investments that are both readily convertible to known amounts of cash and so near their maturity that they present an insignificant risk of changes in value because of changes in interest rates. This is interpreted by GASBS 9 to mean that for an investment to be considered a cash equivalent, it must mature within three months of being bought by the organization. This means that a one-year treasury note that is purchased by a government two months before it matures can be considered a cash equivalent. However, if the government purchased the one-year Treasury note when it was first issued (so that it matured in one year), it would not be considered a cash equivalent. Also, this investment would not be considered a cash equivalent if it was held by the organization and then reached a point where it only had three months left to maturity. Classification as a cash equivalent occurs when the investment is acquired by the organization. Examples of cash equivalents include Treasury bills, money market funds, and commercial paper. Note again that the term original maturity refers to the length of time to maturity at the time that the security is purchased by the government, not to the security’s original duration before maturity.

Investments

Most investments (most stocks, bonds, and other debt instruments) are reported in the statement of net assets at their fair value (fair market value is an older term for what is now referred to as fair value). Changes in the fair value of investments from year to year are reported in the government’s statement of activities as part of overall investment earnings (or losses).

Taxes Receivable

Taxes are one type of “nonexchange” transaction. Earlier in this chapter, some information about recording receivables for real estate taxes, one of the more common taxes received by governments, was provided. It is important to be aware that taxes that are owed to a government – be it real estate taxes, personal or corporate income taxes, sales taxes, or personal property taxes – that are due to a government on the date of its statement of net assets but that have not been paid, are reported on the statement of net assets as a receivable. In some cases the receivable recorded by a government for taxes reflects an estimate of the amounts owed to it.

Accounts Receivable

The other significant category of receivables, accounts receivable, is often referred to as trade accounts receivable. These receivables represent funds that are owed to the government from individuals or other organizations because of services provided or goods sold to these other entities. Some common scenarios where these types of receivables may be present on a government’s financial statements are:

- A governmental college may be owed tuition and fees from students that are past their due date, but have not as yet been paid.
- A government water utility may bill its customers for water that has been provided to the customers and the bill is due but has not as yet been paid.

These types of receivables occur from exchange transactions – the government is not just collecting a tax or a grant, it is providing specific services in exchange for money.

There are two basic considerations that the nonaccountant should understand about accounts receivable. First, a receivable (and the related revenue) should not be recorded until the organization actually earns the revenue and the right to receive the money from the entity to whom they are selling services. Second, not all receivables are ultimately collected.

In terms of revenue recognition, the general rule is that the government would earn the revenue when it provides the services and has a right to collect the revenue. In the case of the governmental college, revenue from tuition would be recorded at the end of the semester to which the tuition related. The revenue is matched to the period in which the college incurred expenses to earn that revenue, which is during the semester to which the tuition relates (assume that the fiscal year-end does not occur during the semester, which would require more complex calculations). As with the governmental water utility example, the utility earns revenue (and records a receivable) when services are provided to its customers. A receivable is recorded at the date of the statement of net assets for water services provided. Some of these services already will have been actually billed and some of these services may not have been billed because of waiting for meter readings or bill processing. An estimate of the unbilled amounts due the water utility would also be recorded as a receivable.

These are two very simplistic examples that are meant to demonstrate a concept. In practice, particularly for commercial enterprises, revenue (and receivable) recognition issues can be quite complex and have been the cause of more than one accounting scandal in recent years.

Another key point to understand about the accounting for these types of accounts receivable is that not all receivables are necessarily collected. This is particularly true of the types of nontax-related receivables where the government does not have the ability to place a lien on a property to ultimately collect its receivable. Generally accepted accounting principles require that an estimate of receivables that will not be collected be made and that an “allowance for uncollectible receivables” be established. This account reduces the overall receivable balance (and charges bad debt expense) so that the net of the gross receivable balance and the allowance represents the best estimate of how much of the receivable balance actually will be collected. Receivables are therefore reported at the net realizable value, which is in accordance with GAAP. Note that the government does not really know which specific receivables (i.e., which students will not pay their tuition bills), but will use historical trends and an aging of receivables (which categorizes how long receivables have been outstanding) to estimate this amount. If the government knows that a particular receivable will not be collected, that particular receivable should be reduced from the gross receivable balance, which is another way of saying that the particular receivable should be written off.

Grants and Other Receivables

Governments often have other receivables reported on their statement of net assets representing money owed to them for reasons other than the main revenue categories mentioned earlier. The same principles generally apply to these other types of receivables, although grant revenue receivable and revenue recognition can be more complex. Grants are also “nonexchange” transactions. Grants may be from the federal government, a different level of government (such as a state providing a grant to a city), or from private (i.e., nongovernmental) sources.

Some of these other common receivables, in addition to grants, are

- Fines and penalties, such as parking violation and other motor vehicle fines
- Expense reimbursements that are expected to be received by the government from individuals, donors, or others
- Reimbursement of expenses paid on behalf of another government. For example, a government might jointly share an expense with another government and bill that government for its allocated share of the expense.

If any of the receivables discussed in this “other” category are significant, they may warrant using a separate line item for them on the statement of net assets. The GASB also has some disclosure requirements concerning the disaggregation of receivables, meaning that information about the various types of receivables that a government has may need to be disclosed in the notes to the financial statements if the information is not readily apparent from the face of the statement of net assets.

Inventories

Inventories are most often associated with manufacturing and retail operations, rather than with governments or governmental entities. Many, if not most governments, however, do maintain inventories, because the definition of what is considered inventory is somewhat broader in the governmental environment. Most inventory amounts reported by governments, however, are not significant in relation to their overall financial statements and this section is not trying to overstate the importance of this item to these financial statements. However, it is useful to understand what the inventory caption means because although not generally large, it is seen frequently.

Traditionally, inventory is considered merchandise or goods that are being offered for sale. Governments, and particularly those with business-type activities, often have items that they sell. A governmental college bookstore would have an inventory of books that it sells. A governmental healthcare organization may have an inventory of medications and other medical supplies that are charged or “sold” to patients as they are being used. In the government accounting environment the financial statement caption called “inventory” often consists of various materials and supplies that are used by the government itself. This may consist of the usual variety of office and general supplies. A government’s motor pool may keep a supply of commonly used automobile and truck parts. Other governmental entities, such as transit authorities, may have a large inventory of spare parts for buses, trains, and so forth.

The accounting for inventories can be fairly complicated and the details are beyond the scope of this course. However, a basic understanding of inventory accounting will go a long way in understanding inventories reported on the statement of net assets of a government.

Inventories are reported on the statement of net assets either at cost or at market value, whichever is lower. One important matter in accounting for inventories is referred to as the flow assumption. The flow assumption determines which items from inventory are considered to be sold or used first. The first-in, first-out (FIFO) flow assumption sounds complicated, but simply means that the oldest items from inventory (that is, the first items “in”) are the first items to be sold or used. This is the most common flow assumption used by governments. Assuming that there is consistent inflation at some level, these older inventory items will have a lower cost assigned to them, because they were theoretically purchased at a lower cost. This means that when these items are sold, the profit realized by the government will be higher than when the last items brought into inventory are sold.

If the items are used by a government, there is no profit earned per se, but a lower cost will be charged to expense when the older item is assumed to be used first. The alternative flow assumption, last-in, first-out (LIFO), assumes that the last items brought into inventory (that is, assuming inflation, the ones with a higher cost) are the first ones sold or used. This means that when these items are sold, the net profit to the government is lower than it would be using the FIFO flow assumption (or if used, the expense will be higher). While the LIFO method has clear tax advantages to commercial organizations because reported profits are lower, its use by governments is less popular, because tax considerations are generally not of importance. A hybrid method, known as the average cost method, is sometimes used instead of a pure “flow assumption” method. Inventory is simply valued at the average of the costs to the government for the inventory items on hand. This would usually result in inventory recorded on the statement of net assets at amounts somewhere between FIFO and LIFO.

The second important consideration for inventory valuation in the statement of net assets is that the amount reported as the cost of inventories on the statement should not be more than the amount that the inventory can be sold for. The commonly used phrase that inventory is reported at the “lower of cost or market” means just that, with the term market referring to how much the item could be sold for, rather than what it would cost the government to replace the inventory item.

> **Tip:** There are many other inventory methods with intimidating names that are variations on these two basic concepts, such as the dollar value retail LIFO method. While the calculations may grow in complexity, the basic concepts remain as described above.

Capital Assets

Sometimes referred to as fixed assets or property, plant, and equipment, the capital assets of a government represent its long-lived assets used in the conduct of the organization’s business. These would include land, buildings, equipment, office furnishings, computers, vehicles, and other similar assets. GASBS 34 created a significant change for governments, requiring that infrastructure assets (such as roads, bridges, tunnels, sidewalks, etc.) also be recorded as part of a government’s capital assets.

The specific assets that are recorded as capital assets is generally determined by a government's capitalization policy. This policy determines what purchases are recorded as assets and what purchases are recorded as expenses. If a purchase of one of these types of assets meets the capitalization policy's criteria, it is recorded as an asset. The capitalization policy is usually based on the useful life of the item. Normally, a minimum useful life of three to five years is required before an item is recorded as an asset. The capitalization policy usually also sets a minimum dollar threshold in order for an item to be recorded as an asset. The threshold amount varies based on the size of the organization. A $500 threshold is reasonably popular among small organizations, although amounts as low as $100 and as high as $50,000 are not uncommon for very small and very large organizations, respectively.

Two other items should be included in fixed assets – leasehold improvements and capitalized leases. Leasehold improvements are purchases that meet the capitalization criteria of an organization, but are improvements to leased property rather than to property owned by the government itself.

Practical Example

A government enters into a 20-year lease for office space. Prior to moving into the space, the government "builds out" the space by moving walls to create the desired office space, installing a reception area, carpeting, and so forth. These leasehold improvements would be considered part of the organization's fixed assets although the organization does not own the building to which these improvements are permanently attached.

Capitalized leases are an accounting creation that recognizes the substance of some lease transactions over their form. In other words, when a government enters into a lease for an item, which, in substance, is a purchase of the item, the item is recorded as a capital asset of the organization, even though the organization does not have title to the asset.

Practical Example

A government leases a copier machine that has a useful life of 10 years. The term of the lease is 10 years. Since the government is using the asset for virtually its entire useful life, GAAP would require the government to record the copier as a capital asset, along with the liability for future lease payments.

Property, plant, and equipment is recorded on the statement of net assets at its cost to the government, reduced by accumulated depreciation (with two exceptions, which are discussed below). Accumulated depreciation represents the decline in value of capital assets as they are used in the operation of the government. Depreciation expense is the annual amount charged to expense in government's statement of activities, which represents an estimate of the amount of the asset that is "used up" in the organization's operations during the year. Accumulated depreciation sums up the annual amounts of depreciation expense for capital assets and represents a reduction in the recorded cost amount of the asset on the organization's statement of net assets.

Practical Example

A government buys a PC for $2,200, which it estimates to have a five-year useful life. At the end of five years, the organization expects that it can sell the PC for salvage for $200. The amount to depreciate is $2,000 ($2,200 less the $200 salvage value). $2,000 divided by five years results in a depreciation expense of $400 per year. This table illustrates the calculations for the life of this asset.

Year	Depreciation expense	Accumulated depreciation	Remaining net book value
1	$400	$ 400	$1,800
2	400	800	1,400
3	400	1,200	1,000
4	400	1,600	600
5	400	2,000	200

At the end of Year 5, the remaining net book value of the asset ($2,200 original cost less $2,000 accumulated depreciation) equals the estimated salvage value of the asset, $200. No further depreciation would be taken and the asset would remain on the books until it was actually disposed of. If the organization managed to sell the asset for $300, it would remove $2,200 from the asset account and $2,000 from the accumulated depreciation account from the books and record a gain of $100 on the disposition of the asset. If the asset was sold for $100, the organization would remove $2,200 from the asset account and $2,000 from the accumulated depreciation account from the books and record a loss of $100 on the disposition of the asset.

Accumulated depreciation is a contra account to property, plant, and equipment, meaning that its balance (which is a credit) offsets the gross amount of capital assets that is recorded on the statement of net assets as an asset (debit). The accumulated depreciation account, as its name suggests, is the cumulative amount of depreciation that has been recorded on the assets that are included in property, plant, and equipment. Each year when the depreciation expense is recorded, the accumulated depreciation amount is increased for the amount of the annual depreciation expense. Conversely, when an asset is retired or sold, the amount of accumulated depreciation that is applicable to that particular asset is removed from accumulated depreciation, meaning that the accumulated depreciation account is reduced for this amount.

It was mentioned earlier that there are two exceptions to calculating and recording depreciation on capital assets. The first involves specific accounts that are not depreciation – land and construction work-in-progress. Land is not depreciated because it is not “used up” by the government – it retains its value and usefulness even though things added to the land, such as a building, do decline in value and are depreciated. Construction work-in-progress represents a capital asset that is being built by a government over a period of time that extends over more than one fiscal year. As costs are incurred, they are recorded as an asset called construction work-in-progress, or something similar. Whatever is being built would not be depreciated until the construction is completed and the capital asset is placed in use.

The second large exception to depreciating capital assets involves infrastructure assets. GASBS 34 gave governments the option to depreciate infrastructure assets as they would their other capital assets, or to adopt something called the modified approach and not depreciate the assets. The modified approach attempts to reflect the notion that infrastructure assets do not decline in usefulness or value. Rather, the government is likely to maintain these assets by incurring additional repair and maintenance costs over the life of the asset, resulting in an almost indefinite life for some assets. As long as the government spends the money (and accounts for these costs as expenses) to maintain the infrastructure asset at a level established by the government, depreciation is not required on these infrastructure assets.

One other accounting term related to capital assets is asset impairment. This concept reflects the fact that sometimes events happen or circumstances change in a way that negatively affects the value or usefulness of a capital asset to a government. If an asset is impaired, even with the accumulated depreciation that may have already been recorded on that asset, the net book value of the asset on the statement of net assets is overstated. The GASB issued Statement No. 42, “Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries,” which sets the rules for when and how governments should record impairments of capital assets.

Intangible Assets

A type of asset that is a bit more difficult to understand is called an “intangible asset.” As its name implies, these are assets that you can’t see or touch, but they are resources of the government that are recorded as assets. Intangible assets include patents, trademarks, easements, water rights, timber rights, and computer software.

The GASB issued Statement No. 51, “Accounting and Financial Reporting for Intangible Assets” (GASBS 51), which provides accounting guidance to governments on how and when to record intangible assets. Basically, intangible assets are considered capital assets, and the accounting rules discussed above related to capital assets would apply.

In order for an intangible asset to be recorded, it needs to meet certain criteria, namely that the asset is “identifiable.” GASBS 51 defines “identifiable” as being capable of being separated from the reporting government (in other words, it can be sold, transferred, licensed, rented, or exchanged) or if the asset arises from contractual or other legal rights (these don’t have to be separable from the government).

GASBS 51 also has special rules for when intangible assets are created or produced by the government (referred to as “internally generated”). Even more specific rules govern when governments can record an intangible asset for internally generated computer software.

While all of these details are beyond the scope of this course, what is important to know is the governments don’t have carte blanche in terms of what assets they can record as intangible assets. The author believes that one of the intents of GASBS 51 is to make sure that governments are not able to record too many costs as assets when those costs really should be charged to expense.

Prepaid Expenses

Prepaid expenses are assets that arise because an organization has paid for services that it will receive in the future, with the future being defined as a time past the fiscal year-end. GASB Concepts Statement No. 4 would define prepaid expenses as a special type of asset that is reported, called a "deferred outflow of resources." The most common example of a prepaid expense is an insurance premium. Let us say that a government has a June 30 fiscal year-end. It pays its general liability insurance premium (assume it is $1,000) on January 1, for the next full calendar year. By June 30, it has used up six months of insurance, but still has another six months of insurance to which it is entitled. The organization would allocate the $1,000 of insurance premium over the 12-month calendar year period. On June 30, it would record a reduction of its insurance expense and record a prepaid insurance expense asset of $500 ($1,000 times 6/12). Note that this organization uses up this prepaid asset during the period from July 1 through December 31. If the organization issued its 6-month financial statements on December 31, it would reduce the entire prepaid asset to zero and record the corresponding $500 as insurance expense, which makes sense because, since the insurance works on a calendar year basis, on December 31, the organization has not prepaid any of its insurance. Assuming in this example that the insurance premiums stay the same every year, the government would have recorded $1,000 of insurance expense in its fiscal year ($500 recognized as a result of the premium payment and $500 recognized when the prepaid expense asset is used up).

While prepaid insurance is the most common and easily understood example of a prepaid expense, there can be many others. Rental payments on facilities or equipment are another example. Some judgment should be used by governments in determining what should be recorded as prepaid expenses. For example, a motor vehicle registration fee is usually paid annually in advance. If the government only owns a few motor vehicles, it is probably not worth the administrative effort to calculate and record this type of prepaid expense, particularly when registrations expire throughout the year.

DEFINING AND UNDERSTANDING THE NATURE OF LIABILITIES

GASB Concepts Statement No. 4 provides this definition of liabilities: "Liabilities are present obligations to sacrifice resources that the government has little or no discretion to avoid." While this definition seems quite simple, applying it is more complicated. Nonaccountants generally think of liabilities as simply "money that you owe." While this is not too far off from a GAAP perspective, there are several ideas in Statement No. 4's definition that will make the simple definition more accurate.

First, liabilities are measured at a point in time, which means, for financial statement purposes, as of the end of the government's fiscal year. To be a present obligation means that the obligation has actually been incurred as of the year-end to be reported on the statement of net assets as a liability, meaning it is the result of past transactions or events. Second, the obligations are not simply those that must be satisfied by the payment of cash. Liabilities also consist of obligations of the organization to perform or transfer assets other than cash to the party to which the organization is obligated.

Some of the more common liabilities found recorded on the statement of net assets of governments are

- Accounts payable and accrued expenses
- Debt
- Deferred income

Accounts Payable and Accrued Expenses

Sometimes governments report both accounts payable and accrued expenses on one line on the statement of net assets. Other times, separate amounts are reported for each. For the purpose of explaining what these liabilities represent, it is helpful to discuss accounts payable and accrued expenses together.

Accounts payable essentially represent the unpaid bills of a government. These are bills for goods or services that have been received by the organization prior to the end of its fiscal year.

> ***Practical Example***
>
> The government receives an invoice in the amount of $1,000 for stationery that it ordered with the new mayor's name. The stationery was received on June 15. The fiscal year-end of the organization is June 30, and a check for $1,000 was issued to the stationery supply store on July 7. As of June 30, the government records a $1,000 accounts payable (representing the unpaid invoice) along with a $1,000 supplies expense. (Note that accounts payable also arise when an organization buys assets or incurs expenses.)

There are two other situations that might also give cause to record amounts as accounts payable, and both of these situations involve issuance of checks. Let us say that a government with a June 30 year-end writes checks for all of its outstanding bills on June 29, even though it realizes that it will not have available funds in its bank account to clear the checks until the second week of July. The government holds all of the checks written on June 29 and first mails them on July 12. When the checks are written, most automated (and manual) accounting systems would record a decrease in cash and a decrease in accounts payable. However, in this example the government has neither expended cash nor reduced its accounts payable on June 30 – all it really did was write checks. Accordingly, the total amount of the checks held by the government until past year-end would be added back to cash and to accounts payable.

A second similar situation arises when the government writes checks prior to its year-end and reduces the book balance of its cash below zero. It can do this because it knows that all of the written checks will take some time to clear the bank, at which time the government expects that the actual balance in its bank account – its bank balance – will be sufficient to clear the checks. The difference between this case and the first situation is that, in this case the government does not physically hold onto the checks. It mails them. In this case, the government would not report a negative balance for cash on its statement of net assets. Rather, it would bring the book balance of the account up to zero and would add the same amount to its accounts payable balance. Effectively, this reclassifies the negative book balance of cash to accounts payable. This makes logical sense because, in effect, the government "owes" the amount of the negative cash amount to the bank, rather than individual vendors.

Accrued expenses represent liabilities for goods and services received by a government for which either an invoice has not been received or the entire invoice does not apply to the fiscal year-end being reported. A simple example should make this clear.

Practical Example

Referring to the $1,000 stationery purchase example used above, let us say that the government did not receive the invoice for the stationery until July 7. Assuming that the physical delivery of the stationery still occurred on or before June 30, the organization would record an accrued expense for this purchase. Basically, a liability is recorded for the accrued expenses and, at the same time, stationery expense is charged. Also keep in mind that amounts might have to be estimated for shipping or similar charges in establishing the accrued expense. Conversely, the government may take into consideration discounts for prompt payment that it intends to take, if it is the organization's normal practice to take advantage of such discounts.

Accrued expenses also arise because invoice amounts or service periods span the end of the fiscal year of an organization. For example, if a monthly telephone bill covers a period that ends on the 15th of each month, the government should accrue a telephone expense for that portion of the July 15 telephone bill that applies to the fiscal year ending on June 30, which would be for the period from June 16 (first day of the bill period) through June 30.

A similar accrued expense concept applies to salary expenses where the pay period does not coincide with the end of a fiscal year. Only the portion of the weekly or biweekly salary expense (including related fringe benefit expenses) that is earned by employees up to and including the date of the fiscal year-end should be accrued as salary (and fringe benefit) expense through the end of the government's fiscal year-end.

Debt

In addition to the accounts payable and accrued expense liabilities described above, governments almost always have a liability for some form of debt that they have issued. Debt is known by several different names, usually based on how long the debt has before it becomes due, or matures. For example, a short-term loan is generally evidenced by some type of legal instrument, commonly referred to as a note. These types of loans are usually recorded in the financial statements as notes payable, and generally mature in five years or less. There are a wide variety of transactions that may give rise to notes payable, some of which are very common.

Several types of notes are unique to governments. These notes are call bond anticipation notes and revenue (or tax) anticipation notes. A bond anticipation note is issued to provide short-term financing that will be repaid with the proceeds of a long-term bond that will be issued. Hence the note "anticipates" the bond to be issued in the future. Another type of note anticipates a future revenue that will be used to repay the note. The future revenue may be in the form of a tax or it may be another type such as a grant that will be received from another level of government.

Most debt issued by governments, however, is in the form of long-term bonds. Governments are often restricted by state and/or local requirements as to the amount of debt that they can issue and the purposes for which debt can be used. While some governments issue debt to fund operating deficits, more often debt is issued to finance construction or purchase of significant facilities. The specific mechanics of these types of transactions are beyond the scope of this course. Suffice it to say that the unpaid principal of the debt, usually in the form of bonds, will be recorded as a liability on the statement of net assets of the government. Since bonds can be sold at either a discount (e.g., a $1,000 face value bond can only be initially sold for $980) or a premium (e.g., a $1,000 face value bond is initially sold for $1,020), the liability recorded on the financial statements would represent the face amount of the bonds (also called their par value), decreased by discounts and increased on premiums on the initial sales of the bonds. Note that the total of the discounts or premiums is amortized (reduced) over the life of the bond. This amortization results in either a decrease in interest expense (in the case of a discount) or an increase in interest expense (in the case of a premium).

All types of debt incurred by governments will give rise to interest expense. Interest expense follows similar concepts for accruing other types of expenses. (The fund accounting discussion in Chapter 2 will point to some important differences as to how principal and interest are accounted for in governmental funds.) Interest expense is recognized as an expense when it is earned by the holder of the government's debt, regardless of when the interest is actually paid, as explained in this example.

> ***Practical Example***
>
> A governmental entity with a September 30 year-end makes semiannual interest payments – on January 1 and July 1 each year – on bonds that it has sold. Interest is paid in arrears, which means that it is paid after it has been earned by the bondholder. In other words, the January 1 interest payment is for interest earned by the bond holder from July 1 to December 31. Accordingly, the January 1 interest payment includes interest relating to the period of July 1 through September 30. Interest related to this period must be accrued in the September 30 government-wide financial statements. Accruing interest results in the recording of an accrued interest liability (another type of accrued expense liability as previously discussed), with a corresponding amount recorded as interest expense. When the actual payment is made on January 1, the accrued interest liability is reduced to zero, with the balance of the interest payment recognized as interest expense in the year that the payment is made.

Deferred Income

The liabilities discussed in the preceding pages are relatively easy to understand. However, liability for deferred income requires a little more conceptual thinking to understand. In fact, GASB Concepts Statement No. 4 refers to this special type of liability as a "deferred inflow of resources." The idea of recording deferred income is matching the recording of income with the period in which the revenue is earned, which in some cases also matches the revenue to the costs incurred to generate that revenue. When cash is received by a government prior to its either having earned the income or the right to keep the income, it records the cash along with a liability-type account called deferred income.

One of the more common types of deferred income recorded by governments is for funds received in advance for a grant. Many grants are structured so that the government is entitled to the grant revenue only after it spends the money for the grant program. In other words, it is reimbursed for the expenses of the program. In the not-so-old days, these were called “expenditure-driven revenue” grants because the level of expenditures drove the amount of revenue to be recorded, up to the maximum amount permitted by the grant. In the current terminology of “nonexchange” transactions, this means that “all of the eligibility requirements” have been met (i.e., you have to spend the money to be entitled to the reimbursement revenue). If a government receives cash as an advance under a grant such as this, the cash advance is recorded as deferred revenue, which appears just like a liability (that is, a credit) on the statement of net assets. Note that this is really a different kind of liability in that the government is not expecting to write a check to pay off the liability. Rather the government has an obligation to spend the money that has been advanced. If the money is never spent on the grant program, then the government would have an obligation to return the advanced funds to whomever it received them from.

DEFINING AND UNDERSTANDING THE NATURE OF NET ASSETS

Net assets are easy to understand in that they represent the difference between a government’s total assets and its total liabilities. Looking at it a different way, if you add a government’s net assets to its liabilities, the amount will equal the government’s total assets.

“Fund balance” is essentially the difference between a governmental fund’s assets and liabilities. What makes the concept of net assets a little more difficult to understand for a government’s financial statements is that GASBS 34 requires that net assets be divided into three categories, assuming that they all apply to a particular government.

1. *Invested in capital assets, net of related debt.* This amount represents the difference between two amounts: the government’s capital assets reduced by any accumulated depreciation (this is the first amount) and the outstanding balance of any debt that was used to purchase or construct those capital assets (this is the second amount). Conceptually, this is not too difficult to understand. For governments trying to calculate this number, however, it can be a nightmare. The complications, which thankfully are beyond the scope of this course, result from trying to properly reflect bond premiums, discounts and issuance costs (which are complicated by amortization and by bonds that have been refunded), and unspent bond proceeds restricted for capital asset purposes, not to mention simply trying to determine which capital assets were purchased or constructed using debt. For the nonaccountant’s view, understanding what the caption is trying to represent should be adequate.

2. *Restricted net assets.* This amount of net assets reflects the net assets that the government has that have some strings attached to them. The attached strings are constraints that are either:

   - Externally imposed by creditors (such as those imposed by debt covenants), grantors, or contributors, or through laws and regulations of other governments, or
   - Imposed by law through constitutional provisions or enabling legislation.

A common example of restricted assets for governments is that of debt service reserve funds. Many times in a debt issuance, the government agrees to put a certain amount (sometimes equal to one year's debt service) in a special account that it cannot use for any purpose other than paying debt service if it happens to default on the debt, which means this money basically cannot be touched. Displaying these types of assets subject to these types of restrictions as "restricted" net assets alerts the financial statement reader that these net assets cannot be freely used by the government.

One other important point regarding restricted net assets is that the government may, or may not, be able to impose restrictions on itself. Let's say that a government decides it would like to accumulate $100,000 each year for the next three years so that in year four it can build some capital project. This would generally not constitute a restriction for reporting purposes. It would not classify these resources as restricted. The government could unilaterally change its mind and decide to not keep the assets for the capital project and use them for something else – meaning that there is no real restriction on the assets in this example.

One of the ways that net assets can be restricted mentioned above is through "enabling legislation." In this case, the government isn't simply setting aside some budgetary funds for some future purpose – it is actually passing legislation that is mandating how certain net assets can be used. Can the government impose restrictions on itself through legislation? Are these restrictions legally enforceable? Could future legislation simply eliminate the requirement? After the issuance of GASBS 34, diversity in practice developed, which caused the GASB to issue Statement No. 46, "Net Assets Restricted by Enabling Legislation" (GASBS 46), to provide additional guidance.

GASBS 46 "clarifies" that a legally enforceable enabling legislation restriction is one that a party outside the government – such as citizens, public interest groups, or the judiciary – could compel the government to honor. Since it is unlikely that the legal enforceability of a restriction would actually be tested in the courts, there is still a significant amount of judgment required to determine whether the affected net assets should be reported as restricted or not. GASBS 46 does require that the amount of net assets restricted by enabling legislation be disclosed in the financial statements.

3. *Unrestricted net assets.* Any net assets that do not belong in the above two categories are called unrestricted net assets.

One final note in discussing net assets is that these categories may have negative amounts on the financial statements. While it should be rare that restricted net assets would be negative, the invested in capital assets net of related debt, and as well as unrestricted net assets can be negative. For example, if a government depreciates capital assets faster than it pays off the related debt, the invested in capital assets net of related debt may be negative. Unrestricted net assets may be negative as a result of accumulated deficits incurred by a government. In other cases, governments may issue debt to provide funds to other governments or other organizations. In these cases, the government has the debt on its statement of net assets, without a corresponding asset, which could cause the unrestricted net asset amount to be negative. Finally, certain long-term liabilities for landfills, judgments and claims, and compensated absences are usually not currently funded by governments, meaning that these long-term liabilities will impact the net asset amount negatively.

Summary

The goal of this chapter is to give the reader a flavor of some of the accounting concepts that can be expected to be found in reading the financial statements of governments. The important point to re-emphasize is that all of the above asset, liability, and net asset examples pertain to the government-wide financial statements and proprietary funds. Governmental funds, discussed in the next chapter, use different accounting principles in the fund financial statements that result in accounting treatments different from many of the items discussed in this chapter. When the governmental fund financial results are converted from the separate fund financial statements to be included in the government-wide financial statements, the financial results are "converted" to the accounting principles used in this chapter.

Chapter 1 – Review Questions

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Each of the following are considered bases of accounting except:

   a) credit basis
   b) cash basis
   c) accrual basis
   d) modified accrual basis

Use the following for questions 2 – 4:

Assume office equipment was purchased for $50,000 and is expected to last 10 years. At the end of its useful life, it will be discarded with no salvage value.

2. Under the economic resources measurement focus, in which financial statement will the asset initially be recorded:

   a) statement of financial position
   b) income statement
   c) operating statement
   d) there is no initial recording

3. Under the economic resources measurement focus, what is the effect on the statement of activities in year 5:

   a) $50,000 expenditure
   b) $5,000 expense
   c) $10,000 expense
   d) no expense recorded

4. Under the current financial resources measurement focus, what is the effect on the statement of activities in year 3:

   a) $50,000 expenditure
   b) $5,000 expense
   c) $10,000 expense
   d) no expense recorded

5. A prepaid expense, such as prepaid rent, falls under which of the following classifications:

   a) asset
   b) net asset
   c) liability
   d) equity

Chapter 1 – Solutions and Suggested Responses

1. **A: Correct.** The credit basis of accounting does not exist. The terminology does intuitively point to the correct basis that incorporates credit sales. However, this is not the correct term.

   B: Incorrect. The cash basis of accounting is considered a base of accounting. Under the cash basis of accounting, revenues are recorded when cash is received, and expenses are recorded when cash is paid out.

   C: Incorrect. The accrual basis of accounting does comply with US GAAP and is used in preparing the government-wide financial statements as well as proprietary funds.

   D: Incorrect. The modified accrual basis is used by funds that are not considered "governmental funds," but do certainly exist.

   (See page 1-1 of the course material.)

2. **A: Correct.** The statement of financial position is synonymous with the balance sheet, where assets, liabilities, and equity items belong.

   B: Incorrect. The income statement lists revenue and expense related items.

   C: Incorrect. The operating statement is synonymous with the income statement.

   D: Incorrect. There is an initial recording, as it must reflect the transaction affecting the change in resources.

   (See page 1-6 of the course material.)

3. A: Incorrect. This is incorrect treatment under the economic resources measurement focus. This would be correct in year 1 for the current financial resources measurement focus.

   B: Correct. The answer can be found by dividing $50,000 by 10. The $5,000 depreciation expense is recorded to decrease the book value of the asset.

   C: Incorrect. This is incorrect treatment under both the economic resources measurement focus and the current financial resources measurement focus. Note that the example asks for the year 5 impact on the life of the $50,000 asset originally estimated at 10 years.

   D: Incorrect. This would be correct under the current financial resources measurement focus for year 5.

   (See page 1-6 of the course material.)

4. A: Incorrect. If this were the first year, then under the current financial resources measurement focus this would be correct.

   B: Incorrect. Under the economic resources measurement focus, this would correctly indicate the annual depreciation expense to monetarily reflect the decrease in useful life.

   C: Incorrect. This is incorrect treatment under both the economic resources measurement focus and the current financial resources measurement focus. Note that the example asks for the year 3 impact on the life of the $50,000 asset originally estimated at 10 years.

   D: Correct. In year 1 an expense of $50,000 would be recorded to show that, in terms of current financial resources, the governmental fund was $50,000 worse off than it was before the purchase. However, there is no change in current financial resources in year 3. Thus, no expense is recorded.

   (See page 1-7 of the course material.)

5. **A: Correct.** Specifically, GASB Concepts Statement No. 4 defines prepaid expenses as a special type of asset that is reported, called a “deferred outflow of resources.”

   B: Incorrect. The net asset refers to the calculation made to arrive at the asset’s current value. This is typically found by deducting accumulated depreciation from the original transfer value of the asset.

   C: Incorrect. A liability is an obligation of an entity originating from past transactions. In the case of prepaid rent, the receiver of the prepayment would assume liability in the form of unearned revenue.

   D: Incorrect. Prepaid rent does belong on the statement of financial position. However, the account type is not an equity item.

   (See page 1-16 of the course material.)

Chapter 2: Understanding Fund Accounting

Under the financial reporting model for governments brought about by GASBS 34, fund accounting, or more correctly fund financial statements, are not the primary reporting tool for governments. Rather, fund financial statements are one of the two methods used by GASBS 34 to present a government's financial position and results of operations. The first method is the government-wide financial statements. These use the accrual basis of accounting and use the accounting concepts as the foundation for reporting the various types of assets and liabilities that were discussed in Chapter 1. The second method is the fund financial statements. These financial statements use both the modified accrual basis of accounting (for funds that are considered "governmental" funds) and the accrual basis of accounting (for funds that are considered "proprietary" funds). Just to complicate things a bit more, a third type of funds, "fiduciary" funds, may use either modified accrual or accrual, depending on which subtype of fiduciary fund they are.

In order to complete our foundation of accounting concepts, this chapter discusses fund accounting concepts. Here is what will be covered:

- Fund fundamentals
- Governmental funds (general fund, special revenue funds, capital projects funds, debt service funds, and permanent funds)
- Proprietary funds (enterprise funds and internal service funds)
- Fiduciary funds (pension and other employee benefit trust funds, investment trust funds, private-purpose trust funds, and agency funds)

The discussion of the governmental funds also considers how the accounting for various types of transactions differs using the modified accrual basis of accounting for the fund financial statements versus using the accrual basis of accounting for the government-wide financial statements. Be forewarned that some of the accounting for governmental funds in the fund financial statements will be different from accounting for the same transaction in the government-wide financial statements. The GASB used to call this the "dual perspective" in governmental financial reporting, although they have since backed away from using this term. Some cynical commentators on GASBS 34 called this "two sets of books." Whatever; suffice to say that there are supposed to be differences in the accounting between the two sets of financial statements and this chapter will do its best to describe the fund perspective.

FUND FUNDAMENTALS

Before looking at the details, it is important to understand just what a fund actually is. Fund was defined by Statement 1 of the National Council on Governmental Accounting (NCGAS 1), entitled "Governmental Accounting and Financial Reporting Principles," as follows:

> 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.

A fund is a separate accounting and financial reporting entity. It is what is called a "self-balancing" set of accounts. This means that a fund's assets will equal the total of its liabilities and its fund balance (or net assets), similar to the way financial statements for a legal entity work, although funds are usually not separate legal entities. Fund accounting for governments was developed in response to the need for governments to be fully accountable for their collection and use of public resources. The use of funds is an important tool for governments to demonstrate their legal compliance with the lawfully permitted use of resources. One thing to keep in mind is what a fund is not – it is not the equivalent of a bank account. The fund will have various assets and liabilities recorded, the difference between the assets and liabilities being called fund balance. That fund balance does not represent "cash" that can be readily spent. Not all of the assets will be in the form of cash, so it cannot be expected that the fund balance is the equivalent of the balance of cash in a bank account. This is a common mistake that nonaccountants sometimes make when reviewing fund financial statements.

Fund accounting remains an important aspect of financial reporting for governments: GASBS 34 includes within its financial reporting model fund financial statements. Fund financial statements enable governments to continue to demonstrate legal compliance, as described above. Since the overwhelming number of governments have legally adopted budgets at the fund level, demonstration of compliance with budgets is an important component of fund reporting under the GASBS 34 reporting model.

One additional aspect to consider is that while governments use fund accounting, most "governmental entities" that are not like general-purpose governments do not use fund accounting. The governmental entities that do not use fund accounting are often those separate legal entities whose activities are accounted for as proprietary activities. These are typically the public authorities (utilities, hospitals, etc.), whose activities use proprietary accounting as described in Chapter 1. These entities usually do not use fund accounting as would a government, such as a city or county.

Number of Funds to Be Established

The number of separate funds that a government establishes is based on both legal requirements and management's judgment as to how many funds it needs to enable sound administration of the financial affairs of the government. In other words, where statute or law requires the establishment of particular funds, certainly the government is going to establish those funds. Similarly, contracts, such as debt indentures, may also require the establishment of certain funds and certainly the government will establish the funds required by contract. Beyond these legal and contractual requirements, the government's management should determine how many funds should be established to separate the activities involved in carrying on specific programs or attaining certain objectives relating to special regulations, restrictions, or limitations.

There is a wide disparity among governments as to the number of funds established. Some moderate-size governments have literally hundreds of funds. Other, larger governments might have no more than a few funds to manage their affairs. It seems that the historical practices of governments, as determined by their executive and legislative branches, have a lot to do with how many funds are established. If new revenue is obtained that must be used for a particular purpose, some governments automatically set up a new "special revenue" fund. Over time, this practice can result in numerous funds. Other governments may simply record this revenue in the general fund and set up general ledger accounts within the general fund to track revenues and expenditures. There is no real “right” answer as to the number of funds that a government should have beyond those required by law or contract. The government must balance the benefits of using separate funds with the costs in terms of accounting and financial reporting complexity that comes with having numerous funds.

GOVERNMENTAL FUNDS

This section will discuss the various types of governmental funds. The governmental funds basically account for the activities of the government that are not considered proprietary (business-type) or fiduciary. These activities are sometimes referred to as the general governmental activities, although the best way to understand what are considered activities to be accounted for in governmental funds is to examine the specific types of funds themselves. Remember from Chapter 1 that governmental funds use the modified accrual basis of accounting and the current financial resources measurement focus.

General Fund

The general fund is the chief operating fund of a government. Generally accepted accounting principles permit a government to have only one general fund. The general fund is a catchall fund. It accounts for all current financial resources of a government except for those current financial resources that are accounted for in another fund. Often when governments talk about “balancing their budget,” what they really mean is that they are balancing the budget of their general fund. Many times when it is said that a government is over budget or has a deficit, the meaning is not for the government as a whole, but for the government’s general fund, since this is usually considered the main operating fund of a government.

The balance sheet of the general fund will include those current financial resources related to transactions that will be accounted for in the general fund. Usually the asset side of the balance sheet consists of cash, investments, receivables, and inventories.

A few words are needed on the accounting for inventories in the general fund. These accounting rules would also apply to other governmental funds discussed in this section of the chapter, but inventories are most often found in the general fund.

There are two acceptable accounting methods for inventories in the general fund and other governmental funds. The first is called the purchase method. This method simply records an expenditure for materials and supplies when they are purchased. The second method is called the consumption method. This method records an expenditure for inventories when they are consumed. Under this method, when inventories are purchased, they are recorded on the balance sheet as an asset. As they are used during the year, the asset account is reduced and an expenditure is recorded. At the fiscal year-end, the amount recorded as “inventory” on the balance sheet represents the cost of the inventory that the government still has on hand, which are those that it has not consumed during the year. While GAAP does permit either the purchase method or the consumption method to be used, it should be noted that GAAP also requires that when a government has significant amounts of inventory at year-end, those inventories should be recorded on the balance sheet. This would point to the use of the consumption method in order to accomplish this.

In reading a government's fund financial statements, the fund balance of the general fund usually has an amount as one of its components called "reserved for inventories" that is equal to the amount of inventories recorded as an asset on the same balance sheet. The reason this is done is to alert the financial statement reader that the balance sheet contains an asset, inventories, that is technically not a current "financial" resource that is available to be spent or to pay the fund's current liabilities. Note that in the near future this term will change from "reserved" to "nonspendable" for these types of assets that are not in spendable form.

The typical liabilities found in the general fund are those for accounts payable and accrued expenditures, deferred revenues, and revenue or tax anticipation notes.

The general fund accounts for accounts payable and accrued expenditures in conjunction with its accounting for expenditures. The expenditure is generally recorded in the fund when a liability is incurred. In the simplest example, goods and services received prior to the end of the fiscal year should be accrued as expenditures (i.e., an account payable or an accrued expense is recorded) because the liability for the goods or services has been incurred. In other words, since the government received the goods or services it is obligated to pay for them. If a bill has been received for the goods and services by the fiscal year-end, the liability is called an "account payable." If a bill has not been received for the goods and services by the fiscal year-end, the liability is called an "accrued expense." This distinction is often not important to the financial statement reader, since accounts payable and accrued expenses are often presented on the same line on the balance sheet.

As usual, there are exceptions to every rule. The special nature of the current financial resource measurement focus used by the general fund and other governmental funds results in eight different types of expenditures that are not to be recognized when a liability is incurred. These types of expenditures are those for

- Compensated absences
- Judgments and claims
- Unfunded pension and other postemployment benefit contributions
- Special termination benefits
- Landfill closure and postclosure costs
- Debt service
- Inventories (discussed above)
- Operating leases with scheduled rent increases

These exceptions arise because governmental funds, such as the general fund, record expenditures when a liability is incurred, but only record the liability for the fund when the liability will be liquidated with expendable available financial resources. As a quick example, most governments have large liabilities that they will owe to employees on termination or retirement for unused vacation and sick leave time (compensated absences). This liability will not be paid with current financial resources. Only some employees leave or retire during the year and are paid for unused vacation and/or sick leave balances. The general fund will not record a liability for all of the compensated absences that will ultimately be expected to be paid by the government because it will not be paid with current resources. In fact, many governments do not record the portion of the liability that can be expected to be paid during the year in the general fund, which is acceptable. What the general fund would be required to record is a liability for any employees that left employment or retired prior to the fiscal year-end, but have not been paid by the end of the fiscal year.

Another liability sometimes found recorded on the general fund's balance sheet is that for revenue or tax anticipation notes. These are short-term borrowings that governments sometimes use to smooth fluctuations in a government's cash flow during the year. For example, suppose a town collects real estate tax revenues on a semiannual basis, say July 1 and January 1. Let us also say the town has very heavy cash needs during the period from September through December. This town may decide to issue tax anticipation notes in which it receives the proceeds from the note in September and pledges the tax revenues that it "anticipates" to receive in January to pay off the note. Since these types of liabilities will be liquidated using current financial resources, this liability is recorded on the balance sheet of the general fund, assuming that this is the fund that will receive the note proceeds and the fund that will repay the note.

Special Revenue Funds

Special revenue funds are used to account for the proceeds of specific revenue sources that are restricted or committed to be expended for specific purposes other than capital projects and debt service. The creation and use of special revenue funds is optional unless there is a legal requirement of the government that a special revenue fund be created. In other words, simply restricting the use of the revenue does not automatically mean that this revenue and the related expenditures must be accounted for in a special revenue fund. In the absence of a legal requirement to create one or more special revenue funds, governments consider whether the creation of a special revenue fund is really necessary. Simply because a certain revenue must be used for a specific purpose does not mean that this revenue and the related expenditure cannot be accounted for in the government's general fund. Generally accepted accounting principles for governments prescribe that a minimum number of funds be used. However, a government may feel that a special revenue fund improves accountability over compliance with a special revenue source's requirements. In these cases, the government will set up one or more special revenue funds to account for these types of resources.

There are two common examples of revenues that are accounted for in special revenue funds. The first are for grants received from other levels of government, such as a federal or state grant, or from individuals or foundations that restrict the use of the funds for specific purposes. For example, a city receives a state grant to build a new recycling center. A special revenue fund may be established to account for the revenue received from the state and the expenditures related to building the recycling center.

The second common example where special revenue funds are used is instances where the proceeds from specific taxes are restricted for certain purposes. For example, a state may impose a gasoline tax, the proceeds from which are required to be used for the construction and maintenance of state highways. A special revenue fund may be established to account for the gasoline tax revenues and the expenditures related to state highways.

Note that in the first example, the special revenue fund has a limited purpose and duration. After the recycling center is built and all bills have been paid and state revenues received, the special revenue fund that was created should be closed. In the second example, the special revenue fund would be expected to continue in perpetuity as long as the gasoline tax was still being levied and as long as the proceeds continued to be restricted to state highway expenditures.

One caveat to the use of special revenue funds is that if the special revenue is a grant or other source that requires that the resources be used for a capital project, a special revenue fund should not be used. This revenue and the related expenditures should be accounted for in a capital projects fund, which is discussed in the following section.

Capital Projects Funds

Governments often use capital projects funds to account for and report resources that are restricted, committed, or assigned for expenditure for capital outlays, including the acquisition or construction of capital facilities and other capital assets. The capital projects fund does not account for the capital activities of proprietary funds or for assets that will be held in trust for others – those activities are accounted for within the proprietary funds or trust fund, where appropriate. The capital projects funds would account only for the capital activities of those projects that are considered to be governmental, rather than proprietary.

Most governments use one or more capital projects funds to account for the acquisition and/or construction of capital assets. As will be seen in the following discussion, the significance of the dollar amounts that flow through the capital projects fund might well result in an overshadowing of the general governmental activities reported in the general fund. Capital projects funds are also used to account for special revenues that relate to capital projects as well as capital improvements financed by special assessments, which will be discussed later. The only instance where GAAP requires that a government use a capital projects fund is where capital grants or shared revenues are restricted for capital acquisition or construction.

Once a government determines that it desires to establish a capital projects fund (or is required by GAAP to establish one), the government then needs to decide how many capital projects funds will be established. A government may determine that it can adequately account for and manage its capital projects with one capital projects fund. However, a government may decide that establishing a number of capital projects funds will better serve its accountability and financial management needs.

The number of categories and types of revenues and “other financing sources” that are typically found in capital projects funds are usually fewer that those found in the general and special revenue funds. Since governments typically finance the acquisition and construction of capital assets through the use of long-term debt, the issuance of long-term debt is typically the most important source of resources for capital projects funds. Proceeds from long-term debt are reported as an “other financing source” of resources. This term refers to those sources of resources that are not considered “revenue” but nevertheless need to be reported on the operating statement of the fund. In addition, capital projects funds may account for receipt of resources in the form of nonexchange transactions from federal, state, or other aid programs, transfers from other funds, and capital leases.

Remember from Chapter 1 that the capital projects fund, as a governmental fund, uses the modified accrual accounting basis and the current financial resources measurement focus. This means, among other things, that long-term assets and long-term liabilities are not recorded in this fund. Therefore, do not expect to find that the capital assets that are purchased or constructed with money from the capital projects fund are recorded as assets of the capital projects fund. You will find the capital assets purchased or constructed through the capital projects fund recorded only on the government-wide statement of net assets. When the capital projects fund spends resources to purchase or construct an asset it charges an expenditure on its operating statement. There is no asset recorded on the balance sheet of the fund. Similarly, do not expect to find a liability on the balance sheet of the capital projects fund for the long-term debt issued to provide funds to purchase or construct the capital assets. You will find the long-term liability for the debt only on the government-wide statement of net assets. When proceeds from long-term debt are received by the capital projects fund, the operating statement records an “other financing source” of funds, which, although titled differently, works just like a revenue in the operating statement.

The astute reader may notice that long-term is used in the above discussion about whether the debt is recorded in the capital projects fund. Keep the following in mind about debt being recorded in the capital projects fund. First, if short-term debt was issued and the proceeds recorded in the capital projects fund, this short-term liability would be paid with current financial resources and would be recorded as a liability of the fund. Second, there are two types of financing vehicles, bond anticipation notes and demand bonds, that, if certain conditions are met (really if certain conditions are not met), can result in these liabilities being recorded as a liability of the capital projects fund. The following sections explain these types of financings.

Bond Anticipation Notes

Bond anticipation notes are short-term notes that are expected to be repaid with the proceeds of long-term debt issued after the bond anticipation notes are issued. The accounting question arises as to whether (1) the bond anticipation notes should be considered a short-term liability and recorded in the fund that receives the proceeds from these notes (usually the capital projects fund) or, (2) since they are expected to be repaid using the proceeds from a long-term debt issuance, they should be treated as a long-term liability. Treating them as a long-term liability means that they would not be recorded in the fund, but would be recorded only on the government-wide statement of net assets. The answer is – it depends. It depends on whether there is strong evidence that the government has the ability to issue the long-term debt to repay the bond anticipation notes. If the government issues long-term debt and repays the bond anticipation notes with the bond proceeds after the end of the fiscal year, but before the financial statements are issued, the bond anticipation notes would be treated as long-term debt at the fiscal year-end and not recorded as a liability of the fund. There is clear evidence that the government has the ability to repay these notes because it actually did so shortly after the fiscal year-end. Another way that allows a government to treat these bond anticipation notes as a long-term liability is if there is a financing agreement in place before the financial statements are issued that meets certain criteria that demonstrate that the government can issue long-term debt that will be used to repay the bond anticipation notes. All of the specific criteria of the financing agreement are beyond the scope of this course. Suffice to say that the financing agreement must clearly be one that is solid enough to provide assurance that the government will be able to issue long-term debt to repay the bond anticipation notes.

Demand Bonds

The second type of financing that may or may not be recorded as a liability of a governmental fund, usually the capital projects fund, depending on whether certain conditions are met, are demand bonds. Demand bonds are financial instruments that create a potential call on a government's current financial resources. Demand bonds are a type of debt that has demand provisions (sometimes called put provisions) as one of the features that give the bondholder the right to require the government issuer to redeem the bond within a certain period. Usually there is some contractually agreed-on term that requires the bondholder to give the government some notice prior to requiring payment, such as a 30-day period. In some cases, the demand provisions can be exercised by the bondholder immediately after the bonds have been issued by the government. In other cases, there is a waiting period, for example, five years, until the put or demand provisions of the bond may be exercised by the bondholder. These provisions mean that the bondholder is less subject to risks caused by rising interest rates. Because the bondholder is assured that he or she can receive the par value of the bond at some future date, a demand bond has some features and advantages of a short-term investment for the bondholder in addition to being a potential long-term investment. Accordingly, depending on the current market conditions, governments can generally issue demand bonds at lower interest rates than would be possible with bonds that did not have the demand bond's put provisions.

Because the issuance of demand bonds can result in significant potential cash outlays by governments if their demand features are exercised by the bondholders, steps are usually taken to protect the government from having to fund, from its own cash reserves, demand bonds redeemed by bondholders. Governments usually appoint remarketing agents whose function is to resell bonds that have been put to the government by the bondholder. In addition, governments usually obtain letters of credit or other arrangements that would make funds available to cover demand bonds for which payment has been demanded.

To provide for long-term financing in the event that the remarketing agents are unable to sell the redeemed bonds within a specified period, the government issuing demand bonds generally enters into an agreement with a financial institution to convert the bonds to an installment loan that is repayable over a specified period. This type of arrangement is known as a takeout agreement and may be part of the letter of credit or may be a separate agreement.

The question as to the accounting for demand bonds centers around whether a demand bond that matures in ten years but may be redeemed by the bondholder at any time with thirty days' notice is a long-term liability or a short-term liability. The accounting for demand bonds was established by GASB Interpretation No. 1, "Demand Bonds Issued by State and Local Governments" (GASBI 1). It addresses the accounting for demand bonds that have demand provisions that are exercisable at the balance sheet date or within one year from the date of the balance sheet. Interpretation No. 1 requires that these bonds be reported as a liability of the fund (usually the capital projects fund) unless all of the following conditions are met:

- The government bond issuer has entered into a financing (takeout) agreement to convert the bonds into some other form of long-term obligation. (Also, this takeout agreement must be with an unrelated third party.)
- The takeout agreement does not expire within one year from the date of the government's balance sheet.
- The takeout agreement is not cancelable by the lender or the prospective lender during that year, and obligations incurred under the takeout agreement are not callable during the year.
- The other party to the takeout agreement is expected to be financially capable of honoring the takeout agreement. During recent turmoil in the financial markets, this became a condition that required more extensive considerations than in the past.

So what does all this mean in English? If a government has a fairly ironclad ability to avoid paying demand bonds out of current financial resources by using a takeout agreement, the liability does not have to be recorded in the governmental fund and would appear only on the government-wide statement of net assets since it would be considered a long-term liability. However, if there is no takeout agreement, or if the takeout agreement has some loopholes, the assumption is that current financial resources may have to be used to pay the demand bonds, and the liability for the demand bonds would be recorded as a liability on the balance sheet of the governmental fund as well as on the government-wide statement of net assets.

Special Assessment Debt

Special assessment debt is another type of debt that might be recorded in the capital projects fund. The reader may be wondering why the capital projects fund section is discussing mostly debt-related matters. To reiterate, governments generally finance capital projects with debt and there are a number of accounting issues that address when that debt is actually recorded as a liability of the capital projects fund.

The capital projects fund typically accounts for capital projects financed with the proceeds of special assessment debt. More often than not, special assessment projects are capital in nature and are designed to enhance the utility, accessibility, or aesthetic value of the affected properties. The projects may also provide improvements or additions to a government's capital assets, including infrastructure. Some of the more common types of capital special assessments include streets, sidewalks, parking facilities, and curbs and gutters. For example, the government will build sidewalks in a neighborhood that previously had no sidewalks and charge the homeowners a special assessment for the portion of the sidewalk that is on their property.

The costs of a capital improvement special assessment project are usually greater than the amount the affected property owners can or are willing to pay in one year. To finance the project, the affected property owners effectively mortgage their property by allowing the government to attach a lien on their property so that the property owners can pay their pro rata share of the improvement costs in installments. To actually obtain funds for the project, the government usually issues long-term debt. Ordinarily, the assessed property owners pay the assessments in installments, which are timed to be due based on the principal and interest payments that must be made for the debt. The assessed property owners may also elect to pay for the assessment immediately, or at any time thereafter, but prior to the installment due dates. When the assessed property owners satisfy their obligations, the government removes the liens from the respective properties.

There is a specific GASB Statement (No. 6, “Accounting and Reporting for Special Assessments,” GASBS 6) that discusses the accounting treatment for special assessments and their related debt. Prior to GASBS 6, there was a special fund type that accounted for special assessments, so the good news is that there is one less type of fund to learn about. The big issue with how special assessments are recorded is whether the government is obligated in any manner for the debt.

- If the government is obligated in some manner to assume the payment of the debt related to the special assessment in the event of default by the property owners, all transactions related to the capital improvements related to the special assessment are accounted for in the same manner as any other capital improvement and financing of the government. Transactions of the construction phase of the project should be reported in the capital projects fund (assuming one is being used), meaning the proceeds from the bonds would be recorded as an “other financing source” and spending on the project would be recorded as expenditures. However, one other set of accounting entries is required. At the time of the levy of the special assessment, a receivable for special assessments should be recorded in the capital projects fund. Because this receivable is not a current financial resource, a deferred revenue amount should also be recorded. As the payments are collected from the property owners, the receivable amount is reduced. As the receivable is reduced, the deferred revenue account is also reduced with a corresponding amount of revenue being recognized.
- If the government is not obligated in any manner for the debt related to a special assessment, the construction phase is treated like other capital projects, meaning that expenditures are recognized in the capital projects fund. The source of the funds in the capital projects fund, however, should be identified by a description other than “bond proceeds,” for example, “contributions from property owners.” Although in both cases the capital projects fund receives the proceeds from debt, in the case where the government is not obligated in any manner for the debt, the accounting reflects the fact that conceptually the property owners are receiving the debt proceeds and then turning them over to the government. The government records the receipt of these funds in the capital projects fund as a contribution from the property owners. In addition, the government will not use a debt service fund (discussed in the next section) to record the collection of special assessments and their payment to bondholders, because the debt is not a debt of the government.

Debt Service Funds

Debt service funds are a type of governmental fund that is used to account for resources that are restricted, committed or assigned for debt service. Debt service is simply a fancy way of saying “making principal and interest payments on the government’s debt.” Once again, the government should determine whether it is legally obligated to establish debt service funds. If it is not, the government should decide whether it would be useful from a managerial perspective to establish such a fund or funds. From a practical perspective, most governments that have long-term debt outstanding do use debt service funds. Where resources are being accumulated for principal and interest maturing in future years, those financial resources should be reported in a debt service fund.

One thing to keep in mind is that establishing debt service funds as an accounting and financial reporting tool is different from the requirement in many bond indentures or similar agreements that establishes reserve funds, or other financial requirements. For example, a bond indenture (contract) may require that one year's worth of debt service be maintained in a restricted cash account to be used only in the event of default by the government on the debt. This is not a debt service fund. This is a restricted cash account often called a debt service reserve fund. A debt service fund is an accounting mechanism used to account for transactions involving making normal principal and interest payments on a government's debt. A debt service reserve fund is money kept out of the reach of the government that will be used to pay bondholders in the event that a government defaults on its debt.

As a governmental fund, the debt service fund uses the modified accrual basis of accounting and the current financial resources measurement focus. There are three accounting issues that are often encountered relating to debt service funds.

1. Whether and when tax revenues should be recorded directly in a debt service fund
2. Expenditure recognition for debt service payments
3. Advance refunding of debt issues

Each of these will be discussed briefly in the following sections.

Whether and When Tax Revenues Should Be Recorded Directly in a Debt Service Fund

This is a fairly narrow issue of situations where a specific revenue source, such as property taxes or sales taxes, is restricted for debt service on general long-term debt. Assuming that the government has established a debt service fund, the accounting question is whether these restricted tax revenues should be recorded directly as revenue of the debt service fund or whether they should be recorded as revenue of the general fund and then recorded as a transfer to the debt service fund.

When taxes are specifically restricted for debt service, they may be reported directly as revenue in the debt service fund, rather than in the general fund with a subsequent transfer to the debt service fund. However, circumstances such as a legal requirement to account for all revenues, including restricted taxes, in the general fund may sometimes require that restricted taxes be first reported in the general fund. In this case, an operating transfer from the general fund to the debt service fund would be recorded for the amount of the specific tax. The accounting may be influenced by the manner in which these revenues are budgeted. For example, the restricted tax revenue and the transfer to the debt service fund may both be part of the budget of the general fund, in which case it may make more sense to have the accounting follow that track than to record the revenue directly in the debt service fund. This will also be true for taxes that are partially restricted for debt service. For example, a property tax may be used to fund current debt service requirements, with any excess property tax revenue over the amount needed for debt service to be used for general operations or other functions of the government. Accounting for the entire property tax in the general fund, with a transfer of the required debt service amount to the debt service fund makes more sense than splitting the tax revenues into two funds. It will also facilitate a financial statement reader's being able to determine how much property tax revenue was recognized during the year without having to add up amounts from two different funds.

Expenditure Recognition for Debt Service Payments

As mentioned, the debt service fund, as a governmental fund, uses the modified accrual basis of accounting. However, generally accepted accounting principles for governments result in debt service expenditures being recorded on an accounting basis similar to the cash basis. Unmatured (meaning that they are not yet due) principal and interest payments on general long-term debt, including special assessment debt for which the government is obligated in some manner, are not recorded as a liability and expenditure of the debt service fund. In other words, if a government with a June 30, 20X1, fiscal year-end makes a debt service principal and interest payment on July 1, 20X1, the principal payment would not be recorded as a liability and an expenditure for the year that ends June 30, 20X1. Nor would the government accrue interest expense for this payment for the year ended June 30, 20X1. Interest would not be accrued at June 30, 20X1, even if the interest paid on July 1, 20X1 was earned by the bondholders during the previous six months, which is often the case. As long as the interest and principal payment is not due until July 1, 20X1, neither would be recorded as a liability and expenditure of a debt service fund on June 30, 20X1.

The preceding discussion assumes that debt service payments are being made on a timely basis. If the principal and interest payment became due and were not paid, the debt service fund would record a liability for the due but unpaid debt service payment. One other consideration is the situation where a government has transferred resources into a debt service fund before the debt service payment has become due. In this case, the debt service fund would reflect the resources available for the debt service payment, but not the liability for the payment itself. Generally accepted accounting principles permit governments to record the liability and expenditure for the debt service payment in this case. Given that the fund has the resources, the liability will be satisfied with current financial resources, consistent with recording a liability in the fund under the current financial resources measurement focus. It is important to note that recording the liability and expenditure for debt service in this limited exception is optional and not required.

Advance Refunding of Debt Issues

Transactions known as advance refundings of debt are one of the unique types of accounting transactions often found in the debt service funds. This topic is closely related to the requirements of GAAP as to when the refunded debt can be removed from the government-wide statement of net assets. Statement No. 7 of the GASB, “Advance Refundings Resulting in Defeasance of Debt” (GASBS 7), provides the accounting rules for these types of transactions.

An advance refunding transaction typically involves a government issuing new debt and using the proceeds to pay off (refund in advance) an existing debt issue. Since the bonds for the existing debt issue have not matured, the government takes the proceeds from the new bonds and places a sufficient amount of these funds in a trust to pay the interest and principal on the existing bonds. As the bonds and debt service from the existing bonds become due, they are paid with the funds that the government had put in the trust. Basically, the government has substituted the new debt for the existing debt.

There are two ways that the government could remove the liability for the old debt from the statement of net assets. The first, called a legal defeasance, occurs when debt is legally satisfied based on provisions of the debt instrument or contract even though the debt has not actually been paid. This situation does not occur frequently. The second, called an in-substance defeasance, is far more common. An in-substance defeasance occurs when debt is considered defeased for accounting purposes even though a legal defeasance has not occurred.

Statement No. 7 of the GASB sets the rules for when the debt can be removed from the statement of net assets as a result of an in-substance defeasance. The government must irrevocably place cash or other assets with an escrow agent in a trust to be used solely for satisfying scheduled payments of both interest and principal of the defeased debt, and the possibility that the government will be required to make future payments on that debt is remote. The trust is restricted to owning only monetary assets that are essentially risk-free as to the amount, timing, and collection of interest and principal. The monetary assets should be denominated in the currency in which the debt is payable. Statement No. 7 also prescribes that for debt denominated in US dollars, risk-free monetary assets are essentially limited to

- Direct obligations of the US government (including state and local government securities, which are a type of investment that the US Treasury issues specifically to provide state and local governments with required cash flows at yields that do not exceed the Internal Revenue Service's arbitrage limits)
- Obligations guaranteed by the US government
- Securities backed by US government obligations as collateral and for which interest and principal payments generally flow immediately through to the security holder

For advance refunding transactions that result in defeasance of debt reported in the government-wide statement of net assets, the proceeds from the new debt should be reported as "other financing source – proceeds from refunding bonds" in the fund receiving the proceeds, which this discussion is assuming is the debt service fund. Payments to the escrow from resources provided by the new debt should be reported as "other financing use – payment to the refunded bond escrow agent." Payments to the escrow agent made from other resources of the government should be reported as debt service expenditures.

Permanent Funds

One additional type of governmental fund that was defined by GASBS 34 is the permanent fund. Permanent funds are used to report resources that are legally restricted to the extent that only the earnings, and not the principal, may be used for purposes that support the government's programs, meaning programs that are for the benefit of the government or its citizens. Permanent funds operate in a manner similar to endowments, where the investment earnings, and not the principal, can be spent. Note that the earnings of a permanent fund are used to support the government's activities. This is in contrast to a type of fiduciary fund, discussed later in this chapter, called the private-purpose trust fund, in which the principal may be spent, but not for activities or programs normally carried on by the government. An example of a permanent fund is a cemetery perpetual-care fund, which provides resources for the ongoing maintenance of a public cemetery.

PROPRIETARY FUNDS

The next type of fund that we will examine is the proprietary fund. There are two types of proprietary funds – enterprise funds and internal service funds. Specific uses for these two types of proprietary funds will also be examined.

The first thing to realize about proprietary funds is that they use a different basis of accounting and measurement focus than the governmental funds than have been discussed in this chapter so far. Proprietary funds use the accrual basis of accounting and the economic resources measurement focus. This means that the balance sheets of proprietary funds will reflect both current and noncurrent assets and liabilities. In other words, capital assets (such as infrastructure, buildings, equipment, etc.) are recorded as assets by the fund. In addition, debt issued related to the activities of the proprietary fund is recorded as a liability on the balance sheet of the proprietary fund. (Keep in mind that the assets and liabilities of the proprietary funds are also included in the assets and liabilities of the government-wide statement of net assets.) In addition to recording noncurrent assets and liabilities, which is basically a result of their measurement focus, proprietary funds also recognize revenues and expense on the accrual basis of accounting, which means that revenues and expenses are recorded in different accounting periods than they would be by governmental funds. Chapter 1 describes the accrual basis of accounting that is used by proprietary funds.

One overly simplified way of viewing the accounting used by proprietary funds is that it is basically the same as that used by commercial enterprises and not-for-profit organizations. However, since commercial enterprises and not-for-profit organizations follow the accounting rules set by the Financial Accounting Standards Board (FASB), does that mean that proprietary funds should also follow those rules? Not exactly. GASB Statement No. 20, “Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting” (GASBS 20), sets the rules in this area and they can be slightly confusing. Statement No. 20 requires that proprietary funds apply all applicable GASB pronouncements, as well as the following pronouncements issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements:

- FASB Statements
- FASB Interpretations
- Accounting Principles Board (APB) Opinions
- Accounting Research Bulletins (ARBs)

Proprietary funds have the option to apply all FASB Statements and Interpretations, APB Opinions, and ARBs issued after November 30, 1989, except for those that conflict with or contradict GASB pronouncements. (The significance of the November 30, 1989 date is that it is the date of SAS 69 which previously set the GAAP hierarchy for governments and nongovernments.) Note that once a proprietary fund elects to apply or not apply these FASB and other pronouncements it must be consistent from year to year. A proprietary fund cannot apply the FASB pronouncements one year and not the next. Nor can a proprietary fund pick and choose the pronouncements that it likes to apply and ignore the others. The election must be applied consistently and uniformly from year to year. The GASB Web site (www.gasb.org) has a useful list of these FASB pronouncements with a brief explanation as to whether they would be applicable to proprietary funds. The list is updated as the FASB issues new pronouncements.

The following sections describe the actual uses of the two types of proprietary funds – enterprise funds and internal service funds.

Enterprise Funds

Enterprise funds are used to account for operations that fall within two basic categories:

1. Activities that are financed and operated in a manner similar to private business enterprises, where the intent of the governing body is to finance or recover costs of providing goods or services to the general public on a continuing basis primarily through user charges
2. Operations 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

Enterprise funds are primarily used to account for activities that are financed through user charges. However, the total cost of the activity does not have to be paid for by the user charges. The government (or other governmental entity) may subsidize a significant portion of the costs of the enterprise fund. Typical activities accounted for in enterprise funds include those that are similar to utilities, such as water and sewer funds and electric utility funds. Parking lots operated by governments are another example of proprietary activities accounted for in a proprietary fund.

Statement No. 34 of the GASB continued the previous practice that an enterprise fund may be used to report any activity for which a fee is charged to external users of goods and services. However, GASBS 34 also specifies three situations where the use of an enterprise fund is required. The criteria are to be applied to the activity's principal revenue sources, meaning that insignificant activities where fees are charged would not automatically require the use of an enterprise fund. An enterprise fund is required to be used if one or more of the following criteria are met:

- The activity is financed with debt that is secured solely by a pledge of the revenues from fees and charges of the activity. Often proprietary funds use revenue bonds to finance their capital activities. The revenue stream from the proprietary activity (such as water and sewer charges received from customers) is pledged to provide for the annual debt service on the revenue bonds. However, if the debt is secured by a pledge of the revenues of the activity and the full faith and credit of the related government or component unit, the debt is not considered to be payable solely from the fees of the activity, even if it is not expected that the primary government or component unit would actually make any payments on the debt. In this case, the criterion is not met and the use of an enterprise fund would not be required.
- Laws or regulations require that the activity's costs of providing services (including capital costs such as depreciation or debt service) be recovered from fees and charges, rather than taxes or similar revenues.
- The pricing policies of the activity establish fees and charges designed to recover its costs, including capital costs such as depreciation or debt service.

Two accounting features of enterprise funds that are important to understanding an enterprise fund's financial statements involving capital contributions and recording defeasances of debt are discussed in the following sections.

Contributed Capital

Because enterprise funds use an accounting and financial reporting model that resembles the commercial accounting and reporting model, the concept of "capital" or how the funds obtain their resources for operations (other than the issuance of debt) must be addressed. The net assets of the proprietary fund (assets less liabilities) are categorized as:

- Invested in capital assets, net of related debt
- Restricted
- Unrestricted

It is important to understand that the proprietary funds define their net assets in different categories.

One of the more significant changes in this area brought about by GASBS 34 is the accounting for capital contributed by a government into the proprietary fund. Previously, these capital contributions were recorded directly as additions to net assets. Statement No. 34 requires that these capital contributions flow through the statement of revenues, expenses, and changes in net assets, where they are reported separately from operating revenues and expenses, but not directly as an addition to net assets. A too-quick read of this statement of a proprietary fund may cause the reader to think that the proprietary activity "made more money" than it actually did because some of the increase in net assets may not be from its proprietary activity, but rather from a capital contribution from the primary government.

Refundings of Debt

The previous section on debt service funds described advance refundings of debt as they impacted the debt service fund and government-wide financial statements as they relate to governmental activities. However, since the debt that is refunded is actually recorded on the financial statements of the proprietary funds, there are some different rules for accounting for these defeasances. The rules are set by GASBS 23, "Accounting and Financial Reporting for Refundings of Debt Reported by Proprietary Activities" (GASBS 23).

This can be a fairly complex accounting area that is beyond the scope of this course. The reader should be aware of one or two simple concepts as to these refundings that will be helpful in understanding a proprietary fund's financial statements. When a government refunds debt in a proprietary fund, it incurs an accounting gain or loss. This gain or loss is calculated as the difference between the carrying amount of the old debt (that is, the amount recorded on the balance sheet) and the reacquisition price (that is, how much the government had to pay or place in escrow to repay the refunded debt). This gain or loss is not recognized immediately in the period that the refunding occurred. Rather, the gain or loss is spread out (or amortized, using the correct accounting term) over the life of the new debt or old debt, whichever is shorter. As the gain or loss is spread out over future years, it is treated as an adjustment of interest expense in each of the future years.

Internal Service Funds

Internal service funds are used to account for the financing of goods or services provided by one department or agency of a governmental unit to other departments or agencies of the same governmental unit on a cost-reimbursement basis. Because internal service funds use the economic resources measurement focus and the accrual basis of accounting, they allow the full cost of providing goods or services to other departments or agencies to be charged to the receiving department or agency.

As the main purpose of internal service funds is to identify and allocate costs of goods or services to other departments, it is generally recommended that governments use separate internal service funds for different activities. Keep in mind, however, the GAAP does not require the use of internal service funds, nor does it require that the internal service fund include the full cost of services that are provided. A government may choose to leave some of the related costs out of the internal service fund, such as a rent charge or a utility charge.

Internal service funds are often used to determine and allocate the costs for a diverse group of activities, such as

- Duplicating and printing services
- Motor pools
- Central garages
- Information processing
- Purchasing
- Central stores and warehousing

Clearly, combining the costs of providing motor pool services with the costs of providing information processing services in the same internal service fund will not result in a very useful basis to allocate costs. Establishing separate funds will result in a more effective cost-allocation process.

While an internal service fund in some cases is used for goods and services provided on a cost-reimbursement basis to quasi-governmental or not-for-profit organization, GAAP requires that if the reporting government itself is not the predominant participant in the activity, the activity should be reported as an enterprise fund. In other words, the "internal" in internal service funds means that the predominant activity of the fund should be internal to the reporting entity.

Many of the transactions between internal service funds and other funds take the form of quasi-external transactions. The funds receiving the goods or services from the internal service fund report an expenditure or an expense, while the internal service fund reports revenue. The consequence of this approach is that there is a duplicate reporting of revenues and expenditures. For example, an internal service fund records an expense to recognize the cost of providing goods or services to another fund. This same expense is then duplicated in the other funds when the funds that received the goods and services are charged for their share of the cost. Elimination entries should be made in the financial statements to remove the "doubling-up" effect of internal service activities.

Internal service funds should be set up so that they break even. The costs that they incur are charged to other funds. There should not be a profit or loss built into the charges to the other fund. Of course, the internal service fund will never exactly break even and small deficits or surpluses in an internal service fund generally does not present a financial reporting problem. However, when an internal service fund has a significant surplus or deficit, the government should adjust the charges made to the other funds in order to more accurately reflect the true costs of the goods or services used by those other funds.

There is an interesting twist for reporting internal service fund asset and liability balances on the government-wide statement of net assets. Any asset or liability balances not eliminated would be reported in the governmental activities column of the statement. While one would expect that internal service fund balances would be reported in the business-type activities column, the rationale for including them in the governmental column is that the activities accounted for in an internal service fund are usually more governmental than business-type in nature. However, if enterprise funds are the predominant or only participant in an internal service fund, the government would report the internal service fund's residual assets and liabilities within the business-type activities column in the statement of net assets.

FIDUCIARY FUNDS

The last major group of funds that need to be examined is the fiduciary funds. Since the fiduciary funds account for "other people's money," their assets, liabilities, revenues, and expenses are not included in the government-wide financial statements. This is certainly different from the assets, liabilities, revenues, and expenditures/expenses of the governmental and proprietary funds, which, after any required adjustment to the accrual basis of accounting and economic resources measurement focus, are reported as part of the government-wide financial statements. You will find fiduciary funds presented as a separate group of funds only within the fund financial statements reported as part of a government's basic financial statements.

There are four types of fiduciary funds, each of which will be briefly described in this section.

1. Pension (and other employee benefit) trust funds
2. Investment trust funds
3. Private-purpose trust funds
4. Agency funds

Pension (and Other Employee Benefit) Trust Funds

Governments almost always offer pension benefits to their employees. The pension plans related to these benefits are reported as pension trust funds in the government's financial statements if either of the following criteria is met:

- The pension plan qualifies as a component unit of the government.
- The pension plan does not qualify as a component unit of the government, but the plan's assets are administered by the government.

Pension (and other employee benefit) trust funds use the accrual basis of accounting and the economic resources measurement focus. A separate pension (and other employee benefit) trust fund should be used for each separate plan. Accounting and financial reporting for pension trust funds is beyond the scope of this course. For now, it is sufficient to understand when these funds are reported as part of a government's fund financial statements and that these funds use the accrual basis of accounting and the economic resources measurement focus.

In addition to pension plans, there may be other types of pension and employee benefit funds that would be reported along with the pension funds described above. For example, governments sometimes have funds that supplement pension benefits that would be reported in this category. In addition, some governments report deferred compensation plans, including those governed by Internal Revenue Code Section 457, as part of the pension (and other employee benefit) trust funds. In practice, many governments find that they do not meet the criteria for including Section 457 deferred compensation within their fiduciary fund financial statements. This results because governments often have little administrative involvement with these plans and do not perform the investing functions for these plans. If governments do administer a Section 457 plan and/or do the investing for the plan, the pension (and other employee benefit) trust fund type of fund is where the plan would be reported.

One other type of pension (and other employee benefit) trust fund that has seen some increase in use is a trust fund set up to accumulate resources to pay for postemployment benefits other than pensions (OPEBs). As governments implemented the requirements of GASB Statement No. 45, "Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions," the magnitude of many governments' liability for these types of benefits (which usually include health-care coverage and other benefits for retirees) became alarmingly clear. The vast majority of governments had not been setting aside resources currently to fund these future obligations, as they typically do for pensions. Accordingly, in some cases, governments began to set aside some resources for these future obligations in OPEB trusts, which would be accounted for as a pension (and other employee benefit) trust fund type.

Investment Trust Funds

A special type of trust fund, the investment trust fund, is used by governments that sponsor external investment pools and that provide individual investment accounts to other legally separate entities that are not part of the same financial reporting entity. For these cases there is GASB Statement No. 31, "Accounting and Financial Reporting for Certain Investments and for External Investment Pools" (GASBS 31), which requires that investment trust funds be established. These rules are described as follows:

- *External portion of external investment pools.* An external investment pool commingles the funds of more than one legally separate entity and invests on the participants' behalf in an investment portfolio; GASBS 31 specifies that the external portion of each pool should be reported as a separate investment trust fund. The external portion of an external investment pool is the portion of the pool that belongs to legally separate entities that are not part of the sponsoring government's financial reporting entity.

- *Individual investment accounts.* Governmental entities that provide individual investment accounts to other legally separate entities that are not part of the same financial reporting entity must report those investments in one or more separate investment funds. In the way that the individual investment accounts function, specific investments that are required for individual entities and the income from and changes in the fair value of those investments affect only the entity for which they were acquired.

In other words, if a government invests funds on behalf of others, these funds should be reported in an investment trust fund. This is regardless of whether the government combines the other entity's money with its own or whether it gives the other entity its own separate account.

Investment trust funds use the accrual basis of accounting and the economic resources measurement focus. A typical example of where an investment trust fund is used is where one level of government, such as a state, pools the investment assets of local governments, and invests those funds on behalf of the local governments.

Private-Purpose Trust Funds

A private-purpose trust fund is a type of fiduciary fund that is used to report all trust arrangements (other than pension and other employee benefit and investment trust funds) under which the principal and income benefit individuals, private organizations, and other governments. Similar to other fiduciary funds, private-purpose trust funds cannot be used to support a government's own programs. It is important, therefore, to make sure that an activity is absent any public purpose of the government before it is accounted for as a private-purpose trust fund, even if individuals, private organizations, or other governments received direct or indirect benefit from the activity. Private-purpose trust funds use the accrual basis of accounting and the economic resources measurement focus.

Agency Funds

Agency funds are used to account for assets held solely in a custodial capacity. As a result, the assets of agency funds are always equal to their liabilities to the owners of the assets. Agency funds typically involve only the receipt, temporary investment, and remittance of assets to their respective owners. Agency funds are often used by school districts to account for student activity funds that are held by the school district but whose assets legally belong to the students. Another common example of agency funds is to account for taxes collected by one government on behalf of other governments. The collecting government has virtually no discretion in how the funds in the agency fund are to be spent. They are simply collected and then remitted to the government on whose behalf they were collected.

There are two instances in GAAP where the use of agency funds is required. First, when a government receives a grant and acts solely as a cash conduit to pass the funds along to others, GASB Statement No. 24, "Accounting and Financial Reporting for Certain Grants and Other Financial Assistance" (GASBS 24), requires that an agency fund be used. However, the use of an agency fund in these instances is infrequent because the government would have to not have any administrative requirements for the grant in order to account for it in an agency fund. In most instances, the government that receives a grant that will be passed through to other entities will have administrative requirements, so that the grant will be accounted for in another fund and revenues and related expenditures will be recorded for the grant activities.

The second instance where an agency fund is required is where a government collects special assessments (described earlier in this chapter) but the government is not obligated in any manner for the debt related to the capital improvements. In this instance, it is merely collecting money and passing it along to the paying agent that will make the principal and interest payments to the holders of the special assessment debt.

Summary

This chapter presents an overview of the various funds that governments use and looks at some of the typical or unique transactions that are accounted for by those funds. It has crammed a lot of information into a (relatively) short space. The reader should have a feel for the complexity of transactions accounted for in funds and be aware of some of the issues that are often required to be addressed in using funds effectively for management purposes, while still accounting for and reporting fund information in accordance with generally accepted accounting principles.

Chapter 2 – Review Questions

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Regarding fund fundamentals, all of the following are true <u>except</u>:

   a) a fund is a “self-balancing” set of accounts
   b) the number of funds established is based on both legal requirements and management’s judgment
   c) moderate-size governments can have hundreds of funds
   d) all governmental entities must use fund accounting

2. This governmental fund is used to report resources that are legally restricted to the extent that only the earnings may be used for purposes that support the government’s programs:

   a) temporary funds
   b) permanent funds
   c) enterprise funds
   d) internal service funds

3. All of the following about internal service funds are true <u>except</u>:

   a) GAAP requires the use of internal service funds
   b) these funds can create a “doubling-up” effect of internal service activities
   c) the main purpose is to identify and allocate costs to other departments
   d) the transactions between an internal service fund and other funds take the form of quasi-external transactions

4. This type of fiduciary fund is used to report all trust arrangements under which the principal and income benefit individuals, private organizations, and other governments:

   a) pension trust fund
   b) investment trust fund
   c) private-purpose trust fund
   d) agency fund

Chapter 2 – Solutions and Suggested Responses

1. A: Incorrect. A fund is a separate accounting and financial reporting entity with a self-balancing set of accounts. “Self-balancing” means that a fund’s assets will equal the total of its liabilities and its fund balance.

   B: Incorrect. Where statute or law requires particular funds, the government certainly will establish funds. But the government will also establish funds if management judges it useful to separate the activities and clarify funding.

   C: Incorrect. There is a wide disparity among governments as to the number of funds established. Some moderate-size governments have literally hundreds of funds, and other larger governments might have only a few funds.

   D: Correct. Most “governmental entities” that are not general-purpose governments do not use fund accounting.

   (See pages 2-1 to 2-2 of the course material.)

2. A: Incorrect. This term does not exist in the context of this course.

   B: Correct. Another way to phrase this definition is that permanent funds apply to programs that are for the benefit of the government or its citizens. These funds operate in a manner similar to endowments, where the investment earnings, and not the principal, can be spent. But the earnings of a permanent fund can only be applied to the government’s activities.

   C: Incorrect. Enterprise funds are primarily used to account for activities that are financed through user charges.

   D: Incorrect. Internal service funds are used to account for the financing of goods or services provided by one department or agency of a governmental unit to other departments or agencies of the same unit on a cost-reimbursement basis.

   (See page 2-13 of the course material.)

3. **A: Correct.** GAAP <u>does not</u> require the use of internal service funds. GAAP does require that if the reporting government itself is not the predominant participant in the activity, the activity should be reported as an enterprise fund.

   B: Incorrect. Internal service funds do create a duplicate reporting of revenues and expenditures. To resolve this, elimination entries should be made to remove the “doubling-up” effect of internal service activities.

   C: Incorrect. As the main purpose of internal service funds is to identify and allocate costs of goods or services to other departments, it is generally recommended that governments use separate internal service funds for different activities.

   D: Incorrect. The funds receiving the goods or services from the internal service fund report an expenditure or an expense, while the internal service fund reports revenue. The consequence of this approach is that there is a duplicate reporting of revenues and expenditures.

   (See page 2-17 of the course material.)

4. A: Incorrect. Pension trust funds are a means to report the pension benefits offered to the employees of their government employers.

   B: Incorrect. This special type of trust fund is used by governments that sponsor external investment pools and that provide individual investment accounts to other legally separate entities that are not part of the same financial reporting entity.

   C: Correct. A private-purpose trust fund is a type of fiduciary fund that is used to report all trust arrangements other than pension and other employee benefit and investment trust funds under which the principal and income benefit individuals, private organizations, and other governments. They cannot be used to support a government's own programs. Therefore, activities must be absent any public purpose of the government before they are accounted for in this type of fund.

   D: Incorrect. Agency funds are used to account for assets held solely in a custodial capacity.

   (See pages 2-20 of the course material.)

Glossary

Accrual basis – A method of accounting that recognizes revenues when earned and expenses when incurred, regardless of when cash is received or paid.

Cash equivalent – Investments that are so close to being realized as cash that they are viewed essentially as the equivalent of cash. As interpreted by GASBS 9, for an investment to be considered a cash equivalent, it must mature within three months of being bought by the organization.

Contra account – A type of account that is found on the financial statements as an offsetting account. The contra account to equipment on the financial statements would be the accumulated depreciation account of that equipment.

Fiduciary fund – A trust or agency fund used to account for assets held by a government as a trustee or agent for individuals, private organizations, other governments, or other funds.

Fund financial statements – Part of the basic financial statements required by GASBS 34, the other part being the government-wide financial statements. Three sets of fund financial statements report, respectively, on governmental, proprietary, and fiduciary funds and also include blended component units and fiduciary component units, if any. Governmental fund statements are on a modified accrual basis; proprietary and fiduciary fund statements are on a full accrual basis.

General fund – A fund used to account for unrestricted resources. This is the chief operating fund of a government.

Government-wide financial statements – Part of the basic financial statements required by GASBS 34, the other part being the fund financial statements. Government-wide statements report on a government's governmental and business-type activities (including its discretely presented governmental and business-type component units, if any), without subdividing the information into funds. Government-wide statements are on a full accrual basis.

Governmental funds – A category of funds used to account for the acquisition, use, and balances of expendable financial resources and the related current liabilities, except those accounted for in proprietary funds and fiduciary funds; the five governmental fund types are general, special revenue, debt service, capital projects, and permanent funds.

Modified accrual basis – The accrual basis of accounting adapted to the measurement focus of governmental funds on current financial resources. Revenues are recognized in the period in which they become available and measurable. Most expenditures are recognized on an accrual basis, but some are on a cash basis.

Proprietary fund – An income-determination fund used to account for a government's business-type activities (enterprise funds) and its internal services provided on a cost reimbursement basis (internal service funds); both fund types use the full accrual basis of accounting.

Index