Chapter One
Introduction to Accounting and Financial Reporting for Governmental and Not-for-Profit Entities

Topics to Be Discussed:

- Government and Non-Profit Entities
- Similarities and Differences Between Governmental and Other NFP Entities
- Criteria for Determining NFP as Governmental Entity
- Major types of governmental and not-for-profit entities
- Similarities and Differences G & NFP Entities and Business Entities
- Objectives of financial reporting for G and NFP Entities
- Sources of Accounting and Financial Reporting Standards for G & NFP entities
- Financial Reporting for State and Local Government
- Comparisons of GASB Standard No. 34 Reporting Model with the Old Reporting Model

Learning Objectives:

After studying this chapter, you should be able to:

- Identify and explain the characteristics that distinguish governmental and not-for-profit entities from for-profit entities.
- Identify the authoritative bodies responsible for setting GAAP and financial reporting standards for all governmental and not-for-profit entities.
- Contrast and compare the objectives of financial reporting for SLG, the federal government, and not-for-profit organizations.
- Explain how management's discussion and analysis (MD&A), basic financial statements, and required supplementary information (RSI) of SLG relate to their comprehensive annual financial reports.
- Explain the different objectives, measurement focus, and basis of accounting of the government-wide financial statements and fund financial statements of SLG.

1.1) Government and Non-for-Profit Entities

Entities or organizations that are established with operating purpose other than profit making include:

- Governmental Entities (Government)
- Nonprofit (NP) Entities

What is a Government?

A government is a body that has the power to make and the authority to enforce rules and laws within a civil, corporate, religious, academic, or other organization or group. For the purpose the course Government and NFP Accounting, Government can also be defined as an entity that provides such major services as administrative, social, economic, and others either free from charge or with a "token" charge.

A government is an organized entity which, in addition to having governmental character, has sufficient discretion in the management of its own affairs to distinguish it as separate from the administrative structure of any other governmental unit. To be regarded as a government, an entity must possess all three of these critical attributes: ***existence as an organized entity****,* ***governmental character****, and* ***substantial autonomy****. Each is explained below.*

1. **Existence as an Organized Entity** - Evidence of this attribute is provided by the presence of some form of organization and the possession of some corporate powers, such as perpetual succession, the right to sue and be sued, have a name, make contracts, acquire and dispose of property, and the

like. Designation of a class of governments in law as "municipal corporations," "public corporations," "bodies corporate and public," and the like indicates that such units are organized entities.

2. Governmental Character - this characteristic is indicated where officers of the entity are popularly elected or are appointed by public officials. A high degree of responsibility to the public demonstrated by requirements for public reporting or for accessibility of records to public inspection, is also taken as critical evidence of governmental character. Governmental character is attributed to any entities having power to levy property taxes, power to issue debt paying interest exempt from Federal taxation, or responsibility for performing a function commonly regarded as governmental in nature. An entity can also be recognized as having governmental character if it meets the indicated requirements as to officers or public accountability. Thus, some districts or zonal governments with no taxing powers are recognized as local governments because of provisions as to their administration and public accountability.

3. Substantial Autonomy - this requirement is met where, subject to statutory limitations and any supervision of local governments by the state, an entity has considerable fiscal and administrative independence. Fiscal independence generally derives from power of the entity to determine its budget without review and detailed modification by other local officials or governments, to determine taxes to be levied for its support, to fix and collect charges for its services, or to issue debt without review by another local government.

Some government agencies having considerable fiscal autonomy are classified as dependent agencies of another government rather than as governments because of one or more of the following characteristics:

- Control of the agency by a board composed wholly or mainly of parent government officials.
- Control by the agency over facilities that supplement, serve, or take the place of facilities ordinarily provided by the creating government.
- Provision that agency properties and responsibilities revert to the creating government after agency debt has been repaid.
- Requirements for approval of agency plans by the creating government.
- Legislative or executive specification by the parent government as to the location and type of facilities the agency is to construct and maintain.
- Dependence of an agency for all or a substantial part of its revenues on appropriations or allocations made at the discretion of another state or local government.
- Provision for the review and the detailed modification of agency budgets by another local government.

For **Example:** National Bank of Ethiopia is not a government

Example of Governments in Ethiopia:

- Federal government of Ethiopia and its agencies
- The Nine Regional State Governments and Two Administrative City councils
- 76 Zonal Level Local Governments
- 587 District Level Local Governments
- Municipality and Town Governments
- Kebele level local governments i.e. Kebele is the lower level government in Ethiopia

Government is classified as **Special Purpose Government** and **General Purpose Governments**. The Special Purpose Government is a government that provides a single service or few services to the citizenry. For Example: Transportation authorities can be taken as Special Purpose Government Entity. The General purpose government provides a wide collection of services to the citizenry. **Examples:** Federal government, state governments, zone government, cities, towns, villages, etc

What is Not-for-profit (NFP) Entity?

NFP Entities are entities other than the government and that provides community services either free from charge or with a "token" charge. The following are the essentials to classify an entity as a not-for-profit:

- Legally separate organizations
- Its operating purpose is other than to provide goods or services at a profit.
- It may not distribute surpluses
- Generating profit is not an objective outlined in its legislation, regulations or constitution
- It does not pay income tax or income tax equivalents – usually exempt from federal, state, and local taxation
- It is not able to transfer ownership

Nonprofit entities are classified into two: governmental and non-governmental

Examples: Religious entities, community service providers, private educational and health care entities, museums, and fraternal and social organizations, etc

In Ethiopia, there are about 660 Nongovernmental NFP entities registered by Ministry of Justice as 2006. Examples:

- Save the Children UK and Canada
- Family Guidance Association of Ethiopia
- Dawn of Hope Ethiopia
- Menschen for Menschen
- Rift Valley Children and Women Development Fund
- National Museum

Major Types of Governmental and Nonprofit Entities

- General Government – includes federal, state, county, city, town, village, special districts
- Educational – includes kindergartens, primary and secondary schools, vocational & technical schools, colleges, and universities
- Health and Welfare – Hospitals, Orphanages, the Red Cross and Red Crescent, etc
- Religious – churches, mosques, missions
- Charitable – includes many NGOs
- Foundations - private organizations that promote research and development for improvement of human life.

1.2) Similarities & Differences: Governmental and NFP Entities

Similarities

- Luck of competitive market place .Governmental and NFP entities operate in an environment which is difficult to set the quality and quantity of service or product
- Use of fund accounting as a control device both classes of organization are organized and operated on fund basis
- Significant investment in non-revenue producing activities

Differences

Government differs from NFP entities in the following manners:

- Public corporations and bodies which are politic
- Power ultimately rests in the hands of the people – public officials are accountable to the general public and the legislative, judicial, and executive bodies will have an impact on their operation
- People can vote and delegate that power to public officials
- Government is created by and accountable to a higher level government
- Government has the power to tax citizens for revenue – taxpayers are the providers of resources but the contribution may not be voluntary and the tax payers have little say in deciding how to use the resources.
- The budget is an expression of public policy and method of providing control.

- The nature of the political process has a significant influence on their operation
- They may have monopoly power on some its services

Criteria for Determining NFP Entity as Government

An entity is said to be a government if one of the following conditions are met:

- Public corporations and bodies politic
- Popular election of officers, or appointment of a controlling majority of the governing body by officials of another government
- Potential dissolution by a government with net assets reverting to a government
- Power to enact and enforce a tax levy

Other NFP Organization differs from government with respect to the following points:

- They are accountable to the resource providers (donors)
- The budget is an expression of the interest of the benefactors.
- The nature of the political system may not influence their operation
- The resource providers are donors, or volunteers and the contribution is mostly voluntary

GASB further distinguishes governmental entities from not-for-profit entities and from NFP entity by stressing that governments exist in an environment in which the power ultimately rests in the hands of the people. Voters delegate that power to public officials through the election process; the power is divided among the executive, legislative, and judicial branches of the government so that the actions, financial and otherwise, of governmental executives are constrained by legislative actions; and executive and legislative actions are subject to judicial review. Further constraints are imposed on state and local governments by the existence of the federal system in which higher levels of government encourage or dictate activities of the lower levels and finance the activities.

1.3) Similarities and Differences: Business Entities and G & NFP Entities

Similarities G and NFP Entities to Business Entities

- Both are integral part of an economic system
- Both acquire resources to provide goods or services
- Both use financial management processes
- Both need financial information systems
- Both undergoes cost analyses, control and evaluation techniques
- Both may provide similar services – e.g. transportation systems; sanitation services; utilities, stadiums, arenas, etc

Differences between Businesses and G&NFP Entities

- Organizational objectives
- Operational focus
- Sources of Financial Resources
- Accounting and Financial Reporting
- Evaluation of Performance and Operating Results
- Regulation and Control
- Other Distinguishing Characteristics

Nature of Differences	**Business Entities**	**G & NFP Entities**
1. Organizational Objectives	Want to maximize income from revenues and other sources.	Absence of profit motive; Most are tax exempt; Want to maximize community services; They provide services as resources permit

2. Operational Focus	† They focus on short-term and also look to long-term	† They focus on short-term, annual budget, and the current year is of primary importance
3. Sources of Financial Resources	† They raise resources from sales, debt transactions, and capital stock. † The resources form different sources are accounted for differently. † Benefits are proportional to resources provided	† They raise resources from grants, shared revenues, and members' contribution. Taxation is unique source of revenue to government. † No distinction made in sources of financial resources. Owner investment and sales are insignificant or non-existent
4. Accounting and Financial Reporting	† Accounting and reporting focuses on net income	† Accounting & reporting focus on budgets and appropriations and funds and fund accounting, etc † Dual basis of accounting & reporting
5. Evaluation of Performance & Operating Results	† Evaluation focuses on measurement net income. † Businesses are able to modify or withdraw unprofitable goods and services from market places	† Profit not a motive and frequently cannot be measured † Not able to modify or withdraw some unprofitable goods and services from the marketplace. Services not found elsewhere so there is no competition
6. Regulation and Control	† They are regulated and controlled by the presence of demand & supply mechanisms and profit devices	† They face rules and regulations not found in private sector. Statutory, fund and budgetary controls are used. † Regulated by federal, state, & local laws; grant regulations; judicial decisions; charter, by-laws, & ordinances; contractual obligations; trust /donor agreements; organization structure - elected governance, line of authority; personnel policies and procedures
7. Other Distinguishing Characteristics	† Perfect competition † Open market for goods and services † All the services are provided at arm's length prices † Use of matching concept † Use of going concept † Use of periodicity concept † Ownership rights are transferrable from one owner to the other † Policy setting that maximizes wealth and profit of the owners.	† Monopolistic services † No open market for goods and services † User charges based on cost or without profit † Matching is a concept used only in business-type activities † Going Concern is only for business-type activities † Periodicity refers to flow of annual financial resources † Absence of transferable ownership rights † Consensus policy-setting by elected or appointed oversight body

1.4) Objectives of Financial Reporting for G&NFP Entities

1. Objectives of Financial Reporting For State and Local Governments (SLGs)

Governmental financial reporting objectives are influenced by the characteristics of the state and local governmental operating environment and by the needs of those who use governmental financial

reports. GASB Concept Statement No. 1 set forth the following three financial reporting (FR) objectives:

A) Financial Reporting should assist users is assessing **accountability** by:

- Providing information to determine whether current-year revenues are sufficient to pay for current-year services **(Interperiod Equity)**
- Demonstrating whether resources are obtained and used in accordance with the entity's legally adopted budget, and demonstrating compliance with other finance-related legal or contractual requirements
- Providing information to assist users in assessing the service efforts, costs, and accomplishments of the governmental entity

ACCOUNTABILITY is the cornerstone of all financial reporting in government **(GASB Concepts Statement No.1, Par. 56)**. Accountability arises from the citizens' "right to know." It imposes a duty on public officials to be accountable to citizens for raising public monies and how they are spent. Interperiod equity relates to accountability. Government officials are accountable and have an obligation to disclose whether current-year revenues were sufficient to pay for current-year benefits or not. If interperiod equity is not achieved, the current citizens are deferring payments to future taxpayers.

B) Financial Reporting should assist users in **evaluating the operating results** of the governmental entity for the year by:

- Providing information about sources and uses of financial resources
- Providing information about how it financed its activities and met its cash requirements
- Providing information necessary to determine whether its financial position improved or deteriorated as a result of the year's operations

C) Financial Reporting should assist users in assessing the **level of services** that can be provided by the governmental entity and its ability to meet its obligations as they become due by:

- Providing information about its financial position and condition
- Providing information about its physical and other non-financial resources having useful lives that extend beyond the current year, including information that can be used to assess the service potential of those resources
- Disclosing legal or contractual restrictions on resources and the risk of potential loss of resources.

In general, financial reports are used in SLGs primarily to:

- Compare actual financial results with legally adopted budget
- Assess financial condition and results of operations
- Assist in determining compliance with finance-related laws, rules, and regulations
- Assist in evaluating efficiency and effectiveness

2. Objectives Of Financial Reporting For Federal Government

Accountability is also the foundation of Federal Government financial reporting. In addition to accountability, Federal Accounting Standards Advisory Board (FASAB**)** identifies the following financial reporting objectives for Federal Government and its agencies:

- FR should assist users in evaluating budgetary integrity
- FR should assist users in evaluating Operating Performance
- FR should assist users in evaluating Stewardship
- FR should assist users in evaluating adequacy of systems and control

The users of financial report include citizenry, legislative and oversight bodies, and investors and creditors

3. Objectives of Financial Reporting for NFP Entities

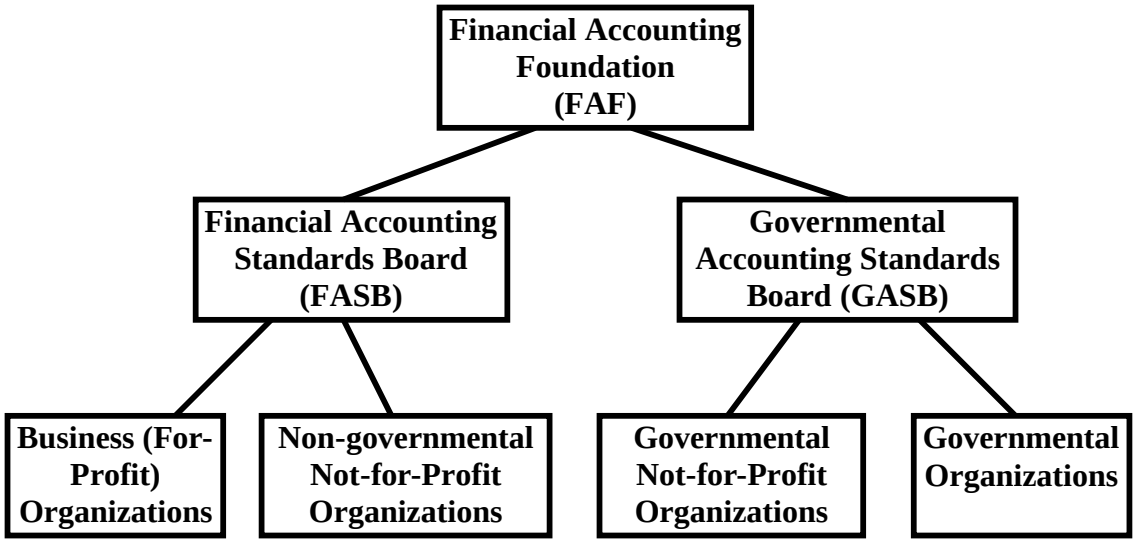
NFP financial reporting should provide information useful in:

- Making resource allocation decisions
- Assessing services and ability to provide services

- Assessing management stewardship and performance
- Assessing economic resources, obligations, net resources, and changes in them

1.5) Sources of Accounting and FR Standards for G & NFP Entities

The FASB establishes accounting and financial reporting standards for business (For-Profit) organizations; the GASB establishes standards for governmental organizations. Authority to establish accounting principles (accounting and financial reporting standards) for not-for-profit organizations is split between the GASB and the FASB because a sizable number of not-for-profit organizations (particularly colleges and universities, and hospitals) are governmentally related, but many others are essential to understanding the unique accounting and financial reporting principles that have evolved for governmental and not-for-profit organizations.

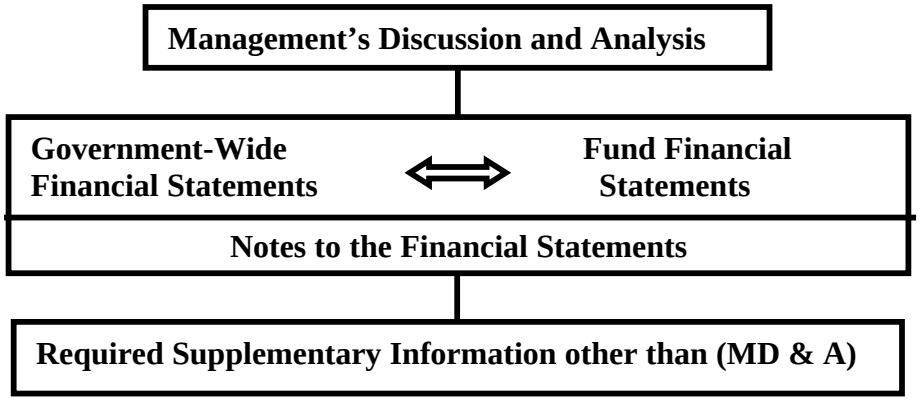


Sources of Accounting and Financial Reporting Standards for G&NFP Organization

1.6) Financial Reporting for State and Local Government

1. Minimum External Financial Reporting

The minimum requirements for general purpose external financial statements under the governmental financial reporting model specified by GASB Statement No. 34 include Management's Discussion and Analysis (MD& A); Basic Financial Statements (Government Wide Financial Statements, Fund Financial Statements, and Notes to Financial Statements), and Required Supplementary Information (RSI) other than MD& A as shown in the illustration below. Central to the minimum requirement of the new reporting model is the **MD & A**. The MD&A is required supplementary information (RSI) designed to communicate in narrative, easily readable form the purpose of the basic financial statements and the government's current financial position and results of financial activities compared with those prior year. GASB Statement No. 34 prescribes two categories of basic financial statements, government-wide financial statements and fund financial statements:



Government-Wide Financial Statements are intended to provide a highly aggregated overview of a government's net assets and results of financial activities. The government-wide financial statements report on the government as a whole and assist in assessing operational accountability – whether the government has used its resources efficiently and effectively in meeting operating objectives.

Fund Financial Statements — the other category of basic financial statements prescribed by the new reporting model, assist in assessing fiscal accountability – with budget plans and in compliance with pertinent laws and regulations.

2. Comprehensive Annual Financial Report (CAFR)

General purpose financial reporting includes not financial statements but also all other means of communicating information that relate directly or indirectly to the information provided by the accounting system. In addition to the minimum financial information, GASB Standards state: "Every governmental entity should publish, as a matter of public record, a comprehensive annual financial report (CAFR). A CAFR includes introductory section, financial section, and statistical section

A) CAFR: Introductory Section

Introductory section includes such items as

- Title page
- Contents page
- Letter of transmittal – a letter from the chief finance officer addressed to the chief executive and governing body of the governmental unit or it may be a narrative over the signature of the chief executive. The letter or narrative material should cite legal and policy requirements for the report
- Other (as desired by management)

B) CAFR: Financial Section (GASB Statement No. 34)

The financial section of a CAFR should include:

- Auditor's report
- MD & A
- Basic Financial Statements
  - **Government-Wide Financial Statements**
    1. Statement of Net Assets
    2. Statement of Activities
  - **Fund Financial Statements**

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

    Proprietary Funds
    1. Statement of Net Assets

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

Fiduciary Funds

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

- **Notes to the Financial Statements**

- Required Supplementary Information (RSI) other than MD&A
- Combining and individual fund statements and schedules

C) CAFR: Statistical Section

A CAFR should contain a statistical section. The statistical section typically presents tables and charts showing and charts showing social and economic data, financial trends and the fiscal capacity of the government in detail needed by readers who are more than casually interested in the activities of the government unit.

1.7) Comparisons of the New and the Old Reporting Model

Comparisons of the GASB Statement No. 34 Reporting Model (The New Reporting Model) and the Old Reporting Model have similarities and differences.

Similarities:

- Fund financial statements are the same
- The reporting entities are the same

Differences:

- No MD&A is required under the Old Reporting Model
- Only Fund Financial Statements were required; government-wide financial statements were not required under the Old Reporting Model
- The required financial statements that constitute minimum GAAP under the Old Reporting model are referred to as General Purpose Financial Statements.
- A budget and actual comparison statement is required under the Old Reporting Model for all governmental funds for which a budget was adopted. This comparison can be reported as part of RSI under the New Reporting Model
- As no government-wide financial statements are required under the Old Reporting Model, thus that model provides for two account groups, a General Fixed Assets Account Group (GFAAG) to record fixed assets acquired from governmental fund resources and a General Long-Term Debt Account Group (GLTDAG) to record long-term liabilities arising from activities of governmental funds. GFAAG and GLTDAG are not needed under the New Reporting Model

Accounting and reporting for governmental and not-for-profit entities differ from those of for-profit entities because each type of entity has different purposes and reporting objectives. "Even when developed to the ultimate stage of perfection, governmental accounting cannot become a guaranty of good government. At best, it can never be more than a valuable tool for promotion of sound financial management..." *Professor R. M. Mikesell, 1951*

Chapter Two
Principles of Accounting and Financial Reporting for State and Local Governments (SLGs)

Topics to Be Discussed:

- Activities of Government
- GASB Statement of Principles of Accounting and Financial Reporting (FR) for SLGs
- Governmental Reporting Entity
- Common Accounting Characteristics of Fund Types

Learning Objectives:

After studying this chapter, you should be able to:

- Explain the nature of the three major activity categories of a state or local government: governmental activities, business-type activities, and fiduciary activities
- Discuss the basic accounting and Financial reporting principles for SLGs
- Explain the components of GASB's integrated accounting and financial reporting model, including the reporting entity, government-wide financial statements, and fund financial statements
- Define fund and principles of fund accounting
- Types of funds in each fund category and characteristics of each fund type

2.1) Activities of Government

There are three major activity categories of a state and local governments – **Governmental Activities**, **Business-Type Activities**, and **Fiduciary Activities**.

1. Governmental Activities

As per GASB Concepts Statements No.1, government provides certain core services called General Activities. General Activities provided by most general purpose governments are related to:

- Protection of life and property, police and fire protection,
- Public works (streets and highways, bridges, and public building),
- Parks and recreation facilities and programs,
- Cultural and social services

Governments also incur costs for general administrative support such as data processing, finance, and personnel. Core governmental services, together with general administrative support, comprise the major part of governmental type activities or simply Governmental Activities

2. Business-type Activities

Governments also engage in business type activities. These include:

- Public utilities (electric, water, gas and sewer utilities)
- Transportation system;
- Toll roads and toll brides;
- Airports;
- Hospitals;
- Parking garages and lots;
- Liquor stores;
- Swimming pools;
- Stadiums and arenas

Many of these activities are intended to be self supporting by charging users for the services they receive. Operating subsidies from general revenues are not uncommon, particularly for transportation systems.

3. Fiduciary Activities

Governments often act in a fiduciary capacity, either as an agent or trustee, for parties outside the government. A government may serve as agent for other governments in the administering and collecting of taxes. Governments serve also as trustees for amounts placed in trust from private citizens for parks and other purposes, for **escheat propertie**s that revert to the government when there are no legal claimants or heirs to a deceased individual's estate, and for assets being held for employee pension plans.

Accounting and financial reporting principles for the **Governmental Activi**ties have evolved to meet the legal budgetary and financial compliance needs of government – **Fiscal Accountability**. Generally, these principles involve segregating the accounting for the receipt and expenditures of *restricted use resources* from *general use resources*. It emphasizes on reporting the inflows and outflows of current financial resources (cash or items expected to be converted into cash during the current period, or soon enough there after to pay current period liabilities).

Accounting and financial reporting principles for the **Business-Type Activities** of governments are quite similar to those for commercial business entities. As in business, if government intends to charge users for goods or services they receive; it needs to know the full cost of goods and services in order to determine appropriate prices. Knowing the full cost is also essential in deciding whether the government should continue to produce or provide particular goods or services, or contract for them with an out side vendor. Thus, as in commercial business accounting, accrual accounting is essential to measuring the full cost of providing governmental business-type services, and reporting on the extent to which each business type activity is self-sufficient or has to be subsidized. The principles of accounting for business type's activities are intended to measure and report on **Operational Accountability**.

Accounting and reporting for the **Fiduciary Activities** of the government use principles similar to those of business type activities. Certain fiduciary activities, those related to defined benefit pension plans and similar post-employment health care plans use unique recognition standards prescribed by GASB.

GASB Statements No. 34 reporting standards reflect the GASB's view that users such as citizens, legislative and oversight bodies and investors and creditors have diverse information needs. In particular, users want and need information about the medium to long term financial performance of government as well as information about short term financial compliance with budget and finance related laws and regulations. To achieve operational accountability reporting for the government as a whole, Statement No 34 requires highly aggregated financial statements (called **Government-Wide Financial Statements**) that report both **Governmental Activities** and **Business-Type Activities** on the accrual basis (the accounting basis used by business organizations), in addition to the traditional disaggregated financial statements (called fund financial statements).

2.2) GASB Statement of Principles of Accounting and FR for SLGs

At its inception in 1984, the GASB adopted 12 accounting and financial reporting principles for state and local governments that had been established by its predecessor standards-setting body. The standards prescribed by GASB Statement No. 34 retain, with certain modifications, the original principles. A separate principle has been articulated for long-term liabilities, bringing the total now to 13 principles as follows:

1. Principle of Accounting and Reporting Capabilities
2. Principle of Fund Accounting Systems
3. Principle of Types of Funds
4. Principle of Number of Funds
5. Principle of Reporting Capital Assets
6. Principle of Valuation of Capital Assets
7. Principle of Depreciation of Capital Assets
8. Principle of Reporting Long-Term Liabilities
9. Principle of Measurement Focus and Basis of Accounting
10. Principle of Budgeting, Budgetary Control, and Budgetary Reporting
11. Principle of Transfer, Revenue, Expenditure, and Expense Account Classification
12. Principle of Common Terminology and Classification
13. Principle of Annual Financial Reports

Each of the above principle is explained in subsequent sections.

Principle No. 1: Accounting and Reporting Capabilities

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

Adherence to GAAPs is essential to ensuring a reasonable degree of comparability among the general purpose financial reports of state and local governmental units.
In some cases, however, laws require the state government and the local governments within the state to follow practices (such as cash basis of accounting) not consistent with GAAP. In those cases, financial statements and reports prepared in compliance with state law are considered "Special reports" or "Supplementary schedules" and are not the basic financial statements. Thus, Governmental units may prepare two sets of financial statements: (a) one set in compliance with GAAP (General purpose financial statements) and (b) one set in compliance with legal requirements (Special Reports).

Principle No. 2: Fund Accounting Systems

Governmental accounting systems should be organized and operated on a fund basis. A **Fund** is defined as a **fiscal** and **accounting entity** with a self-balancing set of accounts reporting 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.

Conceptually, a fund is an entity with its own set of books and statements (i.e., chart of accounts, general journal, general ledger, trial balances, and financial statements).
The term fund, as it is used in commercial accounting refers to (a) segregation of cash for special purpose (e.g. petty cash fund and change fund); (b) the amount of cash and marketable securities segregated to pay long-term obligations (e.g. sinking fund); and (c) working capital (cash and marketable security)

In accounting for governmental activities, the term **Fund** refers to **fiscal** and **accounting** entity that is used to account for resources that are segregated for achieving certain objectives. **Fiscal Entity** refers to any entity that is concerned with some assets set a side for a specific purpose, and **Accounting Entity** refers to anything that uses a double entry accounting entity to balance the resources with claims to resources.

Justification for using fund and fund accounting

- To control and segregate resources that are externally restricted and internally (managerially) designated. Externally restricted resources and internally designated resources have accountability obligation

- To ensure and demonstrate compliance with legal and administrative requirements

Principle No. 3: Types of Funds

State and local governments, both general purpose and special purpose, should use 11 fund types as needed. These fund types are organized into three categories; governmental funds, proprietary funds, and fiduciary funds. Principle No. 3 discusses these fund types. However, funds should be used by state and local governments to the extent that they have activities that meet the criteria for using those funds.

A) Governmental Funds: - account for activities of a government that are carried out primarily to provide services to citizens and that are financed primarily through taxes. Governmental Funds are classified into five: General Fund, special revenue funds, capital projects funds, debt service funds, permanent funds, which are discussed as follows:

1. **The General Fund (GF) –** account for all financial resources except those required to be accounted for in another fund. It is used to account for resources required to provide most of the basic services provided by the governmental unit such as public safety, public works, education, etc. Only one GF is used per government and most financial transactions related to general government operating activities are recorded in the GF.
2. **Special Revenue Funds (SRFs)** – to account for proceeds from specific revenue sources (other than private purpose trusts or major capital projects) that are legally restricted to use for specified purposes. The purpose of special revenue fund is to demonstrate that all revenues from that source are used for the special purpose only. **SRFs** are used when required by law or by policy to account for financial resources earmarked for a specified operating purpose. If for example, a government earmarked 25% of current year revenue from value added tax for draught affected people, special revenue fund may be established to account for this revenue.
3. **Capital Project Funds (CPFs) –** accounts for financial resources to be used for the acquisition or construction of major capital project facilities (other than those financed by proprietary funds or fiduciary funds). They are used to account for financial resources segregated to pay for construction or acquisition of long-lived capital assets such as the construction of bridge, buildings, road, dams, railway, hydroelectric power etc.
4. **Debt Service Funds (DSFs) –** are used to account for the accumulation of resources for, and the payment of, general long-term debt principal and interest. Debt service funds does not account for a government's long-term debt. Rather, it monitors the financial resources currently available to satisfy long-term liabilities and also records the eventual payments.
5. **Permanent Funds (PFs) –** to account for legally restricted resources provided by trust in which the earnings but not the principal may be used for purposes that support the primary government's programs (those that benefit the government or its citizenry) (Note: similar permanent trusts that benefit private individuals, organizations, or other governments that is, private purpose trust funds are classified as fiduciary funds).

B) Proprietary Funds – account for a government's ongoing organizations and activities that are similar to those operated by for- profit organizations. This fund type normally encompasses operations where a user charge is assessed so that determining operating income or cost-recovery is important. For example: a Toll Road would be reported within the proprietary funds. Two types of funds used by state and local governments are classified as proprietary funds.

6. **Enterprise Funds (EFs) –** to account for operations (a) that are financed and operated in a manner similar to private business enterprises–where the intent of the governing body is that the costs (expenses, including depreciation) of providing goods or services to the general public on a continuing basis be financed or recovered primarily through user changes; or (b) where the governing body have 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.
   - They are used when resources are provided primarily through the use of sales and service charges to parties external to the government.

- † Accrual basis of accounting is used to account for operations of enterprise funds. Examples of activities that can be accounted through enterprise funds include water and other utilities, airports, swimming pools and transit systems.

According to GASB, a particular activity is accounted through enterprise fund if it meets any one of the following criteria:

- † Net revenues generated by the activity provide the sole security for the debts of the security
- † Laws or regulations require the activity's costs to be recovered through fees or charges
- † Fees and charges are set at prices intended to recover costs including depreciation and debt service.

7. **Internal Service Funds (ISFs) –** to account for the financing of goods or services provided by one department or agency to other departments or agencies of the governmental unit, or to other governmental units, on a cost reimbursement basis.
   - † Accrual basis of accounting is used for internal service funds.
   - † Like, enterprise funds, fees are charged but the service is performed for the primary benefit of the government rather than for outside users.

Examples of activities that can be accounted through enterprises funds include:

- † Central data processing facility (information services fund)
- † Centralized vehicle maintenance or Garage facility (Fleet services fund)
- † Photo Copy service activities (copy service fund)
- † Providing several type of insurance programs (Insurance revolving fund)
- † Centralized supply stores (Warehouse revolving fund).
- † Central Printing Shop

ISFs are usually reported as governmental activities in the government-wide financial statements because they primarily serve departments financed by governmental funds.

C) **Fiduciary Funds –** these are trust and agency funds that are used to account for assets held by a governmental unit in a trustee capacity or as an agent for individuals, private organizations, and other governmental unit. For these funds the government is acting as a collecting/disbursing agent or as a trustee. These include:

8. **Agency Funds**- are used to account for situations in which the government is acting as a collecting/disbursing agent. An example would be a State tax agency fund, where the State collects property taxes for other taxing unit, such as Federal Government. The accounting is simple: assets = liabilities and no revenue and expense accounts used since there are no net assets
9. **Pension (and Other Employee Benefit) Trusts Funds-** are used to account for pension and employee benefit funds for which the governmental unit is the trustee.
10. **Investment Trust Funds –** account for external investment pools in which the assets are held for other (external) governments, along with funds of the sponsoring government. Assets, liabilities, net assets, and changes in net assets related to the equity of the external participants are reported in this fiduciary fund.
11. **Private Purpose Trust Funds-** report all other trust arrangements under which principal and income benefit individuals, private organization or other governments.

These fund types (Governmental, proprietary and fiduciary) correspond to the types of activities in which governments engage: Governmental funds are used to account for governmental activities, proprietary funds are used to account for business- type activities, and fiduciary funds are used to account for fiduciary activities. Both the definition of fund and the description of each governmental fund types emphasize the segregation of accounting for restricted current financial resources to facilitate reporting on fiscal accountability. Creating a self-balancing set of accounts (fund) for each business type activity permits those activities to be accounted for using accounting principles similar to those of commercial business rather than using the principles for governmental funds. Accounting for fiduciary funds follows the principles of accounting for business type activities.

Principle No. 4: Number of Funds

Governmental units should establish and maintain those funds required by law and sound financial administration. Only the minimum number of funds consistent with legal and operating requirements should be established because unnecessary funds result in inflexibility, undue complexity, and inefficient financial administration. The fund types defined in the types of Funds Principle are to be used if needed by a governmental unit to demonstrate compliance with legal requirements or if needed to facilitate sound financial administration. If legal requirements, GASB standards, or sound financial administration do not require the use of a given fund type, it should not be used.

Principle No. 5: Reporting Capital Assets

A clear distinction should be made between general capital assets and capital assets of proprietary and fiduciary funds. Capital assets of proprietary funds should be reported in both government wide and fund financial statements. Capital Assets of fiduciary funds should be reported in only the statement of fiduciary net assets. All other capital assets of the governmental unit are general capital assets. They should not be reported as assets in governmental funds but should be reported in the governmental activities column in the **Government-Wide Statement of Net Assets**. **General capital assets** include land, buildings, improvements other than buildings, and equipment used by activities accounted for by the fund types classified as governmental funds. Capitalized assets will be reported in the government wide statement of Net Assets, classified as being a part of governmental activities, business type activities, or component units. Capitalized fixed assets are not reported in the governmental fund financial statements but are reported in the proprietary fund financial statements and fiduciary fund financial statements.

Capital Assets and Fund-Based Financial Statements - one interesting result of measuring and reporting only the expenditures within governmental funds is that virtually no assets are recorded other than financial resources such as cash, receivables, and investments. All capital assets such as buildings, equipment, vehicles, and the like have been recorded as expenditures at the time of purchase and then closed out at the end of the fiscal period.

With the creation of GASB statement No. 34, a record of all capital assets can be found in the statements of net assets within the government-wide financial statements. Thus, recording only Expenditures in the fund-based financial statements does not leave a gap in the information being presented. However, prior to statement No-34, a record of the capital assets could not be found within the governmental funds. At the time, to disclose information, a separate account group was maintained for such assets (as well as the long-term liabilities of the governmental funds). These two account groups (the General Fixed Assets Account Group and the General Long-Term Debt Account Group) were no more than a listing of the individual accounts, balances not otherwise recorded or presented by the traditional accounting model. GASB Statement No. 34 eliminated the need for this two account groups since fixed assets and long-term liabilities are reported in the government-wide financial statements.

Principle No. 6: Valuation of Capital Assets

Capital assets be should reported at historical cost. The cost of a capital asset should include capitalized interest and ancillary charges necessary to replace the asset into its intended location and condition for use. Donated capital assets should be reported at their estimated fair value at the time of the acquisition plus ancillary changes if any.

Principle No. 7: Depreciation of Capital Assets

Capital assets should be depreciated over their estimated lives unless they are either inexhaustible or are infrastructure assets according to the modified approach of GASB Statement No. 34. **Inexhaustible assets** such as land, land improvements, historical heritage or antiquities, and fine arts should not be depreciated. Depreciation expense should be reported in the government wide statement of activities; the proprietary fund statement of revenues, expenses and changes in fund net assets; and the statement of changes in fiduciary net assets.

Infrastructure assets are long-lived assets that normally are stationary in nature and normally can be preserved for a significantly greater number of years than most capital assets. Examples of infrastructure assets are roads, bridges, tunnels, drainage systems, water and sewer systems, dams, and lighting systems. With the exception of infrastructure assets reported under the modified approach, all capitalized assets are to be depreciated, using a generally accepted depreciation method, over estimated useful lives. This depreciation charge is included as an expense in the statement of Activities in the government wide financial statements and as an expense in the statement of Revenues, Expenses, and changes in Fund Net Assets in the proprietary fund financial statement. **Infrastructure Assets** must be capitalized. However, a government may choose not to depreciate infrastructure assets, choosing instead to use the modified approach established by GASB. If the modified approach is used, the government will expense expenditures to extend the lives of those assets. Additions and improvement will continue to be capitalized. The logic behind this is that if infrastructure is maintained properly, the useful life is indefinite and depreciation charges would not be necessary.

In fund-based financial statements, depreciation expense has never been needed in with governmental funds for two reasons:

1. These funds record expenditures rather than expenses and the entire cost of the asset was reported as expenditure at the time the original claim against current financial resources. Thus, the impact of the acquisition was recorded when obtained so that reporting a Depreciation Expense account would measure the impact twice-once when acquired and once when depreciated.
2. These funds traditionally do not record expenses. Thus, the reporting of depreciation expense (rather than expenditure) is not consistent with measuring the change in current financial resources.

However, the government-wide financial statements list assets rather than expenditures so that depreciation on all long-lived assets other than land should be calculated and reported each period.

Principle No. 8: Reporting Long-Term Liabilities

A clear distinction should be made between fund long-term liabilities and general long - term liabilities. Long term liabilities directly related to and expected to be paid from proprietary funds should be reported in the proprietary fund statement of net assets and in the government wide statement of net assets. Long-term liabilities directly related to and expected to be paid from fiduciary funds should be reported in the statement of fiduciary net assets. All other unmatured general long-term liabilities of the governmental unit should not be reported in the governmental funds but should be reported in the governmental activities column in the government wide statement of net assets. State and local governments are required to report all long-term debt and long-term liabilities in the statement of Net Assets. This includes debt that is to be paid out of general government resources, such as general obligation (G.O) debt, which is paid out of tax revenues. This debt is reflected in the government type activities column of the statement. The statement of net Assets also includes debt paid from revenues raised by proprietary fund activities, which would be reported in the business type activities column. When reporting long-term debt and other liabilities, a distinction must be made between those portions to be paid in later years. In addition, long-term debt paid from proprietary fund revenues is reported as a liability in the proprietary fund statement of net Assets.

Principle No. 9: Measurement Focus and Basis of Accounting

Measurement Focus

Measurement Focus explains the items measured, accounted for, and reported to prepare basic financial statements and determine accountability for the entrusted resources. There two types of Measurement Focuses: Economic Resource Measurement Focus and Current Resources Measurement Focus

1. Economic Resources Measurement Focus

It measures, accounts for, and report inflows and outflows of economic resources (current and noncurrent). It is also called All Resources Measurement Focus. It mainly focuses on operational accountability; whether management efficiently uses resources in providing services

2. Current Financial Resources Measurement Focus

It measures, accounts for, and report inflows and outflows of current resources (expandable resources i.e., cash or other items expected to be converted into cash during the current period). It mainly focuses on fiscal accountability; whether managers have met budgetary and other legal financial requirements

Basis of Accounting (Accounting Method)

It gives answer to the question when should revenues and expenses or expenditures be recognized?

1. Accrual Basis of Accounting

Accrual Accounting means that (1) revenues should be recorded in the period in which the service is given, although payment is received in a prior or subsequent period, and (2) expense should be recorded in the period in which the benefit is received, although payment is made in a prior or subsequent period.

2. Modified Accrual Basis of Accounting

Under modified accrual basis of accounting, Revenues, should be recognized in the accounting period in which they become **available** and **measurable.** Expenditures should be recognized in the accounting period in which the fund liability is incurred, if measurable, except for unmatured interest on general long-term liabilities, which should be recognized when due. **Measurable** means capable of being expressed in monetary terms; **available** is defined as "collectible within the current period or soon enough thereafter to be used to pay liabilities of the current period. GASB standards require the accrual of revenue from property taxes in the period for which the taxes are levied. For other categories of non-exchange revenue transactions, except when certain time requirements and eligibility requirements have not been met revenues should be accrued if both measurable and available. In respect to expenditure recognition, the modified accrual basis is almost identical to the accrual basis when the only assets of a fund are financial resources.

3. Cash Basis of Accounting

Under Cash Basis of Accounting; (1) revenues should be recorded in the period in which the service is given, although payment is received in a prior or subsequent period, and (2) expense should be recorded in the period in which the benefit is received, although payment is made in a prior or subsequent period.

A) Government-Wide Financial Statements

The government wide statement of net Assets and statement of activities should be prepared using the economic measurement focus and the accrual basis of accounting. Revenue, expenses, gains, loses, assets and liabilities resulting from the exchange and exchange- like transactions should be recognized when the exchange takes place. Revenues, expenses, assets and liabilities resulting from the non – exchange transactions should be recognized in accordance with "Non – exchange transactions".

B) Fund Financial statement

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

(1) Financial statements for governmental funds should be presented using the current financial renounces measurement focus and the modified accrual basis of accounting.

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

(3) Financial statements of fiduciary funds should be reported using the economic resources measurement focus and the accrual basis of accounting except for the recognition of certain post employment health care plans

(4) Transfers (between funds) should be reported in the accounting period in which the inter fund receivables and payable arise.

Summary of Measurement Focus and Basis of Accounting		
Financial Statements	**Measurement Focus**	**Basis of Accounting**
Government-Wide Statements (GASB 34)	Economic Resources	Accrual
Governmental Fund Financial Statements	Current Financial Resources	Modified Accrual
Proprietary Fund Financial Statements	Economic Resources	Accrual
Fiduciary Fund Financial Statements	Economic Resources	Accrual

In a business organization accounting, the accrual basis is employed to obtain a matching of costs against the revenue flowing from those costs there by producing a more useful income statement. In governmental entities, however, even for government wide financial reporting and those funds that attempt to determine net income, the objective is to provide services to the public, not to maximize economic gain or profit. Rather the government as a whole and the funds that use the economic resources measurement focus and accrual basis of accounting make use of revenue and expense accounts to assist in assessing operational accountability and to guard against impairment of ability to render the services desired. For these reasons, the government wide operating statement is called *a statement of activities* and those of proprietary funds are called *statement of revenues, and expenses rather than income statements.*

Most of the governmental fund types (General funds, special revenue funds, capital project funds, and debt service funds) are not concerned with income determination. These funds are concerned with matching expenditures of legal appropriations, or legal authorizations, with revenues available to finance expenditures. GASB standards require that governmental fund types use the modified accrual basis. The modified accrual basis requires recognition of revenues in the period in which they become available and measurable.

Principle No. 10: Budgeting, Budgetary control, and Budgetary Reporting

a. An annual budget(s) should be adopted by every governmental unit
b. The accounting system should provide the basis for appropriate budgetary control.
c. Budgetary compassion schedules should be presented as required supplementary information (RSI) for the general fund and each major special revenue fund that has a legally adopted annual budget. The budgetary comparison schedule should present both (a) the original and (b) the final appropriated budgets for reporting period as well as (c) actual inflows, outflows, and balances, stated on the government's budgetary basis.

Part (a) of the principle is above not an accounting or financial reporting principle, but it is a necessary precondition to parts (b) and (c.) A budget when adopted according to procedures specified in state laws, is binding up on the administrators of a governmental unit. Accordingly a distinctive characteristics of governmental accounting resulting from the need to demonstrate compliance with laws governing the sources of revenues available to governmental units and laws governing the utilization of those revenues is the formal reporting of the legally approved budget compared with actual results for the General fund and all major special revenue funds that have a legally adopted annual budget.

Principle No. 11: Transfers, Revenue, Expenditure and Expense Account Classification

a. Transfers should be classified separately from revenues and expenditures or expenses in the basic financial statements.
b. Proceeds of general long-term debt issued should be classified separately from revenues and expenditures in the governmental fund financial statements.
c. Governmental fund revenues should be classified by fund and source. Expenditures should be classified by fund, function (program) organization unit, activity, character and principal classes of objects.

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

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

This principle is intended to ensure that account classifications provide for separate financial statement reporting of transfers from revenues and expenditures (or expenses) and for appropriate levels of in the basic financial statements.

Principle No. 12: Common Terminology and Classification

A common terminology and classification should be used consistently throughout the budget, the accounts, and the financial repots of each fund. It is a principle of commonsense that if the budgeting, budgetary control, and budgetary Reporting Principle is to implemented,, persons responsible for preparing the budgets and persons responsible for preparing the financial statements and financial reports should work with the persons responsible for designing and operating the accounting system. Agreement on a common terminology and classification scheme is needed to make sure the accounting system produced the information needed for budget preparation and for financial statement and report preparation.

Principle No. 13: Annual Financial Reports

a. A **Compressive Annual Financial Report (CAFR)** should be prepared and published, covering all activities of the primary government (including its blended component units) and providing an overview of all discretely presented component units of the reporting entity including introductory sections, management's discussion and analysis (MD & A), basic financial statements, required supplementary information other than MD & A, combining and fund financial statements scheduled, narrative explanations, and statistical section.

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

1. Management's discussion and analysis
2. Basic financial statements. The basic financial statements should include:
   - Government – Wide Financial Statements
   - Fund Financial Statements
   - Notes to the Financial Statements
3. Required supplementary information other than MD & A.

2.3) Governmental Financial Reporting Entity

In producing financial statements, a state or local government often encounters a unique problem – determining the specific activities to be included. A state or local government may interact with numerous departments, agencies, boards, institutes, commissions and the like that have various relationships with these governments. Should these functions be included as either governmental activities or business type activities within the CAFR of the government? In government accounting and reporting, the financial reporting entity must be identified. The financial reporting entity consists of **primary government** and **component units**.

Primary Government

A **primary government** includes any state government or general purpose local government such as a city or county. It also includes a special purpose local government such as a school system also may be deemed a primary government if it meets three criteria:

- It has a separately elected governing body.
- It is legally independent which can be demonstrated by having corporate powers such as the right to sue and be sued in its on name as well as the right to buy, sell and lease property in its on name.
- It is fiscally independent of other state and local governments. Fiscal independency is normally demonstrated by an activity of its leadership can determine its own budget without having to seek approval from an outside party, levy taxes or set rates without having to seek outside approval, and issue bonded debt without having to seek outside approval.

The primary government includes and must report all funds, activities, organizations, agencies, offices, and departments that are not legally separate from it. A city is clearly a primary government but its police department and fire department are not. However, if a school system is legally separate entity according to the laws of its state and has a publicly elected board which sets its own budget, levies its own tax, and issue its own bonds, it is a primary government that would issue its own **CAFR**. In contrast a school system that which must have its annual budget and tax levies set or approved by the local city council is not a primary government.

Component Units

A Component Unit is (1) organizations for which the primary government is financially accountable and (2) any other organizations for which the nature and significance of their relationship with the primary government are such that exclusion would cause the reporting entity's basic financial statements to be misleading or incomplete.

Some activities can be legally separate from a primary government but still be so closely connected that omission from the statements of the primary government can not be justified. The elected officials the primary governments are still financially accountable for these separate organizations known as component units of the primary government. Because component units are included within the financial statements of the primary government, identification of such activities can be quite important. Two sets of criteria have been established for this purpose. If either set of criteria is met, the activity in question is a component unit to be reported within the CAFR of the primary government.

Criterion One: the separate organization is fiscally dependent on the primary organization regardless of the extent of other relationships. As defined earlier fiscal dependency means that the organization cannot do one or more of the following without approval of the primary government: adopt its own budget, levy taxes or set rates or issue bonded debt. For example, if the budget of a legally separate museum board must be approved by the city government, this board is classified as a component unit.

Criterion Two: First, the officials of the primary government must appoint a voting majority of the governing board of the separate organization. And second, either the primary government must be able to impose its will on the board of the separate organization, or the separate organization must be able to impose its will on the board of the separate organization, or the separate organization must provide a financial benefit or impose a financial burden on the primary government.
GASB standards provide two methods for including component unit financial information with that of primary governments. The first is known as **blending**. Blending involves summing the financial information of the component units with that the primary government in the appropriate fund groups. For example an enterprise activity of a component unit would become an enterprise fund of the reporting entity. Blending is done only when component units are "so intertwined with the primary government that they are, in substance, the same as the primary government and should be reported as part of the primary government. The General Fund of the component unit would normally be a special revenue fund of the reporting entity, and the General fund of the primary government would be the General Fund of the reporting entity. The other method of presenting component units is through **Discrete Presentation**. These component units are presented in the government wide statements as a separate column.

The reporting entity's government wide financial statement should display information about the reporting government as a whole distinguishing between the total primary government's governmental and business type activities. The reporting entity's fund financial statements should present the primary government's (including its blended component units, which are, in substance, part of the primary government) **major funds**[1] individually and **non–major funds** in the aggregate. Funds and component units that are fiduciary in nature should be reported only in the statements of fiduciary net assets and changes in fiduciary net assets.

The notion of financial accountability is basic to the definition of a governmental financial reporting entity. A primary government is, of course, financially accountable for the organizations that make up its legal entity. It is also financially accountable for legally separate organizations if its officials appoint a voting majority of an organization's governing body and either it is able to impose its will on that organization or there is a potential for the organization to provide specific financial benefits to, or to impose specific financial burdens on, the primary government. A primary government also may be financially accountable for governmental organizations that are fiscally dependent on it.

The **nucleus of a financial reporting entity** usually is a primary government. However, a governmental organization other than a primary government (such as a component unit, joint venture, jointly governed organizations or other stand alone government) serve as the nucleus for its own reporting entity when it issues separate financial statements.

2.4) Common Accounting Characteristic of Fund Types

1. Common Accounting Characteristics Governmental Funds

- Focus on fiscal accountability
- Measure and report current (expendable) financial resources
- Use modified accrual basis of accounting
- Account for and report revenues and expenditures
- No capital assets or long-term liabilities accounted for in funds; no depreciation reported in funds
- Budgetary accounts integrated into the funds to achieve legal budgetary control
- Required Financial Statements:
  - Balance Sheet
  - Statement of revenues, expenditures, and changes in fund balances
  - Reconciliation of total fund balances of governmental funds to total net assets of governmental activities at the government-wide level
  - Reconciliation of total changes in fund balances of governmental funds to total changes in net assets of governmental activities at the government-wide level

2. Common Accounting Characteristics Proprietary Funds

- Focus on operational accountability
- Measure and report economic resources (as in business accounting)
- Use full accrual basis of accounting
- Account for and report revenues and expenses
- Account for capital assets or long-term liabilities within the funds; report depreciation
- Budgetary accounts not integrated into the funds; should use budgeting for planning and control purposes
- Required Financial Statements:
  - Statement of net assets

[1] A fund is classified as major if (a) total assets, liabilities, revenues, or expenditures or expenses of the individual governmental or enterprise fund are at least 10% of the corresponding total assets, liabilities, revenues, or expenditures or expenses for all funds of that category (total governmental or total enterprise funds), and (b) total assets, liabilities, revenues, or expenditures or expenses of the individual governmental fund or enterprise fund are at least 5% of the corresponding total for all governmental and enterprise funds combined.

- Statement of revenues, expenses, and changes in net assets
- Statement of cash flows

3. Common Accounting Characteristics Fiduciary Funds

- Accounting for fiduciary funds is similar to that for proprietary funds, i.e., full accrual accounting and focus on flows of economic resources
- Capital assets and long-term liabilities are recorded in the funds, if applicable
- Additions (to net assets) and deductions (from net assets) are recorded instead of revenues and expenses
- Required Financial Statements:
  - Statement of fiduciary net assets; and
  - Statement of changes in fiduciary net assets

Chapter Three
Governmental Operating Statement Accounts and Budgetary Accounting

Topics to Be Discussed:

- Concepts and Rules for Recognition of Revenues and Expenses
- Classification and Reporting of Revenues and Expenses at Government-Wide Level
- Structure and Characteristics of the General Fund: Classification and Description of Operating Statement Accounts
- Budgetary Accounts
- Terminology and Classification for Governmental Fund Budgets and Accounts
- Budgetary Accounting
- Budgeting and its usefulness in government organization
- Historical sketch of the Ethiopian governmental budget
- Legal basis of for the federal government of Ethiopia (FGE) accounts
- Classification of governmental revenues and expenditure with special reference to Ethiopia

Learning Objectives

After studying this chapter, you should be able to:

- Explain how operating revenues and expenses related to governmental activities are classified and reported in the government-wide financial statements
- Distinguish, at the fund level, between Revenues and Other Financing Sources and between Expenditures and Other Financing Uses
- Explain how revenues and expenditures are classified in the General Fund
- Explain how budgetary accounting contributes to achieving budgetary control over revenues and expenditures, including such aspects as recording the annual budget; accounting for revenues; accounting for encumbrances and expenditures; and accounting for allotments
- Describe computerized accounting systems

3.1) Concepts and Rules for Recognition of Revenues and Expenses

Exchange Transactions

GASB standards provide guidance for accounting recognition of revenues and expenses on the accrual basis in the government wide financial statements and revenues and expenditures on the modified accrual basis in the governmental fund financial statements. Recognition rules for **exchange transactions and exchange like transactions** – those in which each party receives values essentially equal to the value given, are general starlight forward. For exchange transactions, the party selling goods or services recognizes an asset (*receivable or cash*) and revenue when the transaction occurs and revenue has been earned. The party purchasing goods or services recognizes an expense or expenditure and liability *(or reduction in cash*). Under the modified accrual basis of accounting, if a governmental fund provides goods or services to another party fund; it should recognize an asset (receivable or cash) and a revenue if the assets (financial resources) are deemed **measurable** and **available**. If governmental funds receives goods or services from another party or fund, it should recognize expenditures (not expense) when the fund liability has been incurred. In most cases, exchange transactions of governmental funds result in measurable and available assets being received or a fund liability being incurred when the transactions occurs and thus result in immediate recognition of revenues and expenditures. For example the General Fund should recognize revenue immediately when a citizen is charged a fee for a building permit and expenditure when a purchase order for supplies has been filled.

† Non-exchange transactions

Non exchange transactions are defined as external events in which a government gives or receives value without directly receiving or giving equal value in exchange. Non-exchange transactions are contrasted from exchange and exchange like transactions in which each party receives and gives up essentially equal values. By their nature governmental funds, including the General Fund and Special Revenues Funds are mostly engaged in non-exchange transactions. Accounting for non-exchange transactions raises a number of conceptual issues. The two key concepts that affect a resource recipient's recognition of revenues and resource provider's recognition of expenses or expenditures are **time requirements** and **purpose restrictions**.

Time requirement relate either to the period when resources are required to be used or when use may begin. Thus, time requirements determine timing of revenue or expense (expenditure) recognition that is whether these elements should be recognized (recorded in the accounts) in the current period or deferred to a future period. **Purpose restrictions** refer to specifications by resource providers of the purpose or purposes for which resources are required to be used. For example grant may specify that resources can be used only to provide transportations for senior citizens. The timing of revenue recognition is unaffected by purpose restrictions. Ruther the purpose restriction should be clearly reported as restriction of net assets in the government wide statements of net assets or as reservations of fund balance in the governmental funds balance sheet.

For certain classes of non-exchange transactions, revenue and expense recognition may be delayed until Program Eligibility Requirements are met. As per GASB Statement No. 33, **Eligibility Requirements** may include the following four general classifications: Time Requirements; Required or specified characteristics of the Program Recipients; Reimbursement Provisions; and Contingencies which are discussed as follows:

- † **Time Requirement**s – Programs can specify when money is to be used. If time requirement for (expenditures) are specified by resource provider or legislation, those time requirements must be met. For example assume that in April, a state provides a grant to a city so that milk can be bought for each child during the subsequent school year starting in September. When should the grant be recognized as revenue? Recognition should be in the period of use or in the period when use of the funds is first permitted.
- † **Required Characteristics of Program Recipients** – the recipient must have the characteristics specified by the provider. For example a state may provide funding on a per student basis to public school. In order to recognize revenue or an asset recipient must be a public school as defined in state statues and regulations
- † **Reimbursement Provisions** – many grants and other programs are designed to reimburse a designated government for amounts appropriately spent. These arrangements are often called "expenditure-driven" programs. For those grant and gifts that are payable only up on the incurrence of qualifying outlays permissible under the grant, receivables and revenues would be recognized only when the expenditures have been incurred. For example, assume that the state informs a locality that it will reimburse the city government for money paid to provide milk to school children who could not otherwise afford it. In such cases, no revenue is recognized until the money is spent. Thus the expense should equal the amount of revenue recognized.
- † **Contingencies** – Revenues pledged that have a contingency attached are not to be recognized until the contingency has been met. In voluntary non-exchange transactions, revenues may be withheld until a specified action is taken. A grant may be given to buy park equipments, for example, but only after an appropriate piece of land has been acquired for the park. Until the lot is obtained, a contingency exists and the revenue should not be recognized. If also a donor indicated that $100,000 will be donated to build an addition to the city library when funds an equal amount have been pledged by others, that receivable and revenue would be recognized only after the $100,000 has been raised from others.

All applicable **program eligibility requirements** must be met before revenues can be recorded from either government-mandated non-exchange transactions or voluntary non-exchange transactions.

Classes of Non-exchange Transactions

For organizational purposes, the GASB classified all non-exchange transactions into four distinct classifications, each with its own rules as to proper recognition:

1. **Derived Tax Revenues** – Examples: Sales taxes, Personal and Corporate income taxes excise taxes, and similar taxes on earnings or consumption. In a **derived tax revenue** transaction, a tax assessment is imposed because an underlying exchange takes place. When a sale occurs and a sales tax is imposed or when income is earned and an income tax is assessed.
   - † **Asset Recognition** – period when underlying exchange has occurred or when resources (assets) are received, which ever is the first
   - † **Revenue Recognition** – period when underlying exchange has occurred. Under modified accrual accounting, resources also should be available.

In general revenue and assets are recognized in the period in which income is earned for income taxes. Likewise, when a sale is made, the government should recognize the resulting sales tax revenue. Obviously, a government cannot an entry every time that income is earned or a sale is made. For convenience, recognition of such revenues is normally made when information becomes available. Assume, for example, that sales within a government amount to $10 million for 2005 and a sales tax of 4 percent is assessed. In the period in which the sales are made, the following entry is required. The amounts should be reported net of any estimated refunds or uncollectible balances.

Government- Wide Financial Statements Journals

Receivables – Sales Tax	400,000	
Revenues – Sales Tax.....		400,000

To recognize amount of sales tax that will be collected in connection with sales

In the above entry, if – because of the nature of the tax or assessment – cash is received prior to the occurrence of the underlying exchange; deferred revenue (liability) is recognized initially. Later when the underlying exchange occurs, the liability is reclassified as revenue.

For fund–based financial statements, the above rules are also used except for one additional requirement that the resources must be available before the revenue can be recognized. In that way, the essence of modified accrual accounting is still being utilized at the fund level of reporting.

A separate issue any tax revenue if government officials have specified that a certain use must be made of the resources. For example, in the above entry assume that the city government has stated that 25 percent of the tax must be used for park beautification. Thus, $100,000 will have to be spent in this designated fashion. According to Statement Number 33, such purpose restrictions are only disclosed in the financial statements by reclassifying an appropriate amount of the fund balance or equity to disclose the intended usage. As indicated here, revenue recognition is not altered:

Purpose restrictions do not affect the timing of recognition for any class of transactions. Rather, recipients of re sources with purpose restriction should report resulting net assets (or equity or fund balance, as appropriate) as restricted until the resources are used for the specified purpose or for as long as the provider requires the resources to be maintained intact (for example endowment principal.)

Consequently, in the statement of net assets for the government wide financial statements $ 100,000 should be reported in the net assets section as restricted for park beautification. A similar treatment is proper the balance sheet created according the fund-based financial statements except that the amount is shown a separate fund balance figure reserved for park beautification.

If revenue is recognized and a purpose restriction is not fulfilled, the money will probably have to be returned as per the requirements. In such a situation, if the return is made in a subsequent period, the government should recognize an expense rather than a revenue reduction

2. **Imposed Non-Exchange Revenues –** Examples: Property taxes, fines and penalties, forfeitures. These are viewed as imposed non-exchange revenues because the government imposes an assessment without existence of underlying transaction. Real estate or other property is owned and a property tax is levied each period. Ownership is being taxed by the government and not a specific transaction.
   - † **Asset Recognition** – period when an enforceable legal claim has arisen or when resources (assets) are received, which ever the first
   - † **Revenue Recognition** – period in which the resources are required to be used or in the first period that the use of the resource is permitted (for example, for property taxes, the period for which levied). In governmental funds, the criterion of availability for use must be met.

Because the government imposes such taxes, the period for which the proceeds are to be used is normally specified. The period of use identifies the period of revenue recognition. If a tax is assessed and usage is not allowed for five years, deferred revenue is recognized until the time restriction passes. For property taxes, which are the largest source of income for many governments, revenue recognition is for the period for which the taxes are levied. Assume, for example that a city assesses $900,000 in property taxes on the first day of the fiscal year and expects to collect $830,000. The initial entry for either set of financial statements would be as follows:

Property Tax Receivables	900,000	
Allowance for Uncollectible Taxes		70,000
Revenues – Sales Tax.....		830,000

To record assessment of property taxes for the current year

A common set of recognition rules applies to the remaining two classes of non-exchange transaction; government mandated and voluntary exchange. An asset (a receivable or cash) is recognized when all legibility requirements have been meet or when cash is received, whichever occurs first. For example although cash has not been received from a grantor, when a program recipient meets matching imposed by the grantor agency in order to become eligible for a social services grant, receivable(Due from (Grantor)) would be recorded. Revenues should be recognized only when all eligibility criteria have been met. Until eligibility has been established, some degree of uncertainty exists that precludes recognition. Thus, in government-wide financial statements revenue recognition occurs at the time of eligibility even if the money is actually received earlier. For fund financial statements, the amounts must also be available for revenue recognition in the same manner as modified accrual accounting. If cash is received in the period prior to intended use (that, there is a time restriction) or before eligibility requirements have been met, deferred revenues should be reported rather than revenues. In the period when the time restriction expires, the account Deferred revenues will be debited and Revenues will be credited.

3. **Government Mandated Non-Exchange Transactions –** grants that are conveyed from higher government to lower government to help pay for the costs of required programs (e.g. certain education, social welfare, transportation services mandated and funded by a higher level of government). If a state specifies that a city must create a shelter for homeless and then provides a grant of $400,000 to help defray the cost, that money should be recorded using these prescribed rules because the final goal for the money has mandated by the state. City officials have no choice; the state government has required the shelter to be constructed and provided part or all of the funding.

4. **Voluntary Non-Exchange Transactions –** in this final classification, money has been conveyed willingly to the state or local government by an individual, another government, or an organization usually for a particular purpose. Examples: grants and entitlements from higher level of government and certain private donations). For example, assume that a state grants a city

$300,000 to help improve reading programs in its schools. Unless the state has mandated an improvement in these reading programs, this grant would be accounted for as a voluntary exchange transaction. The decision has been made that use of the money will provide an important benefit but no government requirement exists led to the conveyance.

For both government mandated non-exchange transactions and voluntary non-exchange Transactions:

- **Asset Recognition** – period when all eligibility requirements have been met or when resources are received, which is the first
- **Revenues and Expenses or Expenditures Recognition** – period when all eligibility requirements have been met

A particular non-exchange transaction may lead to recognition of revenues in one period in the government wide statement of activities, but reported as deferred revenues in a governmental fund because it is deemed not to be available to pay current period obligations.

3.2) Classification and Reporting of Revenues and Expenses at the Government–wide Level

The **Government-Wide Statement of Activities** displays the expense and revenue of each function or program comprising the governmental activities of the government. The net expense or net revenue of each business-segment and discretely presented component units is reported separately from the functions (programs) of the governmental activities. According to GASB, reporting the net expense or net revenue format "identifies the extent to which each function of government draws from the general revenues of the government or is self financing through fees and intergovernmental aid."

Reporting Direct and Indirect Expenses

Except for extraordinary or special expenses, expenses should be reported by function or program. **Direct Expense** – those that are specifically associated with the function or program – should be reported on the line for that function or programs. **Indirect Expenses** –those that are not directly linked to an identifiable function or program – can be reported in the variety of ways. A typical indirect expense is interest on general long-term liabilities. In most cases, interest on general long-term liabilities should be reported a separate line item rather than being allocated to functions or programs.

For capital assets that are clearly identified with a function or program, depreciation expense for those assets should be included in expense of that function or program as a direct expense. Similarly, depreciation expense for infrastructure should be reported as a direct expense of the function responsible for the infrastructure assets (for example, public works or transportation). Depreciation expense for shared assets should be associated to function on appropriate basis (for example, square footage of building use). If a government opts to report unallocated depreciation expenses as separate line item, it should indicate that the amount reported on that line does not include depreciation expense reported as part of direct expense of functions or programs.

To achieve full costing, some government allocates to other functions or programs certain central administrative costs that other governments may report in the general government function, the allocated expenses should be reported in a separate column from the direct expenses, so that the direct expense will be more comparable with the direct expenses of similar functions of other governments. On other hand, if a government regularly assigns administrative overhead costs to functions through an internal service fund or other billings, it is not required to eliminate those costs from the expenses of functions or to report them in a separate column. Rather the government should disclose in the notes to the financial statements that such overhead charges are included as part of function / program direct expense.

Program Revenues and General Revenues

Program revenues are reported in the functions /program section of the statement of activities, where they reduce the net expense of each function or program or produce net revenue. General revenues are not directly linked to specific function or program and thus are reported on the separate section at the bottom of the statement.

Three categories of program revenues are reported in the statement of activities: **charges for services**, **operating grants** and **contributions** and **capital grants and contributions** comprise program revenues. **Charges for services** include charges to customers or other for both governmental and business type activities. Charges for services, within the governmental activities category, are exchange transactions and include fees charged for such items as licenses and permits (for example, business licenses and building permits) and operating special assessments some times charged for services provided out side the normal service area or beyond the normal level of services.

Grants and contributions and other non-exchange revenues restricted by other governments, organizations, and individuals for the **operating purpose** of particular function or program should be reported in the separate column from those restricted for **capital purposes**. GASB requires that multipurpose grants and contributions be reported as program revenues if the amounts restricted to each program is specially identified in either the grant award or grant applications. Otherwise, multipurpose grants and contributions should be reported as general revenue.

Earning from endowments, permanent funds, or other investments that are restricted for a specific purpose in the endowment or permanent fund contract or agreement should be reported as program revenue in the appropriate grants and contribution category. Unrestricted earnings from such resources should be reported as general revenue. In addition all taxes, even those specified by law for a particular use (for example, motor vehicle full taxes that can only be used for road and bridge purposes), should be reported as general revenue.

Reporting Special Items or and transfers

According to Statement No. 34, extraordinary items and special items must be reported as separate line items below General Revenue in the statement of activities to distinguish these nonrecurring items from normal recurring general revenues. Separate reporting of such items serves to inform citizens and other report user when government engage in the unusual practice of balancing their budget by selling government assets or other similar practices. **Extraordinary Items** are transactions or events that are both unusual and infrequent in occurrence. **Special Items** are items with in management control that may be either unusual in nature or infrequent in occurrence but not both (e.g. one- short revenue from the sale a significant governmental asset). Extraordinary items should be reported as the last item on the statement of activity; special, item should be reported before extraordinary items. Special items that are beyond management's control should be disclosed in the notes in the financial statements.

Other items that should be reported on the separate lines below General Revenue are contributions to the principal amount of endowments and permanent funds and transfers between funds reported as part of governmental activities and funds reported as part of business type activities. Interfund transactions between governmental and business type activities that involve the sale of goods or service (such as the sale of water from utility enterprise fund to the General fund) as reported as program revenue and expense, not as transfers.

3.3) Structure and Characteristics of General Fund: Classification and Description of Operating Statement Accounts and Budgetary Accounts

The General Fund has long been the accounting entity of a state and local governments that accounts for current financial resources raised and expended for the core governmental services provided to the people. **General Funds** are some times known as **Operating Funds** or **Current Funds**; the purpose,

not the name is the true test of identity. The typical government unit can engage in many activities that for legal and historical reasons are financed by sources other than those available to the General Fund. Whenever a tax or other revenue source is authorized by a legislative body to be used for specified purpose only a governmental unit availing itself of that source may create **Special Revenue Fund** in order to be able to demonstrate that all revenue from that source was used for the specified purpose only. A common example of **Special Revenue Fund** is one used to account for state gasoline tax receipt distributed to a local government, in many cases; the use of this money is restricted to the **construction and maintenance of street, high ways,** and **bridges**. The accounting structure specified for Special Revenue Funds by GASB standards is identical with that specified for general funds.

Governmental Fund Balance Sheet and Operating Statement Accounts

It should be emphasized that the general fund, special revenue funds, and all other funds classified as governmental funds account for only financial resources (cash, receivables, marketable securities and, if material, prepaid items and inventories). Economic resources, such as land, buildings, and equipments utilized in fund operations, are not accounted for by these funds because they are not normally converted in to cash. Similarly, these categories of funds account for only those liabilities incurred for normal operations that will be liquidated by use of fund assets. General capital assets and general long term liabilities are reported in the statement of net assets at the governmental wide level.

1. Balance Sheet Accounts

The **Arithmetic Difference** between the amount of financial resource and the amount of liabilities recorded in the fund is the **Fund Equity**. Residents of the governmental unit have no legal claim on any excess of liquid assets over current liabilities; there for, the fund equity not analogous to the capital accounts of investors owned entity. Accounts in the fund equity category of general funds and special revenue funds consists of reserve accounts established to disclose that portion of the equity are not available for appropriations; the portion of equity available for appropriation is disclosed in an account called **Fund Balance** (also referred to as **Unreserved Fund Balance**).

2. Operating Statement Accounts

In addition to the balance sheet accounts, the General Fund and special revenue funds account for financial activities during a fiscal year in operating statement accounts classified as *Revenues, Other Financing Source, Expenditures, and Other Financing Uses.* **Revenue** is defined as increases in fund financial resources other than from interfund transfers and debt issue proceeds. Transfers into a fund and debt issue proceeds received by a fund are classified as **Other Financing Sources** of the fund. Accounting standards specify that the revenues of all governmental fund types are be recognized on the modified accrual basis. Because the operations of governmental funds are subject to detailed legal restrictions, governmental fund revenues should be recognized in the fiscal year in which they are available to finance expenditures. In a few jurisdictions laws require that taxes be collected in the year before the year in which they are available to finance expenditures. In such jurisdictions, tax collections should be credited to Deferred Revenues when cash is debited; in the following year Deferred Revenues should be debited and revenue should be credited.

Expenditure is a term that replaces both the terms **costs and expenses** used in accounting for profit-seeking entities. **Expenditures** are defined as decrease in **fund financial resources** other than through interfund transfers. Interfund transfers out of a fund are classified as **Other Financing Uses**. Under the modified accrual basis, expenditure is recognized when a liability to be met from fund asset is incurred. It is important to note that an appropriation is considered to be expended in the amount of a liability incurred whether the liability is for salaries (an expense), for supplies (a current asset), or for land, buildings, or equipment (long-lived capital assets). Of course, at the government-wide levels such items as salaries and utilities are recorded either as expenses rather than expenditures; items such as supplies may be recorded either as expenses or assets at year- end. Capital assets are recorded as assets when acquired and are expensed as the capital assets are depreciated.

An example of the use of transfer accounts occurs in those jurisdictions where a portion of the taxes recognized as revenue by the General Fund of a unit is transferred to a debt service fund that will record expenditures for payment of interest and principal of general obligation debt. The General Fund would record the amounts transferred as Interfund Transfers Out; the **Debt Service Fund** would record the amount received as Interfund Transferred In. Thus, use of the transfer accounts achieves the desired objective that revenue is recognized in the fund that levied the taxes, and expenditure is recognized in the fund that expends the revenue. **Other Financing Sources** accounts and Other Financing Uses accounts are closed to Fund Balance in a manner identical with the closing of Revenues and Expenditures, but are disclosed separately in the Statement of Revenue, Expenditures, and Changes in Fund Balances.

3. Budgetary Accounts

The fact that budgets are legally binding up on administrators has led to the incorporation of the budgetary accounts in the General Fund, and in **Special Revenue Funds** and all other funds required by state laws to adopt a budget. GASB Statement No. 34 requires that a budget to actual comparison schedule be provided for the General Fund and each **major** Special Revenue Fund for which a budget is legally adopted. Statements No. 34 recommends that these schedules be provided as required supplementary information (RSI), which should be placed immediately following the notes to the financial statements. Statement No. 34 also provides the option for governments to the budgetary comparison information in a budgetary comparison statement, a statement of revenues, expenditures and changes in fund balance – budgets and actual, which would then be part of the basic financial statements.

The budgetary comparison schedules must present at minimum separate columns for both the originally adopted and amended budgets and for actual amounts of inflow, outflows, and balances. The presentation of the variance column is encouraged but not required by GASB standards. In order to achieve meaningful budgetary comparisons, the actual amounts in the budgetary comparisons schedule should be reported using the government's budgetary basis. Some governments, for example, budget their revenues on the cash basis. If the actual column of the budgetary comparison schedule (or, statement) uses a non-GAAP budgetary basis, such as cash basis, the column headings should so indicate.

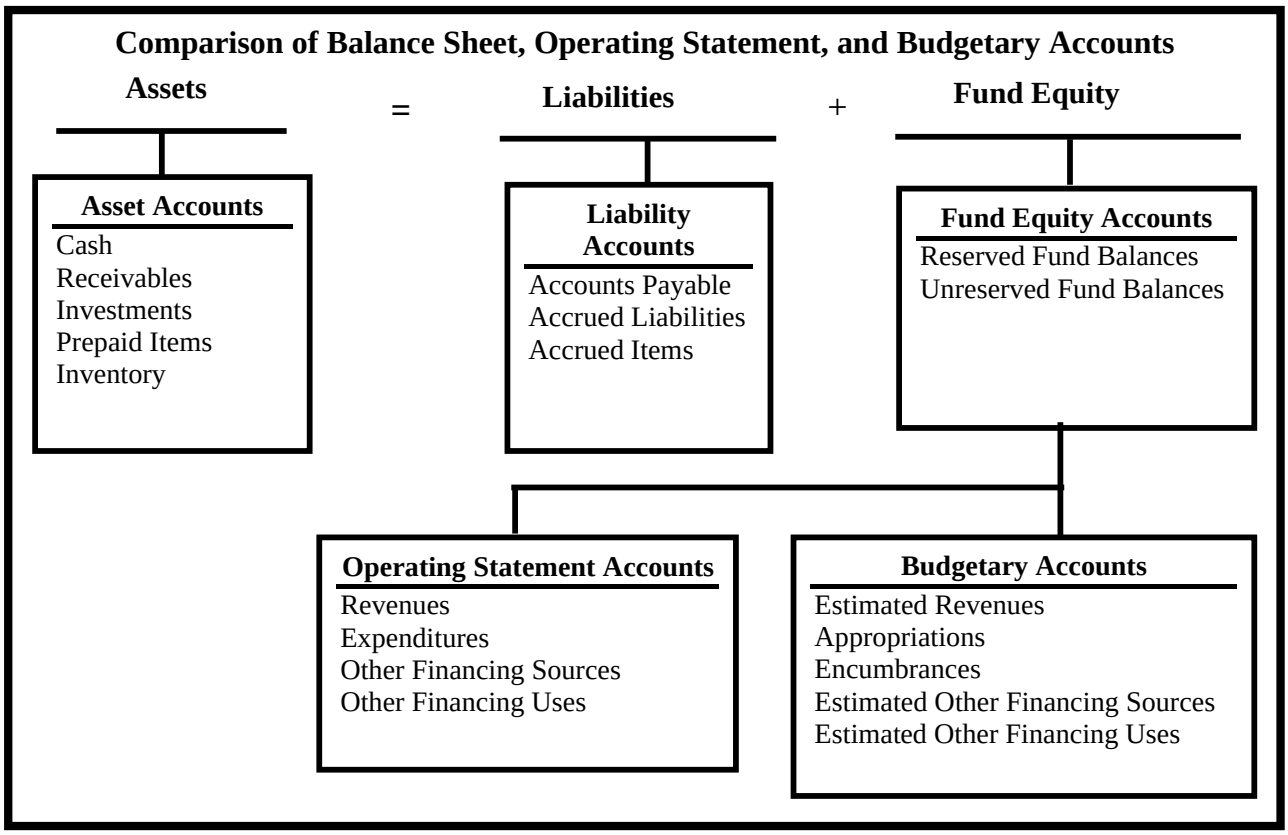
Budgetary practices of a government may differ from GAAP accounting practices in respects other than basis. GASB standards identify timing, entity, and perspective differences. GASB standards require that the amounts shown in the Actual column of the budgetary comparison schedule conform in all respects with practices used to develop the amounts shown in the Budget columns of the schedule, so there is a true comparison. Standards further require that either on the face of the budgetary comparison or on a separate schedule the amount reported in Actual column of the budgetary comparison schedule must be reconciled with GAAP amounts shown in the statement of revenues, expenditure, and changes in fund balances.

In order to provide the information needed to prepare budgets and the budgetary comparison schedules (or statements) accounting system of funds for which budgets are legally adopted include **Budgetary Accounts**, in addition to the normal balance sheet and operating statement accounts. Only three general ledger budgetary control account are needed in the general fund (and other funds in which budget is adopted) to provide budgetary control: *Estimated Revenues, Appropriation, and Encumbrances*. Subsidiary ledger accounts should be provided in what ever detail is required by law or sound financial administration to support each of the three control accounts. Budgeted interfund transfers and debt proceeds must be recorded in two additional budgetary control accounts; Estimated Other Financing Sources and Estimated Other Financing Uses. This control accounts should also be supported by subsidiary detail accounts as needed.

The **Budgetary Accounts** are all temporary subfund balance accounts and like the **Operating Statement Accounts** are closed to Fund Balance at year-end. Comparing the actual **Revenues**

account balance to their corresponding **Estimated Revenues** account balance provides budgetary control over revenues. Similarly, comparing the actual **Expenditures** account balance plus **the Encumbrances Account** balance (estimated budgetary amount for goods or order) to the **Appropriations** account balance (legal authorizations to incur expenditures) provides for budgetary control over expenditures.

- Balance Sheet Accounts are permanent accounts and include Fund Assets, Fund Liabilities and Fund Balance Accounts.
- The Fund Balance Accounts are classified further into two accounts: Reserved Fund Balance and Unreserved Fund Balance.
- Budgetary Accounts and Operating Statement Accounts are temporary accounts and closed at the year-end to Unreserved Fund Balance Accounts.
- Operating Statement Accounts include Revenues, Expenditures, Other Financing Sources (OFSs), and Other Financing Uses (OFUs)
- Budgetary Accounts include Estimated Revenues, Appropriation, Encumbrance, Estimated OFSs, and Estimated OFUs



3.4) Terminology and Classification for Governmental Fund Budgets and Accounts

Budgets as they are incorporated in legal documents and in financial reports required for conformity with GAAP may be described as legally approved plans of financial operations embodying the authorization of expenditures for specified purposes to be made during the budget period and the proposed means of financing them. The sequence of budget preparation in practice is often the same as the sequence in the preceding sentence: **Expenditures are planned first**; then **plans are made to finance the expenditures**.

Classification of appropriations and Expenditures

Recall that an appropriation, when enacted into law, is an authorization to incur on behalf of the governmental unit liabilities for goods, services, and facilities to be used for purposes specified in the

appropriation ordinance, or statute, in amounts not in excess of those specified for each purpose. When liabilities authorized by an appropriation have been incurred, the appropriation is said to be expended. Thus budgeted appropriations are often called **Estimated Expenditures**, and the appropriation budget is called the **Expenditures Budget**. According to the GASB Transfer, Revenue, Expenditure, and expense Account Classifications Principle, expenditures should be classified by (1) fund, (2) function or program, (3) organization unit, (4) activity, (5) character, and (6) object. The GASB Common Terminology and Classification principle should also be recalled at this time. It provides that a common terminology and classification should be used consistently throughout the budget, the accounts, and the financial reports of each fund.

1. Classification by Fund

The primary classification of governmental expenditures is by fund, since funds are the basic fiscal and accounting entity of a governmental unit. Within each fund, the other five classification itemized in the preceding paragraph are used to facilitate the aggregation and analysis of data to meet the objectives of financial reporting.

2. Classification by Function or Program

The GASB distinguishes between functions and programs in the following manner. **Functions** group related activities that are aimed at accomplishing a major service or regulatory responsibility. Examples of **Functional Classifications** commonly found are:

- General government
- Public safety
- Public Works
- Highways and streets
- Health and welfare
- Culture and recreation

Programs are group of activities, operations, or organizational units that are directed to the attainment of specific objectives. The budget can be summarized according to the following **Program Classification**:

- Policy formulation and Administration
- Protection of Persons and Property
- Environmental Protection
- Transportation
- Social enrichment opportunities
- Physical resource development

3. Classification by Organization Unit

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

- Police Department
- Fire Department
- Building Safety Department
- Public Works Department
- City Attorney
- City Clerk
- Personnel Department
- Parks and Recreation Department

The key distinction between classification of expenditures by organization unit and classification by program or function is that responsibility for a department is fixed, whereas a number of departments may be involved in the performance of a program or a function. Management control within a department, and rational allocation of resources within the governmental unit, both require much more specific identification of expenditures (and costs and expenses) than is provided by the major classifications. The next step needed is classification by activity.

4. **Classification by Activity – a**n activity is a specific and distinguishable line of work performed by organization unit. For example, within the Public Works Department, activities such as the following may be performed:
   - Solid waste collection–residential
   - Solid waste collection–commercial
   - Solid waste disposal–landfill (Burying)
   - Solid waste disposal–incineration (Burning)

Activity classification is more meaningful if responsibility for the performance of each activity is fixed, performance standards are established, and a good management accounting system is installed to measure **input of resources** (dollars, personnel time, equipment and facilities used) versus **output of services**. Such information is useful to those interested in assessing the efficiency of government operations. The GASB recommends that expenditures also be classified by character.

5. Classification by Character

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

- Current Expenditure
- Capital Expenditure
- Debt Service Expenditure

Current expenditures are expected to benefit the period in which the expenditure is made. Capital outlays are expected to benefit not only the period in which the capital assets are acquired but as many future periods as the assets provide service. Debt service includes payment of interest on debt and payment of debt principal; if the debt was wisely incurred, resident received benefits in prior periods from the assets acquired by use of debt financing, are receiving benefits currently, and will continue to receive benefits until the service lives of the assets expire.

Character classification of expenditures is potentially of great significance to taxpayers and other citizens. Properly used, it could give them valuable information for appraising the cost of government during a given period. Generally speaking, expenditures for debt service relate to actions incurred by previous administrations. Capital outlays are current expenditures expected to provide benefits in future periods; but the present statement of governmental accounting "Principles" does not allow depreciation expense to be recorded in governmental funds although, depreciation expense on general capital asset is reported in the **government wide statement of activities**. It appears that expenditures in the current expenditures class are the most influential on the public mind, strongly influencing popular attitudes toward responsible officials. A **fourth character** class, intergovernmental, is suggested by the GASB for use by governmental units that act as an intermediary in federally financed programs or that transfer "shared revenues" to other governmental units.

6. **Classification by Object –** the object of expenditure is the thing for which the expenditure was made. Object classes may be viewed as subdivisions of character classifications. One scheme of object classification includes the following major classes:
   - Personal services
   - Capital outlays
   - Supplies
   - Debt service
   - Other services and charges

Classification of Estimated Revenues and Revenues

In order for administrators to determine that proposed expenditures presented in the Appropriations budget can be financed by resources available under the laws of the budgeting jurisdiction and higher jurisdiction, a Revenues Budget should be prepared. **Revenue**, in the sense in which it is customarily used in governmental budgeting, includes all financial resource inflows—all amounts that increase the net assets of a fund—interfund transfers and debt issue proceeds, as well as well as taxes, licenses and permit fees, fines, forfeits, and other revenue sources,

It should be emphasized that a governmental unit, and the funds thereof, may raise revenues only from sources available to them by law. Often, the law that authorizes a governmental unit to utilize a given revenue source to finance general governmental activities, or specific activities, also establishes the maximum rate that may be applied to specified base in utilizing the source, or establishes the maximum amount that may be raised from the source during the budget period.

The **primary classification** of governmental revenue is by fund. Within each fund, the major classification is by source. Within each major source class, it is desirable to have as many secondary classes as needed to facilitate revenue budgeting and accounting. Secondary classes relating to each major source are discussed below under each source caption. Major revenue source classes commonly used are:

- Taxes
- Special assessments
- Licenses and Permits
- Intergovernmental revenues
- Charges for services
- Fines and forfeits
- Miscellaneous revenues

The revenues budget and the accounting system for each governmental fund should include all revenue sources available to finance activities of that fund. The general fund of most governmental units will ordinarily need **seven major classes itemized above**; although additional major classes may be needed. Each special revenue fund will need to budget and account for only those revenues legally mandated for use in achieving the purpose for which the special revenue fund was created. Similarly, debt service funds budget and account for those sources of revenue that are to be used for payment of interest and principal of tax-supported and special assessment long-term debt. Revenues and other financing sources earmarked for construction or acquisition of general capital assets are reported as being budgeted and accounted for by capital projects funds. In order to determine during a fiscal year that revenues are being realized from each budgeted source in amounts consistent with the budget actual revenues should be accounted for on the same classification system as used in the estimated revenues budget.

1. Taxes

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

Ad valorem (based on value) property taxes are a mainstay of financing for many units of local government but are not used as a source of revenue by many state governments or by the federal government. Ad valorem taxes may be levied against real property and personal property. Some property taxes are levied on a basis other than property values, one illustration being the tax on some kinds of financial institutions in relation to the deposits at a specified date. Other kinds of taxes are sales taxes, income taxes, gross receipts taxes, death and gift taxes, and interest and penalties on delinquent taxes. The valuation of **each parcel** of taxable real property, and of the taxable personal property owned by each taxpayer, is assigned by a process known as property assessment.

The assessment process is different from state to state and in some states by jurisdictions within the state. The tax rate is set by one of two widely different procedures:

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

(2) The property tax is treated as a residual source of revenue. In the latter event, revenues to be recognized from all sources other than property taxes must be budgeted; the total of those sources must be compared with the total proposed appropriations in order to determine the amount to be raised **from property taxes**.

Officials serves as an agent for all funds for which property taxes have been levied; the Taxes Receivable are properly accounted for as assets of the funds for which they are levied, and those funds recognize revenues from the taxes to the extent that the taxes are expected to be collectible.

Illustration: Computation of the total amount of revenues to be raised from property under the assumption that property taxes are a residual source of revenues.

Town of Jimma
General Fund
Statement of Amounts to be raised By Property Taxes for 2001
Hamle 1, 2000

Requirements:		
Estimated Expenditures for 2001		Br 4,200,000
Proposed appropriations for 2002		Br 8,460,000
Estimated beginning working balance for 2003		510,000
Total Estimated Requirements		Br13,170,000
Resources other than tax levy for 2002:		
Actual Balance Hamle 1, 2000	Br 654,000	
Installment form income taxes	2,430,000	
Miscellaneous Receipts	1,960,000	
Revenue form other sources	4,544,000	
Total Estimated Resources other than Property Tax		Br 9,582,000
Amount Required from Property Taxes in 2002		Br 3,582,000

Once the amount required from property tax is determined; the second step is the determination from historical data and economic forecasts of the percentage of the tax levy expected to be collectible. Even though property taxes are a lien against the property, personal property may be removed from the taxing jurisdiction and some parcels of real property may not salable enough for the taxing jurisdiction to recover accumulated taxes against the property. Therefore, the levy must be large enough to allow for estimated uncollectible taxes. For example, assume the Town of Jimma can reasonably expect to collect only **96 percent** of the year 2002 property tax levy for its General Fund. Thus, if tax revenue is to be Br 3,582,000, the gross levy must be Br 3,582,000 / 0.96, which is Br 3,731,250

When the gross levy is known, the tax rate may be computed on the basis of the assessed valuation of taxable property lying within the taxing jurisdiction. The term taxable property is used in the preceding sentence in recognition of the fact that property owned by governmental units and property used by religious and charitable organizations are often not taxable by the local government. In addition, some individuals may have statutory exemption from taxation for a limited portion of the assessed valuation of property. Assume net assessed valuation of property taxable by the General Fund of the Town of Jimma is Br 214,348,000. In that case, the gross property tax levy (Br 3,731,250) is divided by the net assessed valuation (Br 214,348,000) to determine the property tax rate. The rate would be expressed as Br 1.75 per Br 100 assessed valuation or rounding up the actual decimal fraction, it is 1.75%.

Interest and Penalties on Delinquent Taxes

A **penalty** is a legally mandated addition to a tax on the day it becomes delinquent (generally, the day after the tax is due). **Penalties** should be recognized as revenue when they are assessed. **Interest** at a legally specified rate also must be added to delinquent taxes for length of time between the day the tax becomes delinquent until the day it is ultimately paid or otherwise discharged; interest revenue should be accrued at the financial statements are to be prepared.

Sales Taxes, Income Taxes, and Gross Receipts Taxes – GASB Statement No. 33 provides that revenue from sales taxes, income taxes, and gross receipts taxes be recognized net of estimated refunds, in the accounting period in which underlying transactions occur.

2. Special Assessments

Special assessments differ from **ad valorem** real property taxes in that the latter are levied against all taxable property within the geographic boundaries of the government levying the taxes, whereas the former are levied against certain properties to defray part or all of the cost of a specific improvement

or service that is presumed to be of particular benefit to the properties against which the special assessments are levied. Briefly, when routine services (street cleaning, snow plowing, and so on) are extended to property owners outside the normal service area of the government, or are provided at a higher level or at more frequent intervals than for the general public, "service-type" special assessments are levied. **Service-type** special assessments are accounted for by the fund that account for similar services rendered to the general public—usually the **General Fund** or **Special Revenue Fund**. Special assessments for capital improvements should be accounted for by a capital projects fund during the construction phase and by debt service fund during the debt device phase.

3. Licenses and permits

Licenses and permits include those revenues collected by a governmental unit from individuals or business concerns for various rights or privileges granted by the government. Some licenses and permits are primarily regulatory in nature, with minor consideration to revenue derived, whereas others are not only regulatory but provide large amounts of revenue as well, and some are almost exclusively revenue producers. Licenses and permits may relate to the privilege of carrying on business for stipulated period, the right to do a certain thing that may affect the public welfare, or the right to use certain public property. Vehicle and alcoholic beverage licenses are found extensively on the state level and serve both regulatory and revenue functions. States make widespread use of professional and occupational licenses for purposes of control. Local governments make extensive use of licenses and permits to control the activities of their citizens; and from some they derive substantial amounts of revenue. Commonly found among licenses and permits are building permits, vehicle licenses, amusement licenses, business and occupational licenses, animal licenses, and street and curb permits.

Regardless of the governmental level or the purpose of a license or permit, the revenue it produces is ordinarily accounted for on a cash basis. Applicable rates or schedules of charges for a future period may be established well in advance, and fairly reliable information may be available as to the number of licenses or permits to be issued, but the probable degree of fluctuation in the latter factor is so great as to prevent satisfactory use of the accrual basis.

4. Intergovernmental Revenue

Intergovernmental revenues include grants and other financial assistance. Grants are usually intended for either operating or capital purposes. GASB standards provide the following definitions.

- **Grants and other financial assistance** are defined as transactions in which one governmental entity transfers cash or other items of value to [or incurs a liability for] another governmental entity, an individual, or an organization as a means of sharing program costs, subsidizing other governments or entities, or otherwise reallocating resources to the recipients
- A **capital grant** is a contribution or gift of cash or other assets restricted by the grantor for the acquisition or construction of fixed (capital) assets.
- An **operating grant** is one that is intended to finance operations or that may be used for either operations or for capital outlays at the discretion of the grantee.

Governmental funds generally should recognize such revenues when all time restrictions and eligibility requirements have been met and the resources are available to pay current period obligations. If a state or federal agency notifies a local governmental unit that a grant of a specified amount will be received at a specified date, and the pre ceding recognition rules are met, the local government should record the accrual of the revenue by debiting Due from state government or similar title and crediting Revenues. In other cases, recognition is not possible until cash is received.

5. Charges for services

Charges for services of the governmental funds (and governmental activities at the government-wide level) include all charges for goods and services provided by a governmental fund to enterprise funds, individuals and organizations, and other governments. A few of the many revenue items included in this category are *court costs*; *special police service*; *solid waste collection charges*

(unless accounted for in an enterprise fund); street, sidewalk, and curb repairs; receipts from parking meters; library use fees (but not fines); and tuition.

The grouping of charges for services revenue may be correlated with the functional classification of expenditures. For example, one functional group of expenditures is named general government, another public safety, and so on. A governmental unit, in connection with providing general government service, collects some revenue such as court cost charges, fees for recording legal documents, and zoning and subdivision fees and should relate the revenues to the expenditures. Charges for services should be recognized as revenue when earned, if that is prior to the collection of cash.

6. Fines and forfeits

Revenue from fines and forfeits includes fines and penalties for commission of statutory offenses and for neglect of official duty; forfeitures of amounts held as security against loss or damage, or collections from bonds or sureties placed with the government for the same purpose; and penalties of any sort, except those levied on delinquent taxes. Library fines are included in this category. If desired, fines and forfeits may be the titles of two accounts within this revenue class, or they may be subgroup headings for more detailed breakdowns.

Revenues of this classification should be accrued to the extent practicable. In direct contrast with general property taxes, neither rates nor base or volume may be predetermined with any reasonable degree of accuracy for this type of revenue. Because of these uncertainties, it is often difficult to determine whether all amounts paid by transgressors on the **cash basis** if accrual is not practicable.

7. Miscellaneous revenues

Although the word miscellaneous is not informative and should be used sparingly, its use as the title of a revenue category is necessary it (1) substitutes for other possible source classes that have rather slight and infrequent usage and (2) minimizes the need for forcing some kinds of revenue into source classifications in which they do not generically belong. While miscellaneous revenues in itself represent a compromise, its existence aids in sharpening the meanings of other source classes. The heterogeneous nature of items served by the title is indicated by the following listing: interest earnings (other than on delinquent taxes); rents and royalties; sales of, and compensation for loss of, capital assets; contributions from public enterprises (utilities, airports, etc.); escheats (taking of property in default of legally qualified claimants); contributions and donations from private sources; and “other”. Some items of miscellaneous revenues, such as interest earnings on investments, might well be accrued, but mostly they are accounted for on the cash basis.

3.5) Budgetary Accounting

At the beginning of the budget period, the estimated revenues control account is debited for the total amount of revenues expected to be recognized, as provided in the revenues budget. The amount of revenue expected from each source specified in the revenues badger is recorded in a subsidiary ledger detail agrees with the debit to the control account, and both agree with the adopted budget. If a separate entry is to be made to record the revenues budget, the general ledger debit to the estimated revenues control account is offset by a credit to **Fund Balance**. Recall that the fund balance account, before the budget is recorded, would normally have a credit balance representing the excess of fund assets over the total of liabilities and reserved fund equity—**referred to as a surplus**. If fund liabilities and reserved fund equity exceed fund assets, the fund balance account would have a **debit balance—referred to as a deficit**. After the revenues budget is recorded, fund balance represents the excess of *fund assets plus the estimated revenues and other financing sources for the budget period over liabilities and reserves*. The credit balance of the fund balance account, therefore, is the total amount available to finance appropriations. Consequently, the accounting entry to record the legally approved appropriations budget is a debit to fund balance and a credit to appropriations for the total amount appropriated for the activities accounted for by the fund. The appropriations control

account is supported by a subsidiary ledger kept in the same detail as provided in the appropriations ordinance, so that the total of the subsidiary ledger detail agrees with the credit to the appropriations control account, and both agree with the adopted budget.

The use of budgetary accounts permits comparison of actual revenues and expenditures to budgeted amounts. Budgetary control is further enhanced by clear and logical classification of revenues and expenditures, and by formally recording the budget in the accounts of the general fund and other funds for which a budget is approved. The use of subsidiary ledgers, which permit recording revenues and expenditures—both actual and budgeted amounts –in the same level of detail as the budget, also helps to achieve sound budgetary control.

Recording the budget

In order to illustrate entries in journal form to record a budget, assume the amounts shown below are the amounts that have been legally approved as the budget for the General Fund of a certain governmental unit for the fiscal year ending December 31, 2001. As of January 1, 2001, the first day of the fiscal year, the total Estimated Revenues should be recorded in the General Fund general ledger control account, and the amounts expected to be recognized during 2001 from each revenue source specified in the budget should be recorded in subsidiary ledger accounts. An appropriate entry would be:

	General Ledger		**Subsidiary Ledger**	
	Debits	Credits	Debits	Credits
1. Estimated Revenues	1,277,500			
Fund Balance		1,277,500		
Revenues Ledger:				
Taxes			882,500	
Intergovernmental Revenues			200,000	
Licenses and Permits			195,000	

The total Appropriations and Other Financing Uses legally budgeted for 2001 for the General Fund of the same governmental unit should also be recorded in the General Fund general ledger control accounts, and the amounts appropriated for each function itemized in the budget should be recorded in subsidiary ledger accounts. An appropriate entry using assumed budget amounts would be:

	General Ledger		**Subsidiary Ledger**	
	Debits	Credits	Debits	Credits
2. Fund Balance	1,636,500			
Appropriations		1,362,000		
Estimated Other Financing Uses		274, 500		
Appropriation Ledger:				
General Government				1,150,00
Public Safety				212,000
Other Financing Uses Ledger:				
Interfund Transfer Out to Other Funds				74,500
Interfund Transfer Out to Component Units				200,000

It would, of course, be acceptable to combine the two entries illustrated above and make one General Fund entry to record Estimated Revenues, Appropriation, and Estimated Other Financing Uses; in this case there would be a debit to Fund Balance for $359,000 (the amount by which Appropriations and Estimated other Financing uses exceed Estimated Revenues). Even if a single combined entry is made in the General Fund general ledger accounts, that entry must provide for entry of the budgeted amounts in each individual subsidiary ledger account as shown in the illustrations of the two separate entries.

Budgetary Control of Revenues

In the preceding section, entries to record the budget in general ledger accounts and in subsidiary ledger accounts are illustrated. During a fiscal year, actual revenues should be recognized in the general ledger accounts of governmental funds by credits to the Revenues accounts (offset by debits to receivable accounts for revenues that are accrued or by debits to Cash for revenues recognized on the cash basis). The general legers revenues account is a control account supported by Revenues subsidiary ledger accounts kept in exactly the same detail as kept for the Estimated Revenues subsidiary ledger accounts. For example, assume the General Fund of the governmental unit for which budgetary entries are illustrated in the preceding section collected revenues in cash during the month of January from Licenses and Permits, $13,200, and Intergovernmental Revenues, $61,900. In an actual case, entries should be made on a current basis and cash receipts should be deposited each working day; however, the following entry illustrates the effect on the General Fund accounts of collections during the month of January 2001:

	General Ledger		Subsidiary Ledger	
	Debits	Credits	Debits	Credits
3. Cash	75,100			
Revenues		75,100		
Revenues Ledger:				
Licenses and Permits				13,200
Intergovernmental Revenues				61,900

Comparability between Estimated Revenues subsidiary accounts and revenues subsidiary accounts is necessary so that periodically throughout the fiscal year actual revenues from each source can be compared with estimated revenues from that source. Material differences between estimated and actual revenues should be investigated by administrators to determine whether (1) estimates were made on the basis of assumptions that may have appeared realistic when the budget was prepared but are no longer realistic (in that event, the budget needs to be revised so that administrators and legislators have better knowledge of revenues to be realized during the remainder of the scale year), or (2) action needs to be taken so that revenues estimated with reasonable accuracy are actually realized (i.e., One or more employees may have failed to understand that certain revenue items are to be collected). Illustration 3-5 shows a form of Revenues subsidiary ledger in which the debit column is subsidiary to the Estimated Revenues general ledger control account and the credit column is subsidiary to the Revenues general ledger control account.

Illustration: Budgetary Control of Revenues

NAME OF GOVERNMENTAL UNIT
REVENUES LEDGER
GENERAL FUND

Class: Licenses and Permits — Number: 351.1
Subclass: — Title:

Date	Item	Reference	Estimated Revenues DR	Revenues CR.	Balance DR. (CR)
2001 January 1	Budget Estimate	J1	$195,000		$195,00
January 31				$13,200	181,800

Budgetary Control of Encumbrances and Expenditures

When enacted into law, an appropriation is an authorization for administrators to incur o behalf of the governmental unit liabilities in the amounts specified in the appropriation ordinance or stature, for the purposes set forth in that ordinance or

Statute, during the period of time specified. An appropriation is considered expended when the authorized liabilities have been incurred. Because penalties are imposed by law on an administrator who incurs liabilities for any amount in excess of that appropriated, or for any purpose not covered by an appropriation, or who incurs liabilities after the authority to do so has expired, prudence dictates that each purchase order and each contract be reviewed before it is signed to determine that a valid and sufficient appropriation exists to which the expenditure can be charged when goods or services are received. If the review indicates that a valid appropriation exists and it has an available balance in excess of the amount of the purchase order or contract being reviewed, the purchase order or contract legally many be issued. When a purchase order or contract being reviewed, the purchase order or contract legally may be issued. When a purchase order or contract has been issued it is important to record the fact that the appropriation has been encumbered in the amount of the purchase order or contract being reviewed, the purchase order or contract legally may be issued. When a purchase order or contract has been issued it is important to record the fact that the appropriation has been encumbered in the amount of the purchase order or contract. The word encumbered is used, rather than the word expended, because the amount is only an estimate of the liability that will be incurred when the purchase order is filled or the contract executed. (It is reasonably common for quantities of goods received to differ from quantities ordered, and it is not uncommon for invoice prices to differ from unit prices shown on purchase orders). The use of appropriation authority is also somewhat tentative inasmuch as some suppliers are unable to fill orders or to perform as stipulated in a contract: in such cases, related purchase orders or contracts must be canceled.

Notice the issuance of purchase order and/or contracts has two effects: (1) the encumbrance of the appropriation (s) that gave the governmental unit the authority to order goods or services and (2) the starting of a chain of events that will result in the government incurring a liability when the purchase orders are filled and the contracts executed. Both effects should be recorded in order to assist administrators to avoid over expending appropriations and to plan to be able to pay liabilities on a timely basis. The accounting procedure used to record the two effects is illustrated by Entry 4. The first effect is recorded by the debit to the general ledger account Encumbrances. Encumbrances is a control account that is related to the Appropriations control account discussed previously and to the Expenditures control account discussed in relation to Entries 5a and 5b. In order to accomplish the matching of Appropriations, Expenditures, and Encumbrances necessary for budgetary control, subsidiary account classifications of all three must correspond exactly. The general ledger account credited in Entry 4. Reserve for encumbrances, is used to record the second effect of issuing purchase orders and contracts the creation of an expected liability. Reserve for Encumbrances, some times called outstanding encumbrances, is not a control account; the balance of the account at the balance sheet data is reported as a reservation of Fund Equity.

Entries 4, 5a, and 5b illustrate accounting for Encumbrances and Expenditures for the General Fund of the governmental unit for which entries are illustrated in previous sections of this chapter. Entry 4 is made on the assumption that early in January purchase orders are issued pursuant to the authority contained in the General Fund appropriations; assumed amounts chargeable to each function for which purchase orders are issued on this data are shown in the debits to the Encumbrances subsidiary accounts.

	General Ledger		**Subsidiary Ledger**	
	Debits	Credits	Debits	Credits
4. Encumbrances-2001	45,400			
Reserve for Encumbrances -2001		45,400		
Encumbrances Ledger:				
General Government				38,000
Public Safety				7,400

When goods or services for which encumbrances have been recorded are received and the suppliers' invoices are approved for payment, the accounts should record the fact that appropriations have been expended, not merely encumbered, and that an actual liability, not merely an expected liability, exists. Entry 5a reverses Entry 4 to the extent that purchase orders are filled (ordinarily some of the purchase orders recorded in one encumbrance entry will be filled in one time period, and some in other time periods); it is important to note that since estimated amounts were used when encumbrances were recorded, the reversing entry must also use the estimated amounts. Thus the balance remaining in the encumbrances control account, and in the reserve for encumbrances account, is the total estimated dollar amount of purchase orders and contracts outstanding. The estimated dollar amount of purchase orders outstanding against each appropriation is disclosed by the subsidiary accounts.

	General Ledger		**Subsidiary Ledger**	
	Debits	Credits	Debits	Credits
5a. Reserve for Encumbrances-2001	42,000			
Encumbrances -2001		42,000		
Encumbrances Ledger:				
General Government				35,000
Public Safety				7,000
5b. Expenditures—2001	42,400			
Vouchers payable.....		42,400		
Expenditures Ledger:				
General Government				35,100
Public Safety				7,300

Expenditures and the liability account must both be recorded at the actual amount the governmental unit agrees to pay the vendors who have filled the purchase orders (see entry 5b). The fact that estimated and actual amounts differ causes no accounting difficulties as long as goods or services are received in the same fiscal period as ordered.

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

It should be apparent that administrators of governmental units need accounting systems designed to provide at any given date during a fiscal year comparisons for each item in the legal appropriations budget of (1) the amount appropriated, (2) the amount of outstanding encumbrances, and (3) the cumulative amount of expenditures to this date. The net of the three items is accurately described as "unencumbered unexpended Appropriations" but can be labeled more simply as "available appropriations" or "available balance." In order to provide needed comparisons, classification of expenditures and encumbrances must agree with the classifications of appropriations mandated by law. In many jurisdictions, good financial management may dictate all three elements be classified in greater detail than required by law.

The Illustration below shows a form of subsidiary ledger that supports all three general ledger control accounts: appropriations, expenditures, and encumbrances. At intervals during the fiscal year, a statement of budgeted and actual expenditures and encumbrances should be prepared to inform administrators and members of the legislative branch of the data contained in the subsidiary ledger records

Illustration: Budgetary Control of Expenditures

NAME OF GOVERNMENTAL UNIT
APPROPRIATIONS, EXPENDITURES, AND ENCUMBRANCES CONTROL
GENERAL FUND

Year: 2001

Code No. 0607 03
Fund: General
Function: General Government

Month and Day	Reference	**Encumbrances**			**Expenditures**		**Appropriations**	
		DR.	CR.	Open	DR.	Cum. Total	DR.	Available Balance
January 2	Budget (Entry 2)						$1,150,000	$1,150,000
	PO Issued (Entry 4)	$38,000		$38,000				1,112, 000
	Invoices Approved (Entries 5a & 5b)		35,000	$3,000	35,100	35,100		1,111,900

Accounting for Allotments

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

Allotments may be formally recorded in ledger accounts. This procedure might begin with the budgetary entry, in which Unallotted appropriations would replace appropriations. If this is desired, a combined entry to record the budget would be (using the numbers given in Entries 1 and 2, omitting entries in subsidiary accounts—which would be as illustrated previously, except the subsidiary ledger credits in Entry 2 would be designated as **Unallotted Appropriations** instead of appropriations):

	General Ledger		**Subsidiary Ledger**	
	Debits	Credits	Debits	Credits
Estimated Revenues	1, 277,500			
Fund Balance	359,000			
Unallotted Appropriations		1,362,000		
Estimated Other Financing Uses		274, 500		

If it is assumed that $342,000 is the amount formally allotted for the first period, the following entry could be made and amounts allotted for each function are shown in the subsidiary ledger entries:

	General Ledger		**Subsidiary Ledger**	
	Debits	Credits	Debits	Credits
Unallotted Appropriations	342,000			
Allotments		342, 000		
Allotments Ledger:				
General Government				289,000
Public Safety				53,000

Illustration 2:

Town of Adama involves the following budgetary transactions during Fiscal Year / Budget Year 2001.

1. It budgeted or estimated revenues of Br 500,000 which includes Br 300,000 taxes, Br 60,000 license and permits; Br 40,000 intergovernmental revenues; Br 50,000 service charges; Br 30,000 fines and forfeits; and Br 20,000 miscellaneous revenues.
2. It budgeted expenditure (appropriation) of Br 450,000 which comprised of Br 120,000 General Government; Br 150,000 Public Safety; Br 100,000 Public Works: and Br 80,000 Sport and Culture
3. Br 4,000 Hall Rent and Br 5,000 Park Service Revenue is earned and collected as per Cash Receipts Journal Page 1 and Page 2, respectively.
4. City of Adama Police Office Order a new Printer on Meskerem 10, 2001 which had a list price in the supplier's catalog Br 10,000
5. The City Police Office received the Printer on Meskerem 24, 2001

Instruction: Record the foregoing budgetary and operating transactions and show budgetary control over revenues; and over encumbrances and expenditures

Illustration 3:

1. Assume the forgoing budgetary and operating transactions except that the government uses allotment system. The Town Council allotted Br 100,000 for the first three months which comprises Br 30,000 public safety; Br 30,000 public works; Br 20,000 General Government; and Br 20,000 Culture and Recreation.

Instruction: Record the above transactions and show budgetary control using the subsidiary ledger account.

Computerized Accounting Systems

- Computerized accounting systems have evolved to meet the fund accounting needs of government
- Revenue and expenditure classifications are achieved through the use of an account number having different segments or fields
- A current challenge is redesigning fund-based accounting information systems to accommodate the government-wide accounting and financial reporting required by GASBS 34

3.6) Budgeting and Its Usefulness in Government Organization

Budgeting has a greater role in governmental accounting than in For-Profit Accounting. Budgets in profit making enterprises are usually fairly flexible, and can be changed as conditions warrant during the year. In a For-Profit Enterprise, money is spent for the purpose of making more money. As long as the For-Profit Enterprise is profitable, the specific purpose of the spending doesn't matter so much, as long as it is helping to contribute to the bottom line. Similarly, if it is felt that a particular usage of money is not generating additional profits, and then spending money on that item can ceased. The profit motive provides the guide to employ resources in the "right" way.

On the other hand, governments have no profit motive to guide the resources represented by their budgets into the "right" usage. Therefore, they rely on legal requirements to insure that money is used for the appropriate purpose. Governmental budgets, once fixed by law for the year, are generally unchangeable without much effort. Altering or exceeding the budget typically carries severe penalties for the administrator who does so. Given the unchanging nature of government budgets, and the penalties for non-compliance, it logically follows that the accounting system should support the budget. The accounting system, at the very least, should give the necessary information for keeping within the budgetary restrictions.

The primary usefulness of For-Profit Enterprise budgets is planning, i.e. "What resources do we have, and how can we plan to spend them in order to maximize profit?" In governments also, the budget is also used for planning, especially in clarifying priority goals. However, government administrators often overlook the planning aspects of a budget and use the government budget primarily as a control

device**.** The government will have certain objectives, and it assigns resources – money, personnel, etc. – for the accomplishment of those objectives. The budget is a way of controlling the assigned resources; ensuring that they are used for the intended purpose. In addition to the primary use of control and the secondary use of planning, the budget provides *information* to decision-makers and indicates to the public what *decisions* have been made about the objectives of the government.

Classification of Budget

Federal, State and local governments prepare and utilize different budgets. Thus, Budgets are classified differently considering dimensions such as Expenditure Program, Legal Status; Flexibility; Source on Finance; and Preparers. Budgets are classified as Capital or Current based on the Expenditure Program; Tentative or Enacted based on legal status; General or Special based on source of Finance; Flexible or Fixed budget based on flexibility; and Executive or Legislative based on preparers of budget.

1. Current or Capital Budget

Current budgets, of course, are concerned with the current year's operating expenditures, sometimes called Recurrent Expenditures or Operating Budget, because similar sorts of expenditures are needed year after year. **Current Expenditures includes** money spent to pay for goods or services. The current expenditures include salaries, wages, repairs and maintenance, telephones, petrol, stationery. Current Expenditures are categorized in two large groups: Salary and Benefits and Non-salary. Non-salary is also called Operating and Maintenance. O&M includes expendable materials and supplies, travel, repair and maintenance.

Capital budgets, obviously, deal with the acquisition of fixed assets. The legislature will likely to plan for the acquisitions fixed assets several years in advance which is called the Capital Program. This is very helpful to wise management of resources. The Capital Program is accomplished by incurring Capital Expenditure which means an outlay for the acquisition of or improvement of fixed assets, and includes expenditures made for Consultancy services. The following expenditures, for more than Br. 200.00, require capital budget in Ethiopia:

- The acquisition, reclamation, enhancement or laying out of land exclusive of roads, buildings or other structures
- The acquisition, construction, preparation enhancement or replacement of roads, buildings or other structures
- The acquisition, installation or replacement of moveable or immovable plant, machinery and apparatus, vehicles and vessels.
- The making of advances, grants or other financial assistance to any person towards expenditure incurred or to be incurred by him/her on the matters mentioned in the three above paragraphs.
- The acquisition of share capital or loan capital in any body corporate. Any associated consultancy costs of all of the above

2. Tentative or Enacted Budget – As the name implies, **tentative budget** is a budget which is in still in process. This budget has not yet been officially approved. An **enacted budget** has been officially approved and is a binding legal document. The Enacted Budget creates accountability for executives.

3. Fixed or Flexible Budget – A fixed budget are those in which appropriation is fixed for total amount Br. and the expenditure cannot be exceeded. A flexible budget, on the other hand, fixes the cost per unit of goods and services. If more units of goods and services are desired because of a change in circumstances or need, the dollar amount of a flexible budget can be increased.

4. General or Special Budget – the budgets of "General Government" Activities which are commonly financed through the General Funds are referred to as General Budget. In Ethiopia, the Consolidated Fund is a General Fund which finances general government activities. "Consolidated Fund" means all public moneys that are on deposit at the credit of any public body where the bank account has been opened by the Ministry of Finance under Proclamation No. 17/1995; all public

moneys held in cash by any public body pending disbursement; and all aid in kind. A budget prepared for any other fund is referred to as a Special Budget.

5. Executive or Legislative Budget – budgets are also categorized by preparers. Budget preparation is an executive function, though the legislative may revise the budget prior to approval. In some instances, however, the legislative branch prepares the budget, possibly subject to executive vote; in other instances, the budget may originate with joint legislative-executive committee (possibly with citizen representatives) or with a committee composed solely of citizens or constituents. Such budgets are frequently referred to by terms such as "Executive Budget," "Legislative Budget," "Joint Budget," and "Common Budget," respectively.

Approaches to Budgeting

There are two approaches to budgeting: Modern and Traditional. The modern approach to budgeting is sometimes called Rational Approach to Budgeting. That is because they all advocate ***thinking carefully*** about the relationship of inputs to outputs, with a special concern for the outputs. Outputs are the goods or services actually provided, inputs are the resources that go into to providing those goods or services. Thinking carefully also involves analyzing the costs and benefits of alternative methods of achieving objectives. The idea that law-making bodies should focus on *broad policy* objectives rather than *details* of spending for particular departments is emphasized. Long-term, ultimate goals are stressed rather than annual budget requests. Attention is directed to continual evaluation of services which are being performed. The three modern approaches to budgeting are Performance Budgeting; Planning-Programming-Budgeting (PBB); and Zero-Base-Budgeting (ZBB).

1. Modern Approaches to Budgeting

A. Performance Budgeting – the performance budget focuses on the outputs generated by the department or organizational unit, rather than looking primarily at the cost of the inputs. The performance budget is mainly concerned with only one year at a time. Basically, the process of making the budget may be summarized as follows and the process is similar to the flexible budget:

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

For Example, a prison holds 1,000 prisoners. The cost of keeping a prisoner is estimated at $5,000 per year. The budget for the prison for 1999 then would be $5,000,000 for a year. However, if the prison actually imprisoned 800 prisoners in 1999, then the budget would be reduced to $4,000,000, and the head of the prison would be expected to return the extra $1,000,000.

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

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

Limitations of the Modern Approaches to Budgeting

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

2. Traditional Approaches to Budgeting

For the reasons stated above, the modern approaches have not been adopted as widely as might be expected. The traditional approach to budgeting is called Object-of-Expenditure (OOE) and it is still the most widely used. It is also called Line-item Expenditure Budgeting. That is, items are listed line by line along with the appropriation to have inbuilt control in the budgeting system. The aim of the OOE budget is controlling expenditures. The OOE is not so concerned about the number or quality of outputs generated by the spending; it is concerned with the item purchased. Applied to the context of a university, OOE would be more concerned with making sure each department used no more than its supply of paper, rather than with the quality of education given, or the number of diplomas and degrees awarded. The objective of the OOE budget is to simply list expected expenditures, and then say how much is required for each one. A Federal Government of Ethiopian budget is a typical example of OOE budgeting.

3.7) Budgeting Process in Ethiopia: Historical Sketch and the Current Scenario

The first mention of a governmental budget in Ethiopian law was in the 1931 constitution, in Article 55. The 1931 constitution was superseded in 1955 by revised constitution. The first governmental budget appeared at the end of 1944 and covered the fiscal year 1945. A budget also was published for 1946, but this second budget appeared only a little more than a week before the end of the year that it covered. After lapse of seven years in which no budget of any kind appeared, a form of budget was published for 1953 as notices of Ministry of Finance. It could not be regarded as proper budget, however, as it appeared after the end of the year and took the form of ministerial notice rather than a statute enacted by a parliament and approved by the emperor. It thus was more in the nature of a statement of governmental revenues and expenditures for previous year, probably partly actual and partly estimated.

The next budget to be published was for 1958, and that year can be considered the turning point in the development of the Ethiopian budget. The 1958 budget in the proper sense of the word is an estimate of anticipated revenues and expenditures that could be used as an instrument of fiscal control. It was enacted by parliament and issued as a proclamation, as required by the revised constitution of 1953. In addition, it marked the beginning of the period of uninterrupted annual enactment of a governmental budget

Budget Cycle in Ethiopia

Budget is a mechanism for transferring funds to governmental body and a procedure for controlling that body's activities. It represents both a statement of resources to be made available and a statement of planned future operations. The successive stages in budgeting are known as the budget cycle. Budget cycle in general involves the Preparation (Formulation); Review & Approval (Authorization); and Execution of the annual budget. In Ethiopia, budgets are prepared according to an authoritative budget calendar. The calendar will schedule the seven phases of budgeting: (1) Call, (2) Request, (3) Recommendation, (4) Approval, (5) Notification, (6) Operation and (7) Execution.

The **first phase**, Call, is when the coordinating MOFED ask each public body to prepare a budget request and would provide the budget ceiling for the public body. The **second phase**, Request, is when public bodies submit their request for recurrent and capital expenditure to the Ministry of Finance and Economic Development. The **third phase**, Recommendation, is a review by the MOFED of the agency requests and then a recommendation for each agency based on a recommended ceiling for the total capital and recurrent budget. The **fourth phase**, Approval, has two stages: approval by the Council of Ministers and approval by the Council of Peoples' Representatives (the Parliament). **Phase five** is Notification where the MOFED notify the public bodies of their approved estimates of revenue and expenditure by class of account and line item. The **sixth phase** of budgeting, Operation, has three tasks: (I) Preparation of action plans for financial and physical implementation which are submitted to MOFED and the Prime Minister's Office (PMO); (II) the elaboration of these action plans for internal use to implement the budget; and (III) the establishment of an operating budget linked to accounts for financial control. The **seventh phase** of budgeting is Execution which has three tasks: (I) Request and adjustment for transfers and supplementary allocations; (II) Preparation of a monthly report on the financial and physical action plans to the MOFED and the PMO; and (III) identification of Transfers[2]

Overview of the FGE Budgeting, Treasury and Accounting Processes

In FGE, there are four different processes each of them having distinct activities. These processes are Budget Request and Approval process; Annual Distribution of the Authorized Budget; Monthly FGE Reporting Flows and Annual FGE Financial Reporting which are presented in the diagram below.

Annual FGE Budget Request and Approval Process

1. Yearly budget request from budgetary institution to the ministry of finance budget department
2. Complied yearly FGE budget request is submitted by the Ministry of Finance Budget to the Prime Minister's Office
3. The FGE budget is submitted By The Prime Minister's To The Council Of Peoples' Representatives

Annual Distribution of the Authorized Budget

4. The annual FGE budget is approved by the Council of Peoples' Representatives and published in the Negarit Gazeta.
5. The approved budget is distributed to MOFED Audit, Treasury and Budget Department
6. Notification of the FGE budget detail is forwarded to Accounts, Treasury and Budgetary Institutions. The budget detail is recorded in the prescribed form.

FGE Reporting Flows

7. Monthly cash request are submitted by Budgetary Institution to the Treasury (Cash Disbursing and Collection Department of the MOFED). Treasury verifies the request and compares the requests with the authorized budget
8. Monthly distribution from Treasury to Budgetary Institutions. Distribution reported to Accounts.
9. Monthly receipts and expenditures reports forwarded by Budgetary Institutions to Accounts. This is verified against in the Negarit Gazeta, budget transfers and/or additions and the monthly Treasury Reports.
10. Requests and approved budget transfers and additions are forwarded by Budget Department to Budgetary Institutions, Accounts and Treasury.

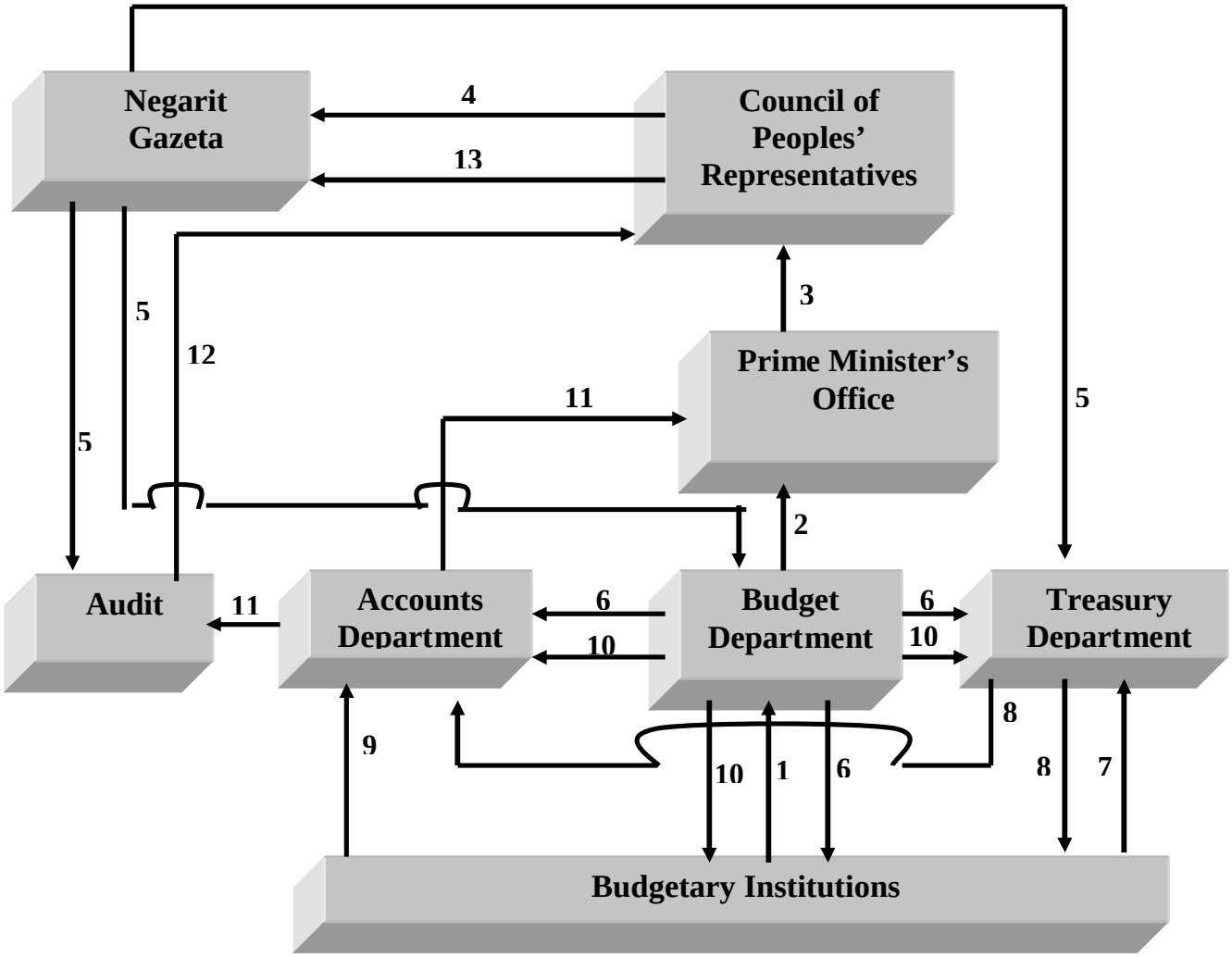
Annual FGE Financial Reporting

11. Annual financial report forwarded by Accounts to Auditor General and the Prime Minister's Office

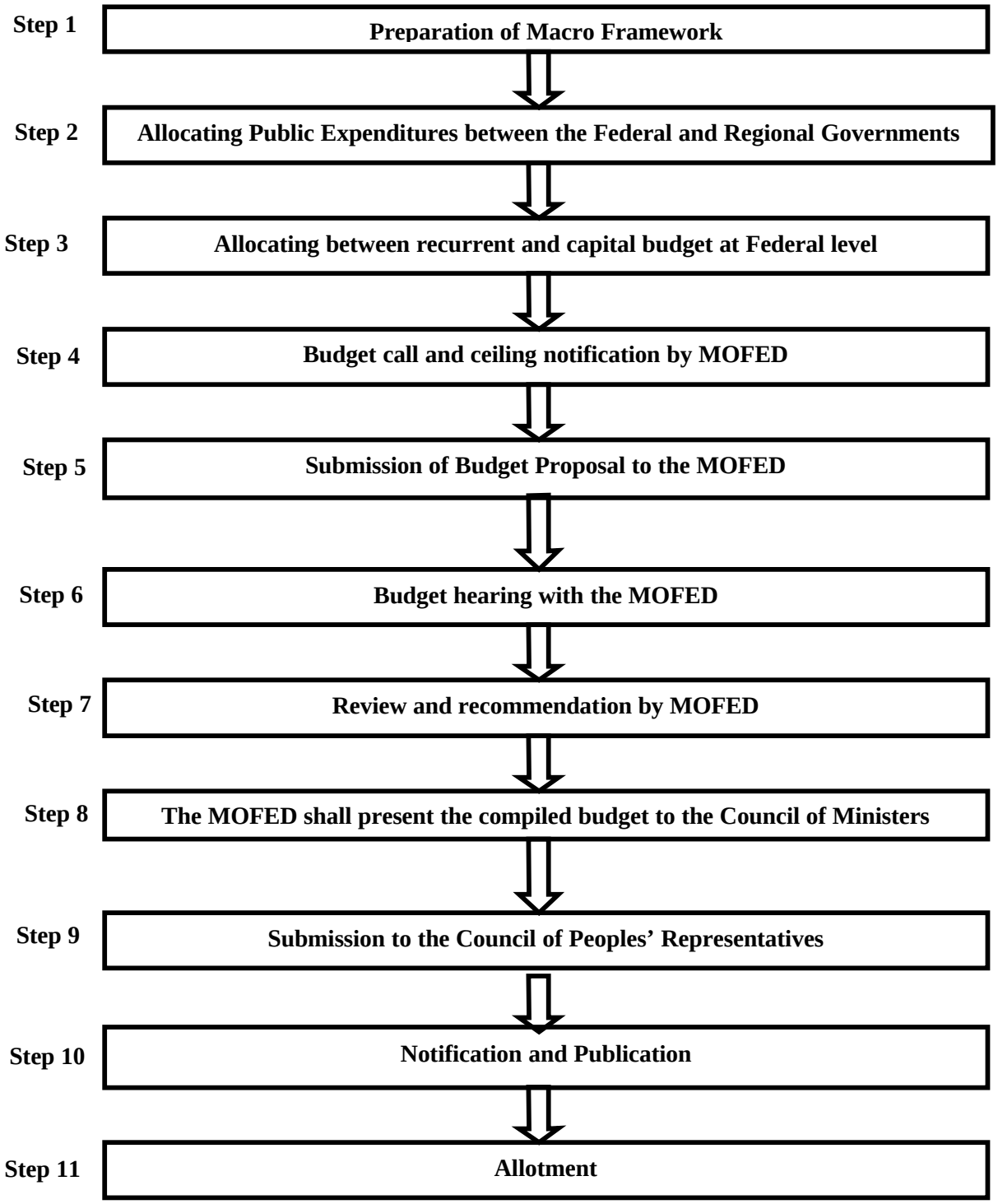
[2] Budget Policy Paper, September 25, 1998

12. The audited financial statement if forwarded by Audit to the Council of Peoples' Representatives
13. The approved audited annual financial statements are published in the Negarit Gazeta.

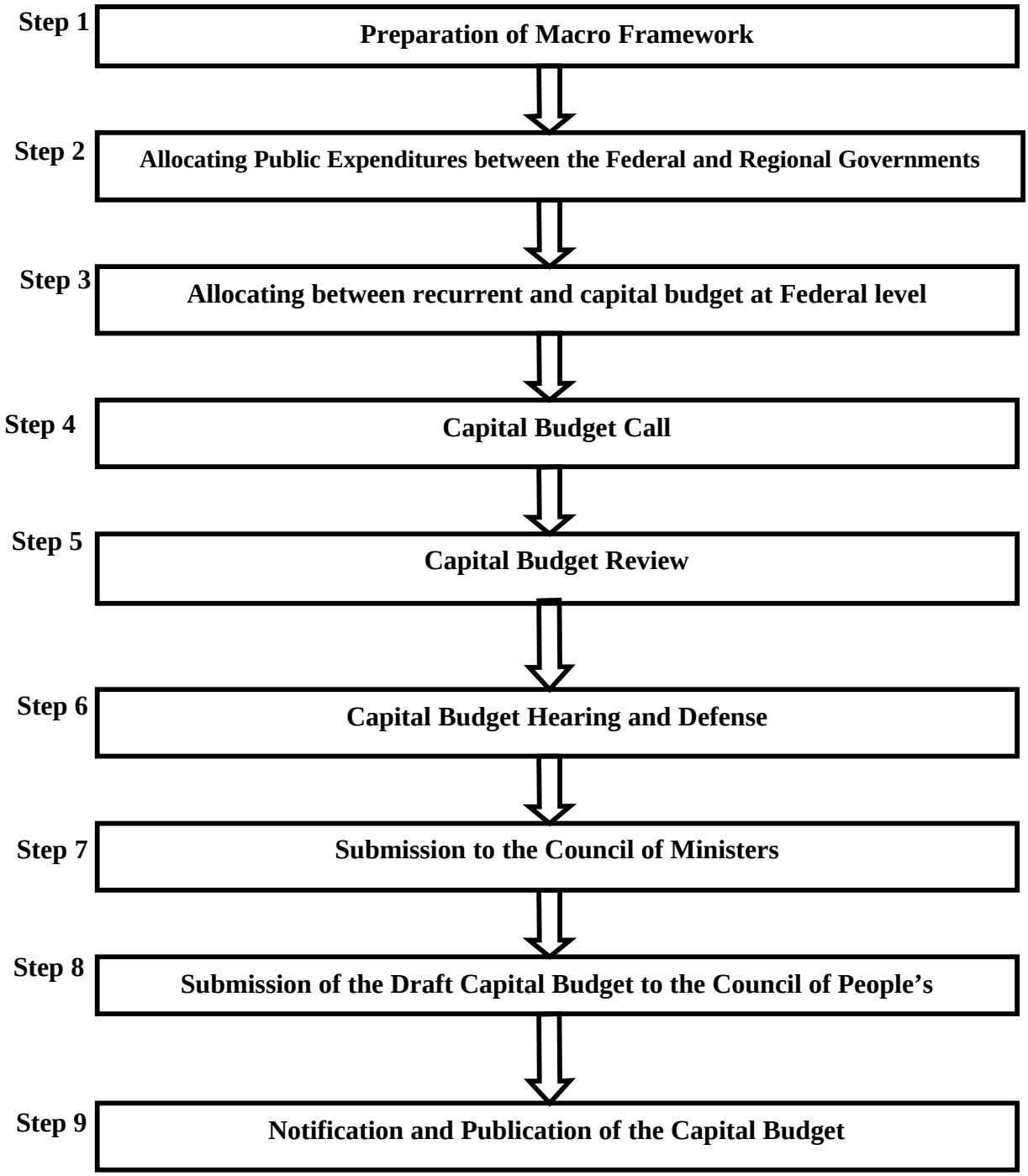
Overview of the FGE Budgeting, Treasury and Accounting Processes



Preparation of Recurrent Budget at Federal level by MOFED

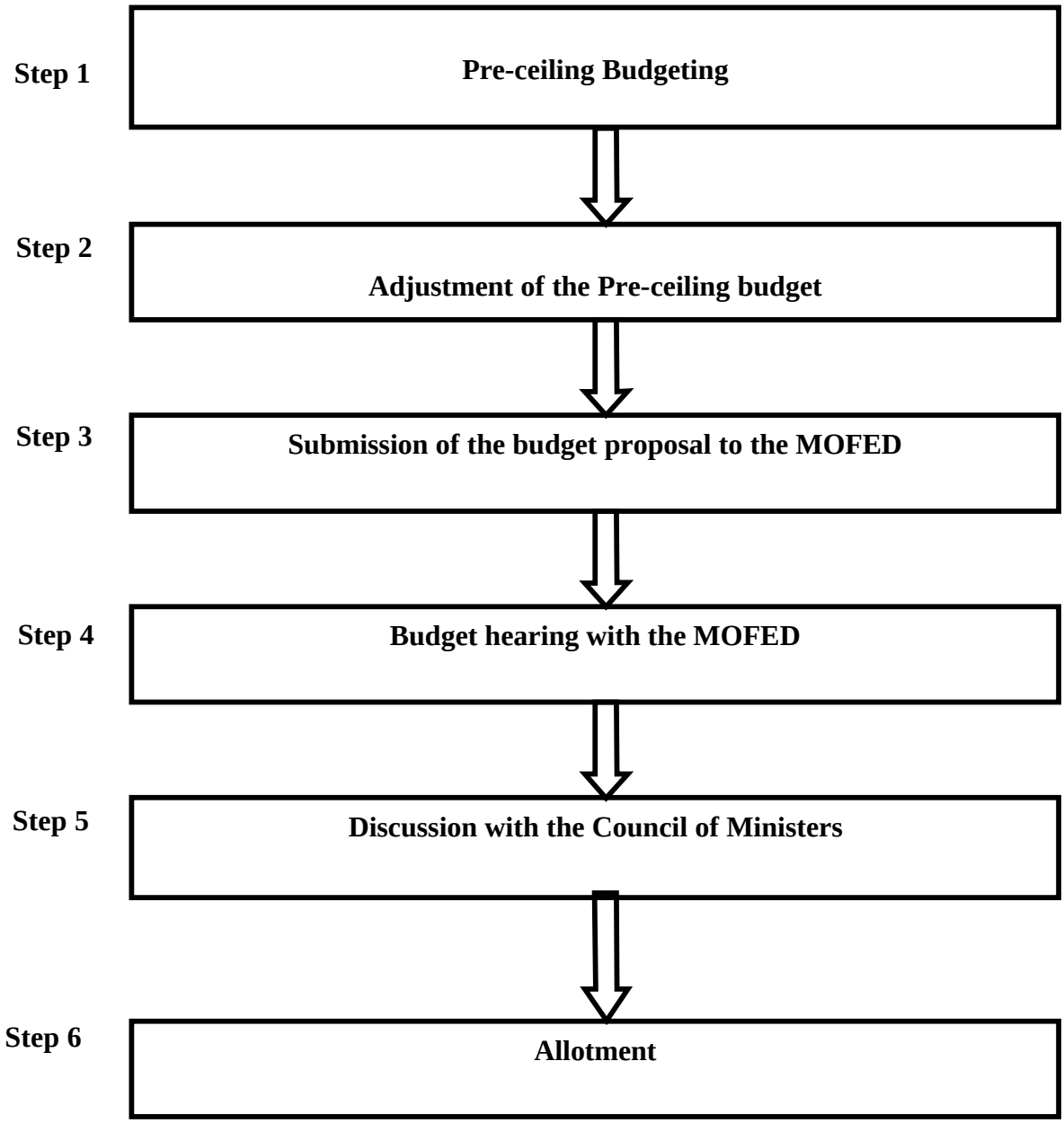


Preparation of Capital Budget at Federal level by MOFED



Sample Recurrent Budgeting by Federal Level Spending Public Body

The recurrent budget is prepared in federal spending bodies by their Administration and Finance Departments. The following description is based on the practice of Ministry of Education but the process broadly similar in all spending public bodies. The process is outlined in the following figure.



Preparation of Recurrent Budget at Regional level by ANSG - BOFED

Step 1 Pre-ceiling budgeting by Woredas

Step 2 **Review of woreda pre-ceiling budgets by Zones**

Step 3 **Review of zone pre-ceiling budgets by regions**

Step 4 **Determination of the regional expenditure envelop**

Step 5 **Allocation of the regional envelop between capital and recurrent expenditure**

Step 6 **Allocation of the recurrent budget between Salary and O & M**

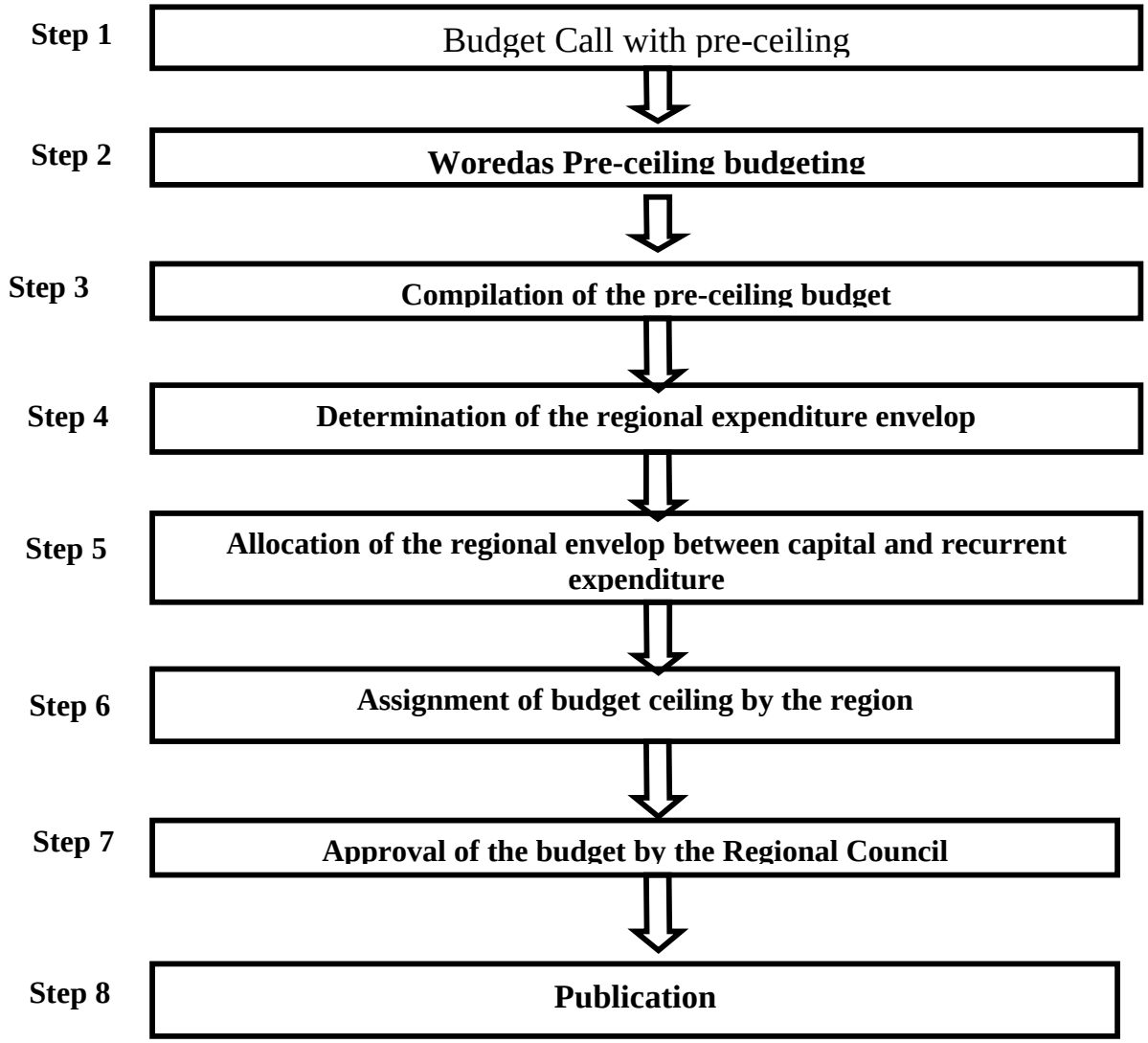
Step 7 **Allocation of Salary and O & M from regional Council to Zones**

Step 8 **Allocation of Salary and O & M from Zone Council to Sectoral Departments**

Step 9 **Allocation of the salary and O & M from woreda council to woreda sectoral offices**

Step 10 **Publication**

Preparation of Capital Budget at Regional level by SNNPSG – BOFED



3.8) Legal Basis of the Federal Government of Ethiopia (FGE) Accounts

The following are legal basis of FGE accounts:

1. Article 55 of the constitution of the Federal Democratic Republic of Ethiopia recognizes that a modern and efficient financial administration system is essential to a well-functioning government

2. Proclamation No.57/1996 – pursuant to Article 55 of the constitution of Federal Democratic Republic of Ethiopia, the Council of Peoples' Representatives determined it was necessary to set out the basic concepts, principles and elements that govern the management of financial resources in the FGE.

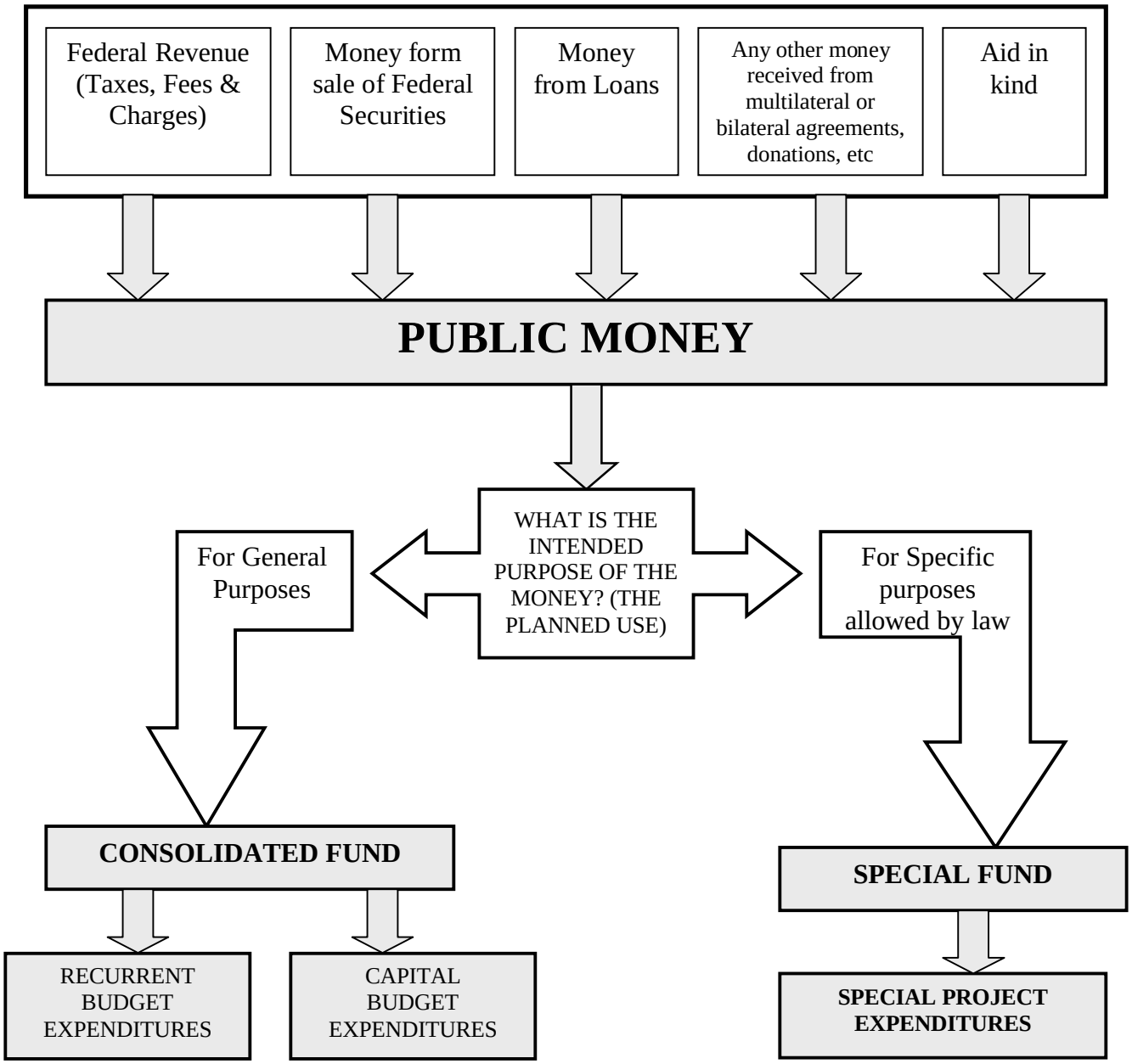
3. Regulation No.17/1997 – the regulations are issued by the Council of Ministers pursuant to Article 5 of the definition of Powers and Duties of Executive Organs of the FGE, Proclamation No. 4/1995, and Article 68 of FGE Proclamation No. 57/1997

4. Directives – pursuant to Proclamation No.57/1997 and Regulations No. 17/1997, the Ministry of Finance is authorized to issue Directives. Six directives issued by the Ministry of Finance are:

- A directive for "Retention of Financial Records

- A directive for "Debt Management and Investment"
- A directive for "Financial Responsibilities of Members of Public Bodies"
- A directive for "Fees and Charges"
- A directive for "Public Property"
- A directive for " Procurement and contracts"

General View of Public Money in Ethiopia at Federal Level



Flow of Public Money Into and Out of the Consolidated Fund

BUDGETARY

Revenues:
- Direct taxes /Acct 1100/
- Indirect taxes /Acct 1200/
- Foreign Trade Taxes /Acct 1300/
- Charges & Fees/Acct 1400/
- Sales of goods & Services /Acct 1500/
- Investment Income/Acct 1600/
- Miscellaneous /Acct 1700/
- Pension Rev /Acct 1800/
- Extraordinary Rev./Acct 1900/

Transferred Receipts:
- Accounts from 4000 – 5999

Others:

External Assistance:
- Counter part Grant /2100/
- Technical Assistance /2200/

Capital Receipts:
- Domestic /3100/
- Counter Part Loan /3200/
- External Loan /3400/

NON-BUDGETARY

Unspent Budget

Other:
- Gov't Borrowing and Int. Loans /5001 – 5200/
- Customs Deposits /5300 – 5400/
- Other Deposits /5401 – 6000/

CONSOLIDATED FUND

BUDGETARY

Expenditure:
- Recurrent Expenditure /Accts 6001 – 7000/
- Capital Expenditure /Accts 8001 – 9000/

Transfers:
- FGE Assistance on the Recurrent Budget /Accts 4001 -4900/

NON-BUDGETARY

Other:
- Cash /Acct 4001 – 4900/
- Gov't Borrow & Int. Loans /Acct 5001 – 5200/
- Customs Deposits /Acct 5300 – 5400/
- Other Deposits /Acct 5401 – 6000/

The General (Consolidated) Fund

The FGE has established the Consolidated Fund in order to control restricted and designated resources and to both ensure and demonstrate compliance with legal and administrative requirements. The Consolidated Fund is a separate fiscal and accounting entity (including cash and non-cash resources as well as related liabilities). The Consolidated Fund involves an accounting separation, not necessarily the physical separation of resources. However, resources are often also physically segregated /for example the use of separate bank accounts for the various cash resources of the Consolidated Fund/

Proclamation No. 57/1996 specifically prescribes that there will be only one Consolidated Fund into which all public money shall be paid unless there are specific exceptions that are allowed by law. Under Proclamation No. 57/1996, the Consolidated Fund is to be maintained and administered by the Ministry of Finance. Under its management responsibilities for the Consolidated Fund, the Ministry of Finance has the authority to open bank accounts for the purpose of depositing money into the Consolidated Fund

Flows of Public Money into the Consolidated Fund

1. Fees and Charges – Fess and Charges are payments made by users of public services and goods to public bodies who supply those goods or services.
2. Public Debt – another sources of public money for the Consolidated Fund is through the ability of the FGE to raise money through the issuance of public debt
3. Unspent Funds – under FGE accounting regulations, at the end of each fiscal year the unspent balance of an appropriation is to be credited to the Treasury Account of the Ministry of Finance.

Flows of Public Money Out of the Consolidated Fund

The FGE accounting system is based on appropriations. Appropriations are the basis by which public money is authorized to be paid out of the Consolidated Fund. Proclamation No.57/1996 states that no disbursements shall be made from the Consolidate Fund without the prior authorization of an appropriation by the Council of Peoples' Representatives. The out flows include:

1. Payment of Public Debt – repayment of public debt obligations of the FGE is an expenditure which is payable out of the Consolidated Fund. The repayment charge payable out of the Consolidated Fund includes not only the repayment of principal, but also interest and administrative expenses related to both direct advances and securities issued by the FGE.
2. Commitments – the ministry of Finance's procedures specifies the form in which financial commitments against budget items must be registered by the public body.
3. Payments for Goods and Services – the regulations related to the payment of suppliers and contractors cover both the procedures for making payment and the types of payments that can be made.
4. Other Payments

3.9) Classification of Governmental Revenues and Expenditure Accounts with Special Reference to Ethiopia

Generally, revenues and expenditures of governmental funds are first classified on Fund basis. Within each fund, revenues are classified based on sources and within each source based on sub-source, if needed. Within each Fund, expenditures are classified based on sector, program, project and account (object)

The FGE Chart of Account: Details of Coding for Accounting Unit and Accounts

Reporting or Accounting Unit / Sector Codes

Recurrent Expenditure Organization:

100 – 199 Administrative and General Services
200 – 299 Economic Services
300 – 399 Social Services
400 – 499 Various Accounts
500 – 599 Budget Support Regional Sub-Codes and Other Codes
600 – 699 Reserved

Capital Expenditure Organization:

700 – 799 Economic Development
800 – 899 Social Development
900 – 999 Administrative and General Services /Building/

ACCOUNTS CODES:

Revenues:

1000 – 1999 Budgetary Revenue
2000 – 2999 External Assistance
3000 – 3199 Counter Part Fund
3400 – 3999 External Loans

Non-budgetary Revenues and Expenditures:

4000 – 5099 Cash Balances and Cash Transfers, Advance Payments and Internal Borrowings
5100 – 5299 Government Borrowing and Internal Loans (Treasury Bills, Bonds, etc)
5300 – 5399 Custom Deposits
5400 – 5999 Other Deposits

Expenditures:

6000 – 6999 Recurrent
7000 – 7999 FGE Assistance on the Recurrent Budget
8000 – 8999 Capital Expenditure
9000 – 9999 Reserved for future use

Sample FGE Chart of Accounts: Codes for Accounting Unit/Sector:

Services	Sector	Head	Sub-Head
100 Administration and General Services			
	110 Organs of State		
		112 Council of Peoples' Representatives	
			01 Office of the President
			02 Council of Peoples' Representatives
			05 Palace Administration
			06 Grand Palace Administration
		114 Council of Ministers and Regional Council	
		118 Office of The Auditor General	
	120 Justice		
		121 Ministry of Justice	
		123 Federal Supreme Court	
		124 Tax Appeal Commission	
	130 National Defence		
	150 General Services		
200 Economic Services			
	210 Agriculture		
	220 Trade and Industry		
	230 Mines and Energy		
	240 Tourism		
	250 Transport and Communication		
	260 Construction		
	270 Economic Development Study		
300 Social Services			
	310 Education and Training		
	320 Sports		
	330 Health		
	340 Labor and Social Services		
	350 Relief and Rehabilitation		
400 Other Services			
	410 Pension Payments		
	420 Public Debts		
	430 Contingencies		
	440 Safety Net		
500 Subsidies			
	510 Subsidies to Regions		
		01 Tigray Region	
		02 Afar Region	
		03 Amhara Region	
		04 Oromiya Region	

Sample FGE Chart of Accounts: Account Codes for Accounts

1000 REVENUES	**TAX REVENUES**
	1100 Direct Tax
	1101 Personal Income Tax
	1102 Rental Income Tax
	1103 Business Profit/Income Tax
	1106 Tax on Dividends and Chance Winnings
	1200 Indirect Taxes
	Excise Tax on locally manufacture Goods
	1201 Petroleum
	1205 Sugar
	1206 Salt
	1207 Soft Drinks and Mineral Water
	1300 Foreign Trade Taxes
	Customs Duty on Imported Goods
	1301 Motor Vehicles and Accessories
	1302 Machines, Capital goods and Accessories
	1303 Building Materials and Metals
	NON-TAX REVENUES
	1400 Charges and Fees
	1401 Passports and Visas
	1402 Registration of Foreigners
	1405 Work Permits
	1406 Court Fines
	1407 Court Fees
	1410 Forestry License Fees
	1411 Housing License
	1500 Sales of Goods and Services
	1600 Government Investment Income
	1700 Miscellaneous Revenues
	1800 Pension Contribution
	1900 Extraordinary Revenues
2000 External Assistance	
3000 Capital Receipts	
6000 Ordinary Recurrent Expenditure	
	6100 Personnel Services
	6101 Salaries for Civilian Employees
	6102 Allowances for Civilian Employees
	6103 Salaries for Military and Police
	6200 Non-Personal and Contractual Services
	6300 Materials and Supplies
7000 External Assistance	
8000 Capital Expenditure	

Chapter Four
Accounting for Governmental Operating Activities: Illustrative Transaction and Financial Statements

Topics to Be Discussed:

- General Fund (GF)
  - Illustrative Case: Beginning Financial Statements for Operating Funds
  - Illustrative Journal Entries: Recording Transactions during the FY
  - Interim Financial Statements
  - Events Subsequent to Date of Interim Financial Statements
- Special Revenue Funds (SRFs)
- Interfund Activity and Other Common Transactions of the GF and SRFs
- Permanent Funds (PFs)

Learning Objectives:

After studying this chapter, you should be able to:

- Recognize typical operating transactions for the governmental activities and prepare appropriate journal entries at both the government-wide and fund levels
- Prepare and explain interim financial statements and schedules
- Distinguish between exchange and non-exchange transactions, and define the classifications used for non-exchange transactions
- Prepare adjusting entries at year-end and a pre-closing trial balance for the General Fund
- Prepare closing journal entries and year-end General Fund financial statements
- Account for interfund and intra-activity and inter-activity transactions
- Account for transactions of a permanent fund

4.1) The General Fund

In Chapter 3, the use of general ledger budgetary control accounts and related operating statement accounts were explained.

General ledger budgetary control accounts include

- Estimated revenue
- Estimated other financing sources
- Appropriations
- Estimated other financing uses
- Encumbrances

And related Operating Statement control accounts include:

- Revenue
- Other financing sources
- Expenditures
- Other financing uses have been discussed in detail

The necessity of subsidiary ledger that supports the budgetary control account and their related statement account is also disused. In this chapter, common transactions and events arising from the operating activities and appropriate accounting entries and financial statements of any potential local governmental unit will be presented and discussed. Operating transactions and events affect the governmental unit's government wide accounting records and financial statements as well as those of its General Fund. Thus, transactions are recorded, where appropriate, in both the general journal used to collect financial information for government – wide financial reporting and the general journal for the General Fund. Subsidiary ledger accounts as well as general ledger accounts will be illustrated for the General Fund. The accounting structure illustrated in this chapter is entirely applicable to special revenue funds of state and local governmental unit as will as to general funds.

4.1.1) Illustrative Case: Beginning Financial Statements

Assume that at the end of a fiscal year, 2005 the following government – wide Statement of Net Assets (only for governmental activities) and the general fund balance sheet is presented for the town of JIMMA.

TOWN OF JIMMA
STATEMENT OF NET ASSETS
DECEMBER 31, 2005

	Primary Government			
	Governmental Activities	Business-Type Activities	Total	Component units
Assets				
Cash	Br. 477,500			
Investments	1,339,040			
Receivables (net)	653,338			
Capital assets (net)	19,330,018			
Total Assets	**21,799,896**			
Liabilities				
Vouchers payable	320,000			
Accrued Interest payable	50,000			
Due to federal Government	90,000			
Current portion of Lon- term debt	200,000			
Bonds payable	3,300,000			
Total Liabilities	3,960,000			
Net Assets				
Invested in capital assets, net of related debt	15,830,018			
Restricted for Debt service	1,659,978			
Unrestricted	349,900			
Total Net Assets	**Br 17,839,896**			

† The General Fund Balances Sheet

TOWN OF JIMMA
GENERAL FUND BALANCE SHEET
AS OF DECEMBER 31, 2005

Asset		
Cash		190,000
Taxes receivable delinquent	66 0,000	
Less: Estimated uncollectible delinquent taxes	50,000	610,000
Interest and penalties receivable on taxes	13,200	
Less Estimated uncollectible interest and penalties	3,300	9,900
Total Assets		**809, 900**
Liabilities And Fund Equity		
Liabilities:		
Vouchers p payable		320,000
Due to federal government.....		90,000
Total liabilities.....		410,000
Fund Equity:		
Reserve for encumbrance 2005	127,000	
Fund balance	272,900	
Total Fund Equity.....		399,900
Total liabilities and fund equity.....		**809,900**

Measurement Focus and Basis of Accounting

As discussed in previous chapters, the **Government Wide Statement of Net A**ssets reports financial position using the economic resources measurement focus and the accrual basis of accounting—using accounting principles similar to accounting for business entities. In contrast, the General Fund Balance Sheet reports financial position using the current financial resources measurement focus and the modified accrual basis of accounting. Although both of these statements represent financial position at the same point in time, even a causal comparison reveals dramatic differences.

Government Wide Statement of Net Assets

- Reports both capital assets and long term liabilities
- Information reported in the governmental activities column of the Statement of Net Assets includes financial information for all governmental activities, not just for the General Fund
- GASB recommended Net Asset Format – Assets minus liabilities equals net assets
- Reports information in a more condensed manner than the General Fund balance sheet

General Fund Balance Sheet

- Reports only current financial resources and current liabilities to be paid from current financial resources
- Reports only recourses and obligations of the General Fund only
- Traditional balance sheet format – Assets equals liabilities and fund equity

The arithmetic difference between total financial resources and total liabilities of the fund is the fund equity. In the balance sheet of JIMMA Town, a portion of fund equity is reserved because not all purchase order issued in the **Fiscal Year** 2005 was filled by the end of that year. A portion of fund equity that is reserved for the purchases order outstanding is shown in the balance sheet as Reserve for Encumbrance.

A portion of fund equity not reserved for expenditure is known as Fund Balance (Available for Appropriation). This is the excess of financial resources over actual liabilities and amounts expected to become liabilities when good and services on order at balance sheet data are received.

4.1.2) Illustrative Journal Entries: Recording Transactions during the FY

A) Recording the Budget

A budget should be recorded in the account of each fund for which a budget is legally adopted. The total estimated revenue and appropriation for Fiscal Year (FY) 2006 is as follows:

The Town Council approved revenue budget of Br 3,986,000 and appropriation budget of Br 4,180,000. Estimated Revenue consists of Br 2, 600,000 Property taxes; Br 13, 000 Interest & penalties on delinquent taxes; Br 408,000 sales taxes; Br 220,000 licenses and permits; Br 308,000 Fines and forties; Br 280,000 Intergovernmental revenue; Br 70,000 Charges for service; and Br 15,000 Miscellaneous revenue

The Appropriation budget includes Br 660,000 General government; Br 1,240,000 Public safety; Br 910,000 Public works; Br 860,000 Heath and welfare; Br 315,000 Parks and recreation; Br 180,000 Contribution to retirement plans; and Br 15,000 Miscellaneous appropriations. On the first day of the new fiscal year the following journal entry would be recorded.

General Fund:	General Ledger Debits	General Ledger Credits
1. Estimated Revenues	3,986,000	
Fund Balance	194, 000	
Appropriations		4,180,000
	Subsidiary Ledger Debits	**Subsidiary Ledger Debits**
Revenue Ledger:		
Property Taxes	2,600,000	
Interests and Penalties on Delinquent Taxes	13,000	
Sales Taxes	480,000	
Licenses and Permits	220,000	
Fines and Forfeits	308,000	
Inter Governmental Revenue	280,000	
Charges for Serves	70,000	
Miscellaneous Revenue	15,000	
Appropriation Ledger		
General Government		660,000
Public Safety		1,240,000
Public Works		910,000
Health and Welfare		860, 000
Parks and Recreation		315,000
Contributions to Retirement Plans		180,000
Miscellaneous Appropriation		15,000

It is possible to record the estimated revenue and appropriation separately as follows:

	General Ledger Debits	General Ledger Credits
Estimated Revenues	3,986,000	
Fund Balance		3,986,000
Fund Balance	4,180,000	
Appropriations		4,180,000

When the two entries combined together they will provide the above journal entry.

† If estimated revenue is greater than appropriation, then there is a budgetary surplus and the fund balance account will have a credit balance.

† If the reverse situation exists there is a budgetary deficit and the fund balance account will have a debit balance.

The "Estimated Revenue" ledger account is known as potential asset, because it reflects revenue to be received during the fiscal period. On the other hand, the "Appropriations" ledger account is considered as potential liabilities, because it reflects the legislative body's commitment.

The major reasons for recording the budgetary entry are:-

1. Recording the budget initiates the accounting process for each funds
2. Recording the budget facilities the preparation of financial statement that compare actual amount of revenue and expenditure with the budget.

B) Tax Anticipation Notes Payable

The treasurer of the town would like to forecast the amount of cash needed to cover its current liability and its disbursement before the major items of revenue are collected.

Current Liabilities (2005—Balance Sheet)

Voucher payable of	320,000
Due to the federal government	90,000

Total..... 410,000

† Assume that disbursement is one fourth of the budgeted appropriation which is 4,180,000, thus it is 4,180,000 @ ¼ = 1,045,000

† Total cash requirement = 410,000 + 1,045,000= 1,455,000

Experience indicates that a conservative forecast of collections of delinquent taxes and interest and penalties there on during the forecast period will amount to 425,000 Br.. Further, the treasurer's review of the items of Estimated Revenue budget indicates that at least 140,000 Br. will be collected in the forecasted period. Therefore, total cash available to meet the 1,455,000 disbursements is 755,000 Br. (190,000 cash available at the beginning of the period, pulse the 425,000and 140,000 Tax receivable delinquent , interest and penalties and revenues respectively) leaving the deficiency to be meet by borrowing of 700,000 Br. from the local banks by providing "Tax Anticipation Note" to the bank. The entry to record borrowing would be as follows:

	General Ledger	
General Fund and Governmental Activities:	**Debits**	**Credits**
2. Cash	700,000	
Tax Anticipation Notes Payable.....		700,000

C) Accounting for Encumbrances

Purchase order for materials and supplies were issued in the total amount of 306,450, which consists of Br 28,000 General Government; Br 72,000 Public Safety; Br 160,000 Public Works; Br 36,000 Parks and Recreation; Br 10,000 Heath and Welfare; and Br 450 Miscellaneous Appropriation

	General Ledger		Subsidiary Ledger	
General Fund	**Debits**	**Credits**	**Debits**	**Credits**
3. Encumbrance-2006	306,450			
Reserve for Encumbrances-2006.....		306,450		
Encumbrance Ledger:				
General Government			28,000	
Public Safety			72,000	
Public Works			160,000	
Parks and Recreation			36,000	
Health and Welfare			10,000	
Miscellaneous Appropriation			450	

D) Payment of Liabilities

Checks were drawn to pay the voucher payable and the amount due to the federal government as of 2005. Entry to record the payment for General Fund and Governmental Activities would be:

	General Ledger	
General Fund and Governmental Activities:	**Debits**	**Credits**
4. Vouchers Payable.....	320,000	
Due to Federal Government	90,000	
Cash		410,000

Note that it is not necessary in the above entry for the General Fund to know which appropriations were affected at the time goods and services giving rise to the liabilities were received, because under the modified accrual basis applicable to the General Fund, the appropriations were considered expended in the prior year, 2005, when the goods and services were received

E) Payrolls and Payroll Taxes

The gross pay of employees of general fund departments amounted to 252,000. Deductions from gross pay for the period amount to 19,278 for employee's share of tax for the federal government, 25,200 employee's federal withholding tax and 5,040 employees' state withholding taxes. The Entry in the General Fund is:

General Fund	General Ledger Debits	General Ledger Credits	Subsidiary Ledger Debits	Subsidiary Ledger Credits
5a. Expenditure 2006	252,000			
Voucher Payable		202,482		
Due to Federal Government		44,478		
Due to State Government		5,040		
Expenditures Ledger:				
General Government			35,040	
Public Safety			156,120	
Public Works			29,160	
Parks and Recreation			19,080	
Health and Welfare			12,600	

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

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

† Payment of the voucher for the net pay results in the following entry in both the General Fund and governmental activities journals:

General Fund and Governmental Activities:	General Ledger Debits	General Ledger Credits
6. Vouchers Payable	202,482	
Cash		202,482

In as much as the town is liable for the employer's share of tax for federal government 19,278 Br. and for contributions to additional retirement plans established by state law assumed to be 5,400 Br. for the pay period ended. The obligations were provided for in the appropriations budget under the caption "Contribution to Retirement Plans".

General Fund	General Ledger Debits	General Ledger Credits	Subsidiary Ledger Debits	Subsidiary Ledger Credits
7a. Expenditure—2006	24,678			
Due to Federal Government		19,278		
Due to State Government		5,400		
Expenditures Ledger:				
Contribution to Retirement Plans			24,678	

Entry 7b is also required to record the payroll expense on the accrual basis at the government wide level.

Governmental Activities:	General Ledger Debits	General Ledger Credits
7b. Expenses—General Government	3,430	
Expenses—Public Safety	15,289	
Expenses—Public Works	2,856	
Expenses—Parks and Recreation	1,869	
Expenses—Health and Welfare	1,234	
Due to Federal Government		19,278
Due to State Government		5, 400

F) Recording Property Tax Levy

The estimated revenue for 2006 form property taxes levied from the Town of **JIMMA** General fund is Br. 2,600,000. If records of property tax collection policy and changes in local economic conditions, indicate that approximately 4% of the gross tax levy will never be collected, the gross tax levy must be large enough, so that the collectible portion of the levy; 96%, equals the needed revenue from this source 2,600,000. Therefore, the gross levy of property taxes for the general fund of the Town of **JIMMA** must be 2,708,333 (2,600,000 /0.96).

General Fund:	General Ledger Debits	General Ledger Credits	Subsidiary Ledger Debits	Subsidiary Ledger Credits
8a. Taxes Receivable Current	2,708,333			
Estimated Uncollectible Current Taxes		108,333		
Revenues		2,600,000		
Revenues Ledger:				
Property Taxes				2,600,000

Governmental Activities:	General Ledger Debits	General Ledger Credits
8b. Taxes Receivable Current	2,708,333	
Estimated Uncollectible Current Taxes		108,333
General Revenues – Property Taxes		2,600,000

G) Recognition of Expenditure/Expenses for Encumbered Items

When supplies and services ordered during the current year have been received and found to be acceptable, the suppliers, or contractors invoices should be checked for agreement with purchase order or contract prices and terms, and for clerical accuracy. If everything is in order, the invoices are approved for payment. If, as is probable, the estimated liability for purchase order and contracts was recorded in the encumbrance account and in the appropriate subsidiary accounts, the encumbrance entry must be reversed and expenditures must be recorded in the control account and appropriate subsidiary account in the amount of the actual liability for goods or service received. Assume Goods and Services ordered during 2006 by department accounted for by the Town of JIMMA General Fund are received. Invoices for the items received total Br 269,450; related purchase orders totaled Br 269,775.

	Invoice Price	Purchase Order
General Government	12,300	12,250
Public Safety	72,000	72,000
Public Works	150,000	150,900
Parks and Recreation	30,000	30,000
Health and Welfare	4,100	4,175
Miscellaneous Appropriation	450	450
Total	269,450	269,775

† Journal entry to reverse encumbrances would be:

General Fund:	General Ledger Debits	General Ledger Credits	Subsidiary Ledger Debits	Subsidiary Ledger Credits
9. Reserve for encumbrances—2006.....	269,775			
Encumbrances—2006.....		269,775		
Encumbrances Ledger:				
General Government				12,250
Public Safety				72,000
Public Works				150,900
Parks and Recreation.....				30,000
Health and Welfare				4,175
Miscellaneous Appropriation				450
10a. Expenditure—2006.....	269,450			
Voucher Payable —2006		269,450		
Expenditures Ledger:				
General Government			12,300	
Public Safety			72,000	
Public Works			150,600	
Parks and Recreation.....			30,000	
Health and Welfare			4,100	
Miscellaneous Appropriation			450	

Assuming that the town uses periodic inventory methods and does not capitalize its inventory of supplies unless they are material, it would record purchases of supplies initially as direct expenses of the functions acquiring the items as shown in entry 10b. (The Br 450 expenditure charged to Miscellaneous Appropriations would most appropriately be considered a direct expense of the General Government Functions.)

Governmental Activities:	General Ledger Debits	General Ledger Credits
10b. Expenses—General Government	12,750	
Expenses—Public Safety.....	72,000	
Expenses—Public Works.....	150,600	
Expenses—Parks and Recreation.....	30,000	
Expenses—Health and Welfare.....	4,100	
Vouchers Payable.....		269,450

H) Revenue Recognized on Cash Basis

Revenue from the following sources not previously accrued is recognized on the cash basis. Collections are assumed to be as follows:

† Licensee and Permits 100000
† Fines and forfeits 151,000
† Charges for Services 7,000
† Miscellaneous Revenues 1,200

† The Entry to record the transaction in General Fund Journal is:

General Fund:	General Ledger Debits	General Ledger Credits	Subsidiary Ledger Debits	Subsidiary Ledger Credits
11a. Cash.....	259,200			
Revenues		259,200		
Revenues Ledger:				
License and Permits				100,000
Fines and Forfeits.....				151,000
Charges for Services				7,000
Miscellaneous Revenue				1,200

Of the above revenues, Licenses and Permits and Charges for Services are deemed by the town of JIMMA to be program revenues at the Government-Wide Level. Licenses and Permits are attributed to the General Government function and Charges for services were received from the customers of the Parks and Recreation Department. Both Fines and Forfeits and Miscellaneous are recorded as general revenues at the government wide level.

	General Ledger	
Governmental Activities:	**Debits**	**Credits**
11a. Cash.....	259,200	
Program Revenues—Charge for services—General Government		100,000
Program Revenues—Charge for services—Parks and Recreation.....		7,000
General Revenues—Fines and Forfeits		151,000
General Revenues—Miscellaneous.....		1,200

I) Collection of Delinquent Taxes

Delinquent taxes are subject to interest and penalties that must be paid at the time the tax bill is collected (paid). It is possible for a government to record the amount of penalties at the time the taxes become delinquent. Interest may be computed and recorded periodically to keep the account on the accrual basis; it must also be computed and recorded for the period from the date of last recording to the date when a tax payer pays its delinquent taxes. Assume tax payers of the town of **JIMMA** have paid delinquent taxes totaling 440,000 Br., on which interest and penalties of Br 8,800 had been recorded as a receivable at the end of 2005; further assume 600 Br. additional interests was paid for the period from the first day of 2006 to the date on which delinquent taxes were paid.

† The entry to record interest and penalties of 2006 would be:

	General Ledger		Subsidiary Ledger	
General Fund:	**Debits**	**Credits**	**Debits**	**Credits**
12a. Interest and Penalties Receivable on Taxes.....	600			
Revenues		600		
Revenues Ledger:				
Interest and Penalties on Delinquent Taxes				600

† The corresponding entry at the government – wide level is:

	General Ledger	
Governmental Activities:	**Debits**	**Credits**
12a. Interest and Penalties Receivable on Taxes.....	600	
General Revenues— Interest and penalties on Delinquent Taxes		600

† The collection of delinquent taxes, interest and penalties is summarized in the following entry in both the General Fund and Governmental Activities journals.

	General Ledger	
General Fund and Governmental Activities:	**Debits**	**Credits**
13. Cash	449,400	
Tax Receivable—Delinquent		440,000
Interest and Penalties Receivable on Taxes.....		9,400

J) Correction of Errors

No problem arise in the collection of current taxes if they are collected as billed, the collections are debited to cash and credited to Taxes Receivable- current. Sometime, even in a well designed and well operated system, errors occur and must be corrected. **Example:** The assessed valuation of a parcel of property were legally reduced but the tax bill erroneously issued at the higher valuation, the following correction entry would be made when the error was discovered, assuming the corrected bill to be Br.364 small than the original bill.

	General Ledger		Subsidiary Ledger	
General Fund:	**Debits**	**Credits**	**Debits**	**Credits**
14. Revenues	364			
Taxes Receivable—Current		364		
Revenues Ledger:				
Property Taxes			364	

A similar entry would also be made at the government-wide level to correct the overstatement of General Revenues and Taxes Receivable—Current. Post audit may disclose errors in the recording of expenditures during the current year, or during a prior year. If the error occurred during the current year, the Expenditures account and the proper Expenditures subsidiary account can be debited or credited as needed to correct them. If the error occurred in a prior year, however, the Expenditures account in an error has been closed to Fund Balance, so logically the correcting entry should be made to the Fund Balance account. The "all inclusive income statement" practice that is considered appropriate for profit seeking entities does not have equal acceptance in governmental accounting because of the greater importance of legal constraints on governmental actions. For example, if a governmental unit collects from a supplier an amount that was erroneously paid in a preceding year, the appropriation for the year of the collection is not increased by the amount collected; it remains as originally budgeted. As a practical matter, collection from suppliers' prior years' overpayments may be budgeted as Miscellaneous Revenues and recorded as credits to the Revenues account.

K) Receipt of Goods Ordered in Prior Year

Budgetary accounting has no effect on the Government-Wide Financial Statements, thus no encumbrance is recorded at the government wide level when goods or services are ordered or contracted for. Purchase orders and other commitment documents issued in 2005 and not fulfilled or cancelled by the end of that year total Br 127,000. This amount is designated as Reserve for Encumbrances—2005 in the December 31, 2005, General Fund Balance Sheet of the **Town of JIMMA**.

When the goods on order at the end of FY 2005 are received in FY 2006 their actual cost is considered an Expenditure of the 2005 Appropriations to the extent of the amount encumbered in 2005; any additional amount must be charged to the 2006 Appropriations. The Appropriations account for 2005, however, was closed at the end of that year to Fund Balance, as were the other budgetary accounts for that year.

The Encumbrances account can be reestablished at the beginning of a new fiscal year. When goods or services ordered in 2005 are received in 2006 it is convenient to debit the Expenditures-2005 account when the liability account is credited eliminate the encumbrance in the in the normal manner. At year end, the Expenditures-2005 account is closed to Fund Balance, along with Expenditures-2005 and all other operating statement and budgetary accounts. For the Town of JIMMA, assuming that the goods were ordered by the Parks and Recreation functions, the Encumbrance Reestablishment Journal Entry is :

	General Ledger		Subsidiary Ledger	
General Fund:	**Debits**	**Credits**	**Debits**	**Credits**
15. Encumbrances—2005	127,000			
Fund Balance		127,000		
Encumbrances Ledger:				
Parks and Recreation—2005			127,000	

Assuming that all goods and services for which encumbrances were outstanding at the end of 2005 were received in 2006 at a total invoice cost of Br. 127,250. Notice that only the estimated amount, Br. 127,000, is charged to Expenditures—2005 since this was the amount of the encumbrance against the 2005 appropriations; the difference between the amount encumbered in 2005 and the amount

approved for payment in 2006 must be charged against the 2006 appropriations for Parks and Recreation.

	General Ledger		Subsidiary Ledger	
General Fund:	**Debits**	**Credits**	**Debits**	**Credits**
16. Reserve for Encumbrances—2005	127,000			
Encumbrances—2005		127,000		
Encumbrances Ledger:				
Parks and Recreation—2005.....				127,000
17a. Expenditures—2005.....	127,000			
Expenditures—2006	250			
Vouchers Payable.....		127,250		
Expenditures Ledger:				
Parks and Recreation—2005			127,000	
Parks and Recreation—2006			250	

† Recording the transaction at the Government-wide Level

	General Ledger	
Governmental Activities:	**Debits**	**Credits**
17b. Expenses- Parks and Recreation	127,250	
Vouchers Payables.....		127,250

4.1.3) Interim Financial Statements

Periodically during a year it is desirable to prepare financial statements, for information, to the administrators and member of the legislative branches of the governmental units. Balance sheet for the town of JIMMA if it were prepared in 2006 after the entries numbered 1 through 17a and additional payroll entries not shown were made; the date is assumed to be March 31, 2006.

The interim balance sheet reflects the balance of both proprietary and budgetary accounts. Instead of "Assets" which those familiar with accounting for profit-seeking entities would expect, the caption must be "Assets and Resources" because the excess of Estimated Revenues over Revenue is not an asset as of the balance sheet date but does indicate the amount that will be added to assets when legally budgeted revenues are recognized. Similarly, the caption is not "Equities," or "Liabilities and capital" or another tile commonly found in financial reports of profit seeking entities, but "Liabilities and fund equity". The liabilities section in consistent with profit seeking entities, but the next sections disclose the three subdivision of the fund equity.

The first division presents the amount appropriated for the year (Appropriation); less the amount of appropriation that have been expended (Expenditures) during the year to date, and less the amount of appropriation encumbered by purchase order and contracts outstanding at the balance sheet date (Encumbrances); the net is the amount that legally may be expended or encumbered during the remaining of the budget year. The second division Fund Balance Reserved for Encumbrances discloses the portion of net asset and resource that is not available for appropriation because expected liabilities exist.

The last subdivision, fund balance, discloses the portion of the tax payer equity available for appropriation. Accordingly, in financial statement presentation, the world Unreserved or Available for Appropriation is sometimes used in the place of fund balance.

TOWN OF JIMMA
GENERAL FUND BALANCE SHEET
AS OF MARCH 31, 2006
Asset and Resources

Assets:		
Cash		513,660
Taxes Receivable—Current	2,707,969	
Less: Estimated Uncollectible Current Taxes	108,333	2,599,636
Tax Receivable–Delinquent	220,000	
Less: Estimated Uncollectible Delinquent Taxes	50,000	170,000
Interest and penalties receivable on taxes	4,400	
Less Estimated uncollectible interest and penalties	3,300	1,100
Total Assets		3,284,396
Resources:		
Estimated Revenue	3,986,000	
Less: Revenue	2,859,436	1,126,564
Total Assets and Resources		**4,410,960**

Liabilities and Fund Equity

Liabilities:			
Vouchers Payable			581,450
Due to Federal Government			51,520
Due to State Government			10,800
Tax Anticipation Notes Payable			700,000
Total liabilities			1,343,770
Fund Equity:			
Appropriation		4,180,000	
Less: Expenditure—2006	1,191,710		
Less: Encumbrance—2006	36,675	1,228,385	
Available Appropriation		2,951,615	
Reserve for Encumbrance—2006		36,675	
Fund Balance		78,900	
Total Fund Equity			3,067,190
Total liabilities and fund equity			**4,410,960**

TOWN OF JIMMA
GENERAL FUND
STATEMENT OF ACTUAL AND ESTIMATED REVENUES
FOR THE THREE MOTHS ENDED MARCH 31 2006

Source of revenue	Estimated	Actual	Estimated Revenue Not Yet Realized
Taxes:			
Property Taxes	2,600,000	2,599,636	364
Interest and Penalties Taxes	13,000	600	12,400
Sales Taxes	480,000	-	480,000
Total Taxes	3,093,000	2,600,236	492,764
License and Permits	220,000	100,000	120,000
Fines and Forfeits	308,000	151,000	157,000
Intergovernmental Revenue	280,000	-	280,000
Change for Services	70,000	7,000	63,000
Miscellaneous Revenue	15,000	1,200	13,800
Total General Fund Revenue	3,986,000	2,859,436	1,126,564

TOWN OF JIMMA
GENERAL FUND
STATEMENT OF BUDGETED AND ACTUAL EXPENDITURE AND ENCUMBRANCE
FOR THE THREE MOUTHS ENDED MARCH 31, 2006

Function	Appropriation	Expenditure of 2006 Appropriations	Outstanding Encumbrance	Available Appropriators
General Government	660,000	129,100	15,750	515,150
Public Safety	1,240,000	592,400	-	647,600
Public Works	910,000	247,800	9,100	653,100
Health And Welfare	860,000	67,700	5,825	786,475
Parks And Recreation	315,000	72,000	6,000	237,000
Cont. to Retirement Plan	180,000	82,260	-	97,740
Misc. Appropriation	15,000	450	-	14,550
Total General Fund	4,180,000	1,197,710	36,675	2,951,615

4.1.4) Events Subsequent to Date of Interim Statements

A) Revision of Budget

Administrators of the town must review the information to determine whether the budget was legally approved before the beginning of the year appears was realistic or whether changes should be made in the revenue budget in the light of current information about local economic conditions, possible changes in state or federal laws relating to grants, entitlements or shared revenue or other changes relating to licenses and permit fees, fines, forfeits and charges for service. Similarly, revenue collection procedures and revenue recognition polices should be reviewed to determine if changes should be made in the remaining month of the year. In the same manner administrator of the town review the appropriation to determine the legally approved appropriation before the beginning of the year appears realistic in the light of the expenditure incurred and encumbrance out standing during the past period.

Example: The Town of JIMMA General Fund revenues budget for 2006 has been reviewed as described and the budget is legally amended to reflected that revenue from charges for services are expected to be 5,000 more than originally budgeted and miscellaneous revenue are expected to be 15,000 more than originally budgeted, revenue from other sources even not expected to be materially different from originally budgeted and appropriations have been reviewed and legally amended to reflected a 50,000 Br. decrease in the appropriation for public works and an 80,000 Br. increase in the appropriation for public safety. The Entry to record the revision of budget is:

		General Ledger		Subsidiary Ledger	
General Fund:		**Debits**	**Credits**	**Debits**	**Credits**
18.	Estimated Revenue.....	15,000			
	Fund Balance.....	15,000			
	Appropriation.....		30,000		
	Revenues Ledger:				
	Charges for services			5,000	
	Miscellaneous Revenue.....			10,000	
	Appropriations Ledger:				
	Public Works			50,000	
	Public Safety				80,000

B) Collection of Current Taxes

Collection of property taxes levied in 2006 for the general fund of the Town of JIMMA amount to Br. 2,041,668. Since the entry was recognized at the time levy was recorded, the following entry is made in both the General Fund and governmental activities journals.

General Fund and Governmental Activities:	General Ledger Debits	General Ledger Credits
19. Cash	2,041,668	
Taxes Receivable—Current		2,041,668

C) Repayment of Tax Anticipation Notes

As tax collection begin to exceed current disbursements, it becomes possible for the town to repay the local bank for the money borrowed on tax anticipation notes. Just as borrowing the money did not involve the recognition of revenue, the repayment of the principal is merely the extinguishment of debt of the general fund and is not expenditure. Payment of interest, however, must be recognized as the expenditure of an appropriation, because it requires a reduction in the net assets of the fund. Assume the interest to be Br. 13,500 and the amount is properly chargeable to miscellaneous appropriation, the entry is:

General Fund:	General Ledger Debits	General Ledger Credits	Subsidiary Ledger Debits	Subsidiary Ledger Credits
20a. Tax Anticipation Notes Payable	700,000			
Expenditure—2006	13,500			
Cash		713,500		
Expenditures Ledger:				
Miscellaneous Appropriation			13,500	

A similar entry, is made at the government-wide level, except an expense rather expenditure is recorded for the interest charged on the note. The expense is deemed to be an indirect expense that benefits no single function.

Governmental Activities:	General Ledger Debits	General Ledger Credits
20b. Tax Anticipation Notes Payable	700,000	
Expenses—Interest on Tax Anticipation notes	13,500	
Cash		713,500

D) Internal Exchange Transactions—Interfund Transactions

Water utilities ordinarily provide fire hydrants and water service for fire protection at a flat annual charges. A governmentally owned water utility accounted for by an enterprise fund should be expected to support the cost of its operations by user charge. Fire protection is logically budgeted for as an activity of the fire department, a general fund department. Assuming the amount charged by the water utility to the general fund for hydrant and water service is 30,000 Br., and the fire department budget is a part of the public safety category in the TOWN of JIMMA, the general fund should record its liability as:

General Fund:	General Ledger Debits	General Ledger Credits	Subsidiary Ledger Debits	Subsidiary Ledger Credits
21a. Expenditure—2006	30,000			
Due to Other Funds		30,000		
Expenditures Ledger:				
Public Safety			30,000	

The corresponding entry to record the inter-activities transaction (between the governmental activities and business type activities) at the Government–Wide Level is:

Governmental Activities:	General Ledger Debits	General Ledger Credits
21b. Expense—Public Works	30,000	
Due to Business–Type Activities		30,000

Government utilities property is not assessed for property tax (Generally we can say tax) purpose, but a number of governmental utilities make an annual contribution to the general fund in recognition of the fact that the utility does receive police and fire protections and other services. If the water utility of the **Town of JIMMA** agrees to contribute Br. 25,000 to the general fund in lieu of taxes, the required journal entries for the General Fund and Governmental activities are:

	General Ledger		Subsidiary Ledger	
General Fund:	**Debits**	**Credits**	**Debits**	**Credits**
22a. Due Form Other Funds	25,000			
Revenues.....		25,000		
Revenues Ledger:				
Miscellaneous Revenue				25,000

Interfund transactions of the nature illustrated above are called ***quasi-external transactions***. That is, transactions that are recognized as revenues and expenditure (or expenses, incase of proprietary funds) of the fund involved because they would be recognized as revenue and expenditure (or expenses) if the transaction involve organizations external to the governmental unit. In addition to quasi-external transactions, interfund transactions that constitute reimbursements of one fund for expenditures (or expenses) initially recognized by it, but that are properly applicable to another fund should be recognized as expenditures (or expenses) by the reimbursing fund and as reduction of the expenditure (expenses) in the fund that is reimbursed. Another types of inter fund transaction are classified as transfers, or as interfund loans and do not, in a strict sense, result in the recognition of revenue, expenditure or expense.

	General Ledger	
Governmental Activities:	**Debits**	**Credits**
22b. Due form Business-Type Activities.....	25,000	
General Revenues—Payments in lieu of Taxes		25,000

E) Adjusting Entries

Physical Inventories

In a governmental unit, it is recommended that the purchasing function be centralized and the supply activity be accounted for by an internal service fund. For one reason or another, some governments may not create that appropriate **Internal Service Fund** and account for the supply activity as part of **General Fund**. In either case, accountants would feel better control if perpetual inventory account were kept. The purchase of material and supplies must be authorized by an appropriation; therefore, when material and supplies are received the expenditure account is debited. It would be possible to credit the expenditures account for the dollar amount of inventory that a physical count disclosed was on hand and debit the inventory account for the same amount. This procedure, called the **Consumption Method of Accounting for Inventory**. Since the inventory will not be converted into cash in the normal operation of a governmental fund, it is not a liquid asset whose carrying cost should be reflected in fund balance. Rather; the inventory account should be offset by a reserve for inventory account that is classified for balance sheet purposes in the same manner as we do for encumbrance (Reserve for encumbrance) - both represent elements of fund equity not available for appropriation.

If a governmental unit uses the consumption method of inventory accounting, the reserve for inventory account is credited, and the fund balance account is debited for the increase in the amount of the physical inventory at the time entries are made in the Inventory and Expenditures accounts. (If the amount of the physical inventory has decreased, Reserve for Inventory should be debited and Fund Balance credited for the amount of the decrease.)

Example: Assume that the Birr amount of the physical inventory of the **Town of JIMMA General Fund,** as of the end of 2006 is Br. 61,500 and that the inventory at the end of 2005 was such a small amount that it was not recorded, the increase in both the inventory account and the Reserve for

Inventory Account is Br. 61,500. (For simplicity, it is assumed that all items in inventory were acquired by expenditure of the public work appropriation.)

	General Ledger		Subsidiary Ledger	
General Fund:	**Debits**	**Credits**	**Debits**	**Credits**
23a. Inventory of Supplies	61,500			
Fund Balance	61,500			
Expenditure—2005		61,500		
Reserve for Inventory of Supplies		61,500		
Expenditures Ledger:				
Public Works			61,500	

† Journal Entries at Government Wide Level

	General Ledger	
Governmental Activities:	**Debits**	**Credits**
23b. Inventory of Supplies	61,500	
Expense—Public Works	13,500	

An alternative method of accounting for inventories of governmental funds- equally acceptable under present GASB standard — is known as the **Purchase Method**. Under the purchase method the expenditures account is not credited for the dollar amount of the physical inventory, nor is the fund balance account debited .The only entry required is the debit to the asset account, Inventory, with off setting credit to the reserve for inventory account.

Write-Off of Uncollectible Delinquent Taxes

Example: The treasurer of the **Town of JIMMA** receives approval to write off delinquent taxes totaling Br. 26,300 and related interest and penalties of Br. 1,315, the entry in both the General Fund and Governmental Activities would be:

	General Ledger	
General Fund and Governmental Activities:	**Debits**	**Credits**
24. Estimated Uncollectible Delinquent Tax	26,300	
Estimated Uncollectible Interest & Penalties	1,315	
Tax Receivable—Delinquent		26,300
Interest and Penalties Receivable on Taxes		1,315

Reclassification Of Current Taxes

Assuming all property taxes levied by the TOWN of JIMMA in 2006 were to have been paid before the end of the year, any balance of taxes receivable at year end is properly classified as “delinquent” rather than “current”. The related allowance for estimated uncollectible taxes should also be transferred to the delinquent classification. An entry to accomplish this, using amounts assumed to exist in the account Year—end is:

	General Ledger	
General Fund and Governmental Activities:	**Debits**	**Credits**
25. Taxes Receivable Delinquent	666,301	
Estimated Uncollectible Current Taxes	108,333	
Taxes Receivable Current		666,301
Estimated Uncollectible Delinquent Tax		108,333

Accrual of Interest and Penalties

Delinquent taxes are subject to interest and penalties. If the amount of interest and penalties earned in 2006 by the **Town of JIMMA** and not yet recognized is 13,320, but it is expected that only 10,800 of that can be collected. The following entry is necessary.

General Fund:	General Ledger Debits	General Ledger Credits	Subsidiary Ledger Debits	Subsidiary Ledger Credits
26a. Interest & Penalties Receivable on Tax	13,320			
Estimated Uncollectible on Interest and Penalties		2,520		
Revenues		10,800		
Revenues Ledger:				
Interest & Penalties on Delinquent Taxes				10,800

† The transaction is recorded at Government-Wide Level as follows:

Governmental Activities:	General Ledger Debits	General Ledger Credits
26b. Interest & Penalties Receivable on Taxes	13,320	
Estimated Uncollectible on Interest and Penalties		2,520
General Revenue- Interest & Penalties on Delinquent Taxes		10,800

F) Pre-Closing Trial Balance

Assuming the illustrated entries for the transactions and events pertaining to the year 2006 for the Town of JIMMA have been made and posted, and **a number of other entries—not illustrated because they pertain to similar transactions and events—**have been made and posted, the trial balance below shows the General Fund general ledger accounts before closing entries:

TOWN OF JIMMA
PRE-CLOSING TRIAL BALANCE
AS OF DECEMBER 31, 2006

	Debits	Credits
Cash	$ 145,800	
Taxes Receivable—Delinquent	666,300	
Estimated Uncollectible Delinquent Taxes		$ 88,000
Interest and Penalties Receivable on Taxes	3,085	
Estimated Uncollectible Interest & Penalties		1,985
Due from Other Funds	25,000	
Inventory of Supplies	61,500	
Estimated Revenues	4,001,000	
Revenues		4,015,000
Vouchers Payable		396,800
Due to Federal Government		126,520
Due to State Government		39,746
Due to Other Funds		30,000
Expenditures—2005	127,000	
Appropriations		4,210,000
Expenditure—2006	4,069,260	
Encumbrances—2006	70,240	
Reserve for Encumbrances—2006		70,240
Reserve for Inventory of Supplies		61,500
Fund Balance		129,400
Total	$ 9,169,185	$ 9,169,185

G) Closing Entries

The essence of the closing process for a governmental fund is the transfer of the balances of the operating statement account and the balances of the budgetary accounts for the year to the fund balance account.

General Fund:	General Ledger Debits	General Ledger Credits
27. Revenues	4,015,000	
Appropriations	4, 210,000	
Fund Balance	45,500	
Estimated Revenues		4,001,000
Expenditures—2006		4,069,260
Expenditures—2005		127,000
Estimated Uncollectible Delinquent Tax		70,240

The closing entry has the effect of reversing the entry made to record the budget and the entry made to amend the budget. Therefore, after the closing entry is posted, the Fund Balance account is purely a balance sheet account and not one in which historical and expected effects are mixed, as is true during a year. That is, it again represents the net amount of financial resources available for appropriations for fund purpose

H) Year-End Financial Statements

A) General Fund Balance Sheet

Since only balance sheet accounts are open, the captions "Assets" and "Liabilities and Fund Equity" are used instead of the captions used in Interim Balance Sheet.

TOWN OF JIMMA
GENERAL FUND BALANCE SHEET
AS OF DECEMBER 31, 2006

Assets:		
Cash		145,800
Tax Receivable–Delinquent	666,300	
Less: Estimated Uncollectible Delinquent Taxes	88,000	578,300
Interest and Penalties Receivable on Taxes	3,085	
Less Estimated uncollectible interest and penalties	1,985	1,100
Inventory of Supplies		61,500
Total Assets		**786,700**
Liabilities and Fund Equity		
Liabilities:		
Vouchers Payable	396,800	
Due to Federal Government	126,520	
Due to State Government	39,740	
Due to Other Funds	5,000	
Total liabilities		568,060
Fund Equity:		
Reserve for Encumbrance—2006	70,240	
Reserve for Inventory of Supplies	61,500	
Fund Balance	86,900	
Total Fund Equity		218,640
Total liabilities and fund equity		**786,700**

B) Statement of Revenues, Expenditures and Changes in Fund Balance

TOWN OF JIMMA
GENERAL FUND
STATEMENT OF REVENUE, EXPENDITURE AND CHANGE IN FUND BALANCE
FOR THE YEAR ENDED DECEMBER 31, 2006

Revenues:		
Property Taxes	2,599,636	
Interest and Penalties on Delinquent Tax	11,400	
Sales Taxes	485,000	
License and Permits	231,200	
Fines and Forfeits	310,800	
Intergovernmental Revenue	284,100	
Changes for Services	82,464	
Miscellaneous Revenue	28,400	
Total revenue		4,015,000
Expenditures—2006:		
General Government	649,400	
Public Safety	1,305,435	
Public Works	778,300	
Health and Welfare	850,325	
Parks and Recreation	292,500	
Contribution to Retirements Plans	179,100	
Miscellaneous appropriations	14,200	
Expenditures—2006, Total	4,069,260	
Expenditures—2005:		
Parks and Recreation	127,000	
Total Expenditures		4,196,260
Excess of Expenditure Over Revenues		(181,260)
Other Financing Sources (Uses):		
Operating Transfer In	–0–	
Operating Transfer Out	–0–	
Total Other Financing Sources		–0–
Excess of Expenditure and OFUs over Revenues and OFSs		(181,260)
Increases in Reserve for Inventory of Supplies		(61,500)
Decrease in Reserve For Encumbrances During—2006		56,760
Change in Fund Balance for Year		(186,000)
Fund Balance, January, 1, 2006		272,900
Fund Balance, December 31, 2006		**$ 86,900**

4.2) Special Revenue Funds

Special Revenue Funds are needed when legal or policy considerations require separate funds to be created for current purposes other than those served by proprietary or fiduciary funds.

- † As example of a Special Revenue Funds created to demonstrate legal compliance is a Street Fund, which is largely financed by a local government's share of the motor fuel tax levied by the state to be used only for maintenance and construction of streets, roads, and bridges (**State Motor Fuel Tax Fund**).
- † Emergency 911 Access Fund

- A second example of a special revenue fund is a **Library Operating Fund** created to account for a special fund to account for an activity that differs from other governmental activities. It is the desire of the governing board to have a separate fund to account for an activity.
- A third example is a fund to account for grants received from a higher jurisdiction, such as a Federal **Community Development Block Grant** (Community Development Fund).
- A final example, for governments that have implemented the GASB Statement No. 34 reporting model, is a trust fund in which both the investment principal and the investment earnings are available to support a government program or the citizenry.

Accounting for Operating Grants

Grants received by a local government from the state of federal government – or received by a state from the federal government – are often restricted fro specified operating purposes. Consequently, revenues of such grants are frequently accounted for by use of a special rvenue fund. A number of grants provide that the grantor will pay the grantee on a reimbursement basis. In such instances, GASB Standards require that the grant revenue not be recognized until the expenditure has taken place. As an example of appropriate accounting procedures, assume a local government has been awarded a state grant to finance a fine arts program, but the state will provide reimbursement only after the grantee has made expenditures related to the fine arts program. It is a voluntary non-exchange transaction in which an eligibility requirement (incurrence of allowable costs) must be met before the local government can recognize an asset and revenue. Assuming the grantee government creates a special revenue fund to account for the fine arts program, and has incurred qualifying expenditures or expense at the government-wide-level, the required entries in both the special revenue fund and the governmental activities would be (assuming Br 50,000 operating grant):

	General Ledger	
Special Revenue Fund and Governmental Activities:	**Debits**	**Credits**
Expenditures (Expense)	50,000	
Vouchers Payable (or Cash)	50,000	
Cash		50,000
Revenues		50,000

The second entry records the reimbursement, which presumably would be a short time after the expenditures are incurred. If the grant provided instead that a specified amount would be available for the current accounting period, regardless of whether qualifying expenditures are incurred, there would be no eligibility requirement. In this case, it would be appropriate for the special revenue fund to recognize an asset (Grants Receivable) and Revenues upon notification by the state grantor agency. If the grant should specify that the amount is intended for a future accounting period, a liability account, Deferred Revenues, would be credited upon notification of the grant rather than Revenues.

Financial Reporting

Special Revenue Fund accounting and financial reporting are essentially the same as for the General Fund. Along with the General Fund, amounts for major Special revenue funds would be included in the Balance Sheet and Statement of Revenues, Expenditures, and Changes in Fund Balances prepared for the governmental funds. A budgetary comparison schedule is also provided as required supplementary information (RSI) for each major special revenue fund. In CAFR, a combining balance sheet and combining operating statement (Combining Statement of Revenues, Expenditures, and Changes in Fund Balances for non-major governmental funds) should be provided for all non-major governmental funds, including non-major special revenue funds.

Illustration on Special Revenue Fund

Assume the Village of Elizabeth maintains a Motor Fuel Tax Fund, as required by State Law. Revenues include State motor fuel tax receipts and State Reimbursement Grants. Expenditure is incurred for Road Repairs and Maintenance. A legally adopted annual budget is not required or used.

Assume, at the beginning of 2005, the Motor Fuel Tax Fund has cash of Br 212,500 offset by Unreserved Fund Balance in the same amounts.

1. Motor Fuel Tax Revenues—During 2005, the State notified the Village that Br 650,000 in motor fuel taxes will be awarded. Records show Br 575,000 was received in cash; the remainder is due from the state. Motor fuel taxes are derived tax revenue; under modified accrual accounting, the amount that can be recognized is the amount that is measurable and available.
2. Expenditures for Road Repairs—During 2005, expenditures for road repairs amounted to Br 605,000, of which Br 540,000 was paid in cash. Note that encumbrance accounting might be used but is omitted fro the sake of brevity.
3. Payment to General Fund—General Fund charged the Motor Fuel Tax Fund Br 20,000 for Road Repairs and Maintenance. The corresponding Interfund reimbursement entry is to charge the Motor Fuel Tax Fund and to reimburse cash to General Fund.
4. Grant Accounting—Assume the state awarded the village of Elisabeth Br 450,000 for major repairs to three Village Intersections. The Funds will be released by the State only as work is completed, as reimbursement. GASB Statement No. 33 considers this to be an eligibility requirement. Accordingly, Grant Revenues and receivables would be recognized as expenditures are incurred. During 2004, expenditures in the amount of Br 350,000 were incurred, of which Br 280,000 were paid in cash. The State had remitted Br 300,000 cash as of the end of 2005

Instruction: Record the foregoing Transactions and Prepare Year-End Financial Statements assuming that it is a major fund.

		General Ledger	
Special Revenue Fund:		**Debits**	**Credits**
1.	Cash	575,000	
	Due from State Government	75,000	
	Revenues-Control		650,000
2.	Expenditure–Control	605,000	
	Cash		540,000
	Accounts Payable		65,000
3.	Expenditures–Control	20,000	
	Cash		20,000
4.	Expenditures–Control	350,000	
	Cash		280,000
	Accounts Payable		70,000
5.	Due from State Government	350,000	
	Revenues–Control		350,000
6.	Cash	300,000	
	Due from State Government		300,0000
7.	**Closing Entry:**		
	Revenues–Control	1,000,000	
	Expenditure–Control		975,000
	Unreserved Fund Balance		25,000

1. Balance Sheet

Village of Elizabeth
Motor Fuel Tax Fund Balance Sheet
As of December 31, 2004

Assets:	
Cash	247,500
Due from State Government	125,000
Total Assets	**372,500**
Liabilities and Fund Equity:	
Liabilities:	
Vouchers Payable	135,000
Fund Equity:	
Fund Balance—Unreserved	86,900
Total Liabilities and Fund Equity	**372,500**

2. Statement of Revenues, Expenditures, and Change in Fund Balances

Village of Elizabeth
Motor Fuel Tax Fund
Statement of Revenues, Expenditures, and Change in Fund Balances
For the Year Ended December 31, 2006

Revenues:	
Motor Fuel Taxes	650,000
State Grant	350,000
Total revenues	1,000,000
Expenditures:	
Public Works	975,000
Net Change in Fund Balance for Year	25,000
Fund Balance, January, 1, 2005	212,500
Fund Balance, December 31, 2005	**$ 237,500**

4.3) Interfund Activity

1. Reciprocal Interfund Activity

Interfund Services Provided and Used – Internal exchange transactions which involve the sales and purchases of goods and services in a reciprocal exchange between two funds are termed *interfund services provided and used* in GASB Statement No. 34.

Interfund Loans – are sometimes made from one fund to another with the intent that the amount be repaid. If the loan must be repaid during the current year or soon thereafter, the lending fund should record a current receivable and the borrowing fund should record a current liability. Example: the General Fund makes a short-term loan in the amount of Br 100,000 to the Central Stores Fund (an ISF)

General Fund:

	Debits	Credits
Interfund Loans Receivable—Current	100,000	
Cash		100,000

Internal Service Fund:

	Debits	Credits
Cash	100,000	
Interfund Loans Receivable—Current		100,000

If this interfund loan did not require repayment for two (or more) years, the suffix "Noncurrent" should be used rather than "Current" to signify the noncurrent nature of the loan.

General Fund:

	Debits	Credits
Interfund Loans Receivable—Noncurrent	100,000	
Cash.....		100,000

Internal Service Fund:

	Debits	Credits
Cash	100,000	
Interfund Loans Receivable—Noncurrent		100,000

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

General Fund:	Debits	Credits
Fund Balance	100,000	
Reserved for Noncurrent Interfund Loans–Receivable		100,000

2. Nonreciprocal Interfund Activity

Interfund Transfers – the reporting model superseded by GASB Statement No. 34 identified two types of interfund transfers: Operating Transfers and Residual Equity Transfers, which were reported in two different ways in governmental fund operating statements. Under GASB Statement No. 34, both types of transfers are described simply as interfund transfers and reported in the same manner—as other financing sources by the receiving fund and as other financing uses by the transferring funds. For routine interfund transfers, the transfer of tax revenue to the expending fund is recorded by transferor as an Interfund Transfer Out and by the transferee as an Interfund Transfer In. The creation of a fund by transfer of assets and/or resources from an existing fund to a new fund, or transfers of residual balances of discontinued funds to another fund, results in the recognition of an other financing source rather than as revenue by the new fund and an other financing use rather than an expenditure by the transferor fund.

Reimbursement – is not revenue to be recognized**.** In some instances, one fund may record as expenditure an item that should have been recorded as expenditure by another fund. It is usually an accounting error. When the second fund reimburses the first fund, the first fund should recognize the reimbursement as a reduction of its expenditures account, not as an item of revenue. The second fund should debit expenditures and credit cash.

Intra-activity versus Inter-activity Transactions (Government-Wide Level)

Intra-activity transaction

- A transaction between two governmental funds (including an internal service fund) or between two enterprise funds
- Neither governmental activities nor business-type activities is affected at the government-wide level

Inter-activity transaction

- Interfund loans or transfers between a governmental fund (including internal service fund) and an enterprise fund
- Report these as "Internal Balances" on the government-wide statement of net assets and "Transfers" on the statement of activities

Intra-Entity Transactions

- Exchange or non-exchange transactions between the primary government and its blended or discretely presented component units
- Receivables and payables from these transactions are reported on a separate line in the statement of net assets.

4.4) Permanent Funds

GASB Statement No. 34 model requires that public-purpose trusts for which the earnings are expendable for a specified purpose, but the principal amount is not expendable (also referred to as endowments), must be accounted fro in a **governmental fund** called a Permanent Fund. Permanent Funds is specifically intended for a public purpose (i.e., to benefit a government program or function, or the citizenry, rather than individuals, private organizations, or other governments).

Budgetary Accounts

Budgetary accounts generally should not be needed for permanent funds because transactions of the fund result in changes in the fund principal only incidentally; by definition, the principal cannot be appropriated or expended. Public-purpose expendable trust funds accounted for in special revenue funds, however, may be required by law to use the appropriation procedure to ensure adequate budgetary control over the expenditure of fund assets. If the appropriation procedure is required, the use of other budgetary accounts is also recommended.

Illustration for permanent fund trust principal and expendable trust revenue

Assume on November 1, 2001, James Smith died, having made a valid will that provided for the gift of various securities to the City of Columbia to be held as a nonexpendable trust; the net income from the securities for distribution purposes it to be computed on the full accrual basis, but does not include increases or decreases in the fair value of investments. Income, so measured, is to be transferred to the City's Library Operating Fund, a special revenue fund. Accounting for the Library Operating Fund is not illustrated here. For sake of brevity, corresponding entries in the general journal for governmental activities at the government-wide level are also omitted. The gift was accepted by the City of Columbia and the Library Endowment Fund (a Permanent Fund) was established to account for the nonexpendable trust. The following securities were received by the Library Endowment Fund.

Bonds:	Interest Rate Per Year	Maturity Date	Face Value	Fair Value as of 11/1/01
AB Company	10%	1/1/06	$330,000	$340,000
C&D Company	9%	7/1/03	110,000	112,000
D&G Company	9%	1/1/25	200,000	200,000
Total			$640,000	$652,000

Stocks:	**Number of Shares**	Fair Value as of 11/1/01
M Company, Common	2,400	126,000
S Company, Common	10,000	96,000
K Company, Common	3,000	129,000
GF Company, Common	2,000	145,000
Total		496,000

Journal Entries—Permanent Fund

The receipt of the securities by the Library Endowment Fund is properly recorded at the fair value of the securities as of the date of the gift because this is the amount for which the trustees are responsible. Although the face value of the bonds will be received at maturity, GASB Standards require that investments in bonds maturing more than one year from receipt be reported at fair value on the balance sheet date. Thus the entry in the Library Endowment Fund to record the receipt of the securities at initiation of the trust on November 1, 2001, is:

Permanent Fund:		**Debits**	**Credits**
1.	Investment in Bonds	652,000	
	Investment in Stocks	496,000	
	Accrued Interest Receivable	20,300	
	Revenues—Contributions for Endowment		1,168,300

[Interest accrued is AB ($ 330,000 @ 10% @ 4/12 = $ 11,000), C&D ($110,000@9%@4/12 = $3,300), and D&G ($200,000 @ 9% @ 4/12 = $6,000)]

As of January 1, 2002, interest is received on all bonds— $16,500 from AB Company; $4,950 from C&D Company; and $9,000 from D&G Company; however, only two months of this interest is earned investment revenue that can be transferred to the **Library Operating Fund**. The entry for the receipt of bond interest on January 1, 2002, and the revenue earned for transfer to the Library Operating Fund is:

Permanent Fund:	**Debits**	**Credits**
2. Cash	652,000	
Accrued Interest Receivable		20,300
Revenues—Contributions for Endowment		10,150

Dividends on Stock do not accrue. They become a receivable only when declared by the corporation issuing the stock. Ordinarily the receivable is not recorded because it is followed in a reasonably short time by issuance of a dividend were early in January 2002 in the amount of $9,800, Entry 8 is appropriate:

Permanent Fund:	**Debits**	**Credits**
3. Cash	9,800	
Revenues—Investment Earnings		9,800

The **Library Endowment Fund** has sufficient cash to pay the amount owed to the Library Operating Fund for bond interest during the two months since the bond interest and dividends were received in cash (10,150 + 9,800 = $19,950). Assuming cash in transferred as of January 3, 2002, Entry 4 is:

Permanent Fund:	**Debits**	**Credits**
4. Interfund Transfers Out	19,950	
Cash		19,950

On the advice of an investment manager, 1,000 shares of GF Company stock were sold for $78,750; this amount and cash of $19,000 were invested in 2,000 shares of LH Company Common Stock. The GF Company stock sold was half the number of shares received when the trust was established; therefore, it was recorded at its fair value hen of $72,500; the difference between its book value and the proceeds is considered in this trust to belong to the corpus and doest not give rise to gain or loss that would adjust the net income to be transferred to the Library Operating Fund. Therefore, the sale of GF Company stock and the purchase of LH Company stock should be recorded in the Library Endowment Fund as shown in Entries 5a and 5b

Permanent Fund:	**Debits**	**Credits**
5a. Cash	78,750	
Investment in Stocks		72,500
Revenues—Change in Fair Value of Investments		6,250
5b. Investment in Stocks	97,750	
Cash		97,750

Assuming there were no further purchases or sales of stock and that dividends received on April 1, 2002, amounted to $9,920, Entry 6a is necessary, as well as Entry 6b to make the required operating transfer to the Library Operating Fund.

Permanent Fund:	**Debits**	**Credits**
6a. Cash	9,920	
Revenues—Investment Earnings		9,920
6b. Interfund Transfer Out	9,920	
Cash		9,920

Interest accrued on June 30, 2002, amounted to $30,450, the same amount received early in January 2002. The fair value of the Library Endowment Fund investment as of June 30, 2002, the last day of the City of Columbia's fiscal year, is given below:

Bonds:	Fair Value as of 11/1/01	Fair Value as of 6/30/02	Change in Fair Value
AB Company	$340,000	$360,000	$20,000
C&D Company	112,000	108,000	(4,000)
D&G Company	200,000	206,000	6,000
Total	$652,000	$674,000	$22,000

Stocks:	**No. of Shares**	Fair Value as of 11/1/01	Fair Value as of 6/30/02	Change in Fair Value
M Company	2,400	$126,000	132,000	$6,000
S Company	10,000	96,000	98,000	2,000
K Company	3,000	129,000	122,000	(7,000)
GF Company	1,000	72,500	75,500	3,000
LH Company	2,000	97,750	96,450	(1,300)
Total		$521,250	$523,950	$2,700

Entry 7a records the accrual of interest earned for transfer to the Library Operating Fund. Entry 7b records the adjusting entry to record the change in fair value of investments at the end of the fiscal year, compared with the prior fair value recorded for the investments. Entry 7c records the liability to the Library Operating Fund.

Permanent Fund:		**Debits**	**Credits**
7a.	Accrued Interest Receivable	30,450	
	Revenues—Investment Earnings		30,450
7b.	Investment in Bonds	22,000	
	Investment in Stocks	2,7000	
	Cash		24,700
7c.	Interfund Transfers Out	30,450	
	Due to Library Operating Fund		30,450

The Closing entry at the end of the fiscal year, June 30, 2002, is shown in Entry 8

Permanent Fund:		**Debits**	**Credits**
8.	Revenues—Contributions to Endowment	1,168,300	
	Revenues—Investment Earnings	60,320	
	Revenues—Change in Fair Value of Investment	30,950	
	Interfund Transfers Out		60,320
	Fund Balance—Reserved for Endowment		1,199,250

In Entry 8, one can see that the total interest earned on bonds and dividends received on investments in stocks in the amount of $60,320 was transferred during the year to the Library operating Fund; the net change (increase) in fair value of investments, $30,950 and the original contributions are added to the Fund Balance. If the net increase in the value of investments was permitted under the trust agreement to be used for Library operating purposes, the entire $91,270 (sum of earnings and increase in fair value) would have been transferred out, and the addition to Fund Balance would have been just for the $1,168,300 original contribution.

At year-end, financial statements for the Library Endowment Fund would be presented in essentially the same formats as the General Fund Balance Sheet and General Fund Statement of Revenues, Expenditures, and Changes in Fund Balance. If the Library Endowment Fund meets the criteria for a major fund, its balance sheet and operating statement information would be included as a column in the Balance Sheet—Governmental Funds and Statement of Revenues, Expenditures, and Changes in Fund Balances—Government Funds. If the fund is determined to be a non-major fund, it would be reported in the combining balance sheet and operating statement for non-major governmental Funds.

Chapter Five
Accounting for General Capital Assets and Capital Projects Funds

Topics to Be Discussed:

- Introduction to Capital Assets and Capital Projects
- Accounting for General Capital Assets
  - Required Disclosures about Capital Assets
  - Typical classification of General Capital Assets: Costs and Depreciation of General Capital Assets or Modified Approach for Infrastructure Assets
  - General Capital Assets acquired under Capital Lease Agreement
  - Costs incurred after acquisition
  - Reduction of Costs (Disposal of Capital Assets)
  - Illustrative Entries
- Accounting for Capital Projects
  - Legal Requirements
  - Illustrative Transactions of Capital Project Funds
  - Required Financial Statements
  - Alternative treatment of Residual Equity
  - Retained Percentage

Learning Objectives:

After studying this Chapter, you should be able to:

- Describe the nature and characteristics of general capital assets
- Account for the acquisition, maintenance, and disposition of general capital assets
- Account for depreciation of general capital assets, including the modified approach for infrastructure assets
- Explain the purpose and characteristics of a capital projects fund
- Explain the typical sources of financing for capital projects
- Prepare journal entries for a typical capital project, both within the capital projects fund and within the governmental activities category at the government-wide level
- Explain the concepts and accounting procedures for special assessment capital projects
- Prepare financial statements for capital projects funds

5.1) What are General Capital Assets?

Long lived assets used by activities accounted for governmental fund types are called **General Capital Assets**. General capital assets should be distinguished from capital assets that are specifically associated with activities reported in proprietary and fiduciary funds. Capital assets acquired by proprietary and fiduciary funds are accounted for in those funds.

Financing Sources for General Capital Assets

Acquisitions of general assets that require major amount of money ordinarily cannot be financed from General Fund or special revenue fund appropriation. Major acquisitions of general capital assets are commonly financed:

- By issuance of long term debt to be repaid from tax revenues, or
- By special assessments against property deemed to be particularly benefited by the long-lived asset.
- Other sources of financing the acquisition of long lived assets include
  - grants from other governmental units,

- transfers from other funds,
- gifts from individual or organizations,
- Or a combination of several of these sources

- Capital leases
- tax increment financing

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

General capital assets may be acquired from expenditures of General Fund, special revenue funds, or capital project funds. The cost or other carrying value of general capital assets, and long-term debt related to general capital assets acquisition, is accounted for in the general ledger for the governmental activities category at the government-wide level.

General Capital Asset Acquisition: Governmental Funds and Government-wide Governmental Activities		
General Fund and/or Special Revenue Funds:	**Capital Project Funds:**	**Government-wide Governmental Activities:**
Account for capital outlay expenditures from annual budget appropriation. General Capital assets acquired Are accounted for in the Governmental activities general ledger at the government-wide level.	Account for construction or major capital expenditures from debt proceeds, capital grants, and special statements and other sources for capital assets acquisition. General capital assets acquired and related Long-term debt to be Serviced from tax revenue or from special assessments, are recorded in the governmental activities **General Ledger** at The government-wide Level.	Account for the cost and depreciation of general capital assets (GCA) acquired by expenditures of the general, special revenue Funds, and capital project funds. Also account for GCA acquired under capital Leases and for GCA acquired by gift. Account for all unmatured long term except debt being repaid from revenues of Enterprise Fund

5.2) Accounting for General Capital Assets

Only enterprise and internal service funds routinely account for capital assets (property, plant and equipment) used in their operations. The relatively few governmental trust funds that use capital assets for the production of income also account for property, plant and equipment. All other funds account only for financial resources. Capital assets acquired by those funds cannot be accounted for in the funds. Rather, general capital assets purchased or constructed with governmental fund resources are accounted for in the governmental activities general ledger at the government- wide level.

In conformity with generally accepted accounting principles, general capital assets are recorded at historical cost or fair value at time of receipt if assets are received by donation. Historical cost includes acquisition cost plus ancillary costs necessary to put the asset in to use. Ancillary costs may include items such as freight and transportation charges, site preparation costs, set-up costs, and, for assets acquired through construction projects, capitalized interest. If the cost of capital assets was not recorded when the assets where acquired and is unknown when accounting control over the assets is established, it is acceptable to record them at estimated cost.

Until implementation of GASB Statement No. 34, depreciation was not recorded on general assets in any governmental fund, but accumulated depreciation could optionally be reported in the General Fixed Assets Account Group. Few governments opted to report the depreciation since it was not required.

As per GASB Statement No. 34, *General capital are recorded in the governmental activities ledger at the government-wide level* and reported in the *governmental activities column of the Statement of Net Asset*, net of accumulated depreciation, where appropriate. Even though the general capital assets are acquired for the production of governmental services rather the production of service that are sold, reporting depreciation on the general capital may provide significant benefits to users and managers alike. Reporting deprecation expense as part of the direct expenses of functions and programs in the governmental activities column of the Government-wide Statement of Activities helps to determine the full cost of providing each function or program. Depreciation expense on the capital assets used in the operation a government grant-financed program is often an allowable cost under the terms of the grant. In addition the, depreciation expense may provide useful information to administrators and legislators concerned to the allocation of resources to programs, departments, and activities. To a limited extent, a comparison of accumulated depreciation on an asset with the cost of the asset may assist in budgeting outlays for replacement of capital assets. For these reason, Statement No. 34 requires to report deprecation on general capital assets in the government-wide financial statements as a significant improvement in governmental financial reporting.

Required Disclosures about Capital Assets

GASB standards require certain disclosures about capital assets in the notes to the basic financial statements, both the general capital assets reported in governmental activities column and these reported in the business type activities column of the government-wide financial statements. Capital assets that are not being depreciated should be separately disclosed from those assets that are being depreciated. Require disclosures about each major classes of capital assets include:-

1) *Beginning of year and end of year balances, showing accumulated depreciation separate from historical cost.*
2) *Capital acquisition during the year.*
3) *Sales or other disposition during the year.*
4) *Depreciation expense for the current period, with disclosure of the amount charged to each function in the statement of activities*

Typical Classification of General Capital Assets

- Land – the cost of land acquired by a governmental unit through purchase should include not only the contract price but also such other related costs as taxes and other liens assumed, title search costs, legal fees, surveying, filling, grading, draining, and other costs of preparation for the use intended.
- Buildings and Improvements Other than Buildings –
- Equipment, or Machinery and Equipment –
- Construction Work-in-Progress –
- Infrastructure Assets –

Depreciation Accounting and Reporting

- Depreciation on general capital assets, including infrastructure assets, is required at the government-wide level under GASBS 34
- Depreciation is not recorded on inexhaustible assets, such as land and non-capitalized collections of art
- The government can elect not to depreciate certain eligible infrastructure assets, under the modified approach (see next slide).

Election to use the **Modified Approach for Infrastructure Assets**

- The government can elect not to depreciate certain "eligible" infrastructure assets if
  An asset management system is in place that includes
  - An up-to-date inventory of eligible assets
  - Condition assessments of the assets and summary of results using a measurement scale
  - Estimates each year of the annual amount needed to maintain and preserve the assets at the established condition level
- The government documents that these assets are being preserved at or above established levels of condition.

General Capital Assets Acquired under Capital Lease Agreements

State and local governmental units generally are subject to constitutional or statutory limits on the amount of long term debt they may issue. Consequently, it has been customary for governmental units that have reached their legal limit or nearly done so to acquire the use of capital assets through a lease agreement.

For equipment lease an entry is made in the General Fund or other appropriate governmental fund to debit Expenditure offset by a credit to other Financing Sources, in the amount of the present value at the inception of the lease of the stream of lease payments. The amount (or the fair value of the leased property, if less) is also recorded in the governmental activities ledger at the government wide level as the cost of the leased property.

FASB SFAS No. 13 defines and establishes accounting and financial reporting standards for operating leases and capital. GASB standards accept the SFAS No. 13 definitions of these two forms of leases and prescribe accounting and financial reporting for lease agreements of state and local governmental units. If a particular lease meets any one of the following classification criteria, it is a **Capital Lease.**

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

If no criterion is met, the leases are classified as an **Operating Lease** by the lessee. Rental payments under an operating lease for assets used by governmental funds are recorded by the using fund as expenditures of the period.

Example: assume that a city leases a truck which has a ten year life and a fair market value of Br 50,000. Here are four sample situations where the city is required to account for the property as a capital lease:

- *The lease is for six years but the city automatically receives title to the truck at the end of that term (Criterion one is met so it is a capital lease)*
- *The lease is for five years but the city can buy the truck for Br 3,000 at the end of that time, an amount that is viewed significantly less than the expected fair value of Br 11,000 (Criterion two is met so it is a capital lease)*
- *The lease is for eight years after which the truck will be returned to the lessor (Criterion three is met so it a capital lease)*
- *The lease is for seven years but the present value of minimum lease payments is over Br 45,000 (90 percent of Br 50,000) (Criterion four is met so it is a capital lease)*

Recording Capital Lease:

As an example of accounting for the acquisition of general capital assets under a capital lease agreement, assume a governmental unit signs a capital lease agreement to pay $10,000 on January 1, 2001, the scheduled date of delivery of certain equipment to be used by an activity accounted for by a

special revenue fund. The lease calls for annual payments of $10,000 at the beginning of each year thereafter; that is, January 1, 2002, January 1, 2003, and so on, through January 1, 2010. There are 10 payments of $10,000 each, for a total of $100,000, but GASB standards require entry in the accounts of the present value of the stream of annual payments, not their total. Since the initial payment of $10,000 is paid at the inception of the lease, its present value is $10,000. The present value of the remaining nine payments must be calculated using the borrowing rate the lessee would have incurred to obtain a similar loan over a similar term to purchase the leased asset. Assuming the rate to be 10%, the present value of payments 2 through 10 is $57,590. The present value of the 10 payments is, therefore, $67,590. GASB standards require a governmental fund (including, if appropriate, a capital projects fund) to record the transactions at fund level and governmental wide level.

Fund–Based Financial Statements

Assume that the same lease is being reported in the fund based financial statements. The recording of this same lease by the General Fund may actually appear to double count expenditures. However this required approach seeks to mirror the reporting that would have resulted if the city had performed a series of events: (1) borrowed money on a long term liability, (2) used that money to acquire the asset in question, and (3) subsequently paid off this long term liability. If that series of events had occurred, the recording would have been as follows in the fund-based financial statements:

1. *When the money was borrowed on a long term liability, the city would have reported another financing resource because the inflow of financial resources did not come from revenue.*
2. *When the money was spent to acquire this asset, an expenditure would be recorded in keeping with goal of measuring the amount of current financial resources.*
3. *When the debt and interest were subsequently paid, an Expenditure amount would have been recorded for both payments.*

Thus, an acquisition would have led to another financing source at the time money was borrowed, Expenditure when the asset was acquired, and an additional second expenditure when the debt and interest were paid. In fund-based financial statements, identical transactions are mirrored for a capital lease. Using the same eight year lease in connection with the above truck for Br 10,000 per year, an amount with a present value of Br 67,590, the General Fund records the following entry:

General Fund:

Expenditures-Leased Asset	67,590	
Other Financing Sources—Capital Lease Agreement		67,590

Note that neither the asset nor the long term liabilities are reported because they do not fall within the definition of current financial resources. At the end of the first year, when the next payment is made, Br 5,759 (10 percent of the obligation after the first payment) is considered interest while the rest reduces the principal as follows:

Expenditures—Interest	5,759	
Expenditures—Principal	4,241	
Cash		10,000

Government–Wide Financial Statements

In accounting for a capital lease within the government wide financial statements, the accounting is the same as that appropriate for a profit enterprises. Both an asset and a liability are reported initially at the **present value** of the minimum lease payments in the same manner as a debt- financed acquisition. The PV of the minimum lease payments applying a 10 percent rate to annuity due for ten years is Br 67,590.

Equipment	67,590	
Capital Lease Obligation		57,590
Cash		10,000

Depreciation expense should be recognized over the lease term. However, if title to the asset is to **transfer to the city or if a bargain option exists,** the full economic life should be used for depreciation purposes because the lessee will expect to get full use of the asset.

At the end of the first year, when the next payment is made, part of that Br 10,000 will be attributed to interest with the remainder viewed as a reduction in liability principal. Because the obligation is being reported at Br 57,590 and the interest rate is 10 percent, the interest recorded for the first year will be Br 5,759. The remaining Br 4,241 (Br 10,000 less Br 5,759) decreases the debt to Br 53,349.

Interest Expense	4,241	
Capital Lease Obligation	5,759	
Cash		10,000

Costs Incurred after Acquisition

Any outlay that definitely adds to the utility or function of a capital asset or enhances the value of an integral part of it may be capitalized as part of the asset. Thus, drainage of land, addition of a room to a building, and changes in equipment that increase its output or reduce its cost of operation are clearly recognizable as additions to assets. Special difficulty arises in the case of large-scale outlays that are partly replacements and partly additions or betterments. An example would be replacement of a composition-type roof with a roof of some more durable material. To the extent that the project replaces the old roof, outlays should not be capitalized unless cost of the old roof is removed from the accounts; and to the extent that the project provides a better roof, outlays should be capitalized. The distribution of the total cost in such a case is largely a matter for managerial determination. Consistent with policy in recording original acquisition costs, some outlays unquestionably representing increases in permanent values may not be capitalized if the amount is less than some specified minimum or on the basis of any other criterion previously decided on.

Outlays that are partly replacements and partly additions or betterments occasion some accounting difficulty. The distribution of the outlay having been decided on, the estimated amount of addition or betterment might be added to the asset.

Reduction of Cost (Disposal and Exchange)

Reductions in the cost of capital assets may relate to the elimination of the total amount expended for a given item or items, or they may consist only of removing the cost applicable to a specific part.

Reductions in the recorded cost of capital assets may be brought about by sale, retirement from use, destruction by fire or other casualty, replacement of a major part, theft or loss from some other cause, and possible other changes. The cost of capital assets recorded in the governmental activities ledger may sometimes be reduced by the transfer of a unit to an enterprise fund, or vice versa.

Since depreciation is now recorded on general capital assets, the removal of a capital asset from the governmental activities general ledger may be accomplished by crediting the ledger account recording its cost and debiting Accumulated Depreciation and Cash, if the item was sold. Gains or losses should be recognized if the value received differs from the book value of the assets removed. The gains and losses are reported on the government-wide statement of activities.
Governments sometimes trade used capital assets for new items. In the governmental activities general ledger, the total cost of the old item should be removed and the total cost (not merely the cash payment) of the new one set up.

Illustrative Entries:

Acquisition of general capital assets requires a debit to the appropriate governmental activities account and a credit to Cash or a liability account. Thus, if office equipment is purchased for the treasurer's office from General Fund resources, the following journal entries would be made in the general

journals for the General Fund (ignoring encumbrances) and governmental activities at the government wide level:

General Fund:		
Expenditures	450	
Vouchers Payable		450
Governmental Activities:		
Equipment	450	
Vouchers Payable		450

General capital assets acquired by use of Capital Projects Fund resources would be recorded in essentially the same manner as if acquired from the General Fund. If construction of a general capital asset is in progress at the end of a fiscal year, Construction Expenditures to the date of the financial report should be capitalized in the governmental activities ledger.

Accounting for an asset disposal requires elimination of the capital asset and accumulated depreciation accounts and recognition of a gain or loss, as appropriate. Assuming a building that cost $100,000, and with $ 80,000 of accumulated depreciation, is retired without revenue or expenditure to the General Fund, the following entry in the governmental activities general journal would be required:

Governmental Activities:		
Loss on Disposal of Building	20,000	
Accumulated Depreciation—Buildings	80,000	
Buildings		100,000

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

General Fund:		
Expenditures	3,000	
Vouchers Payable		3,000
Governmental Activities:		
Loss on Disposal of Building	23,000	
Accumulated Depreciation—Buildings	80,000	
Buildings		100,000
Vouchers Payable		3,000

If cash is received from the disposal of a general capital asset, some question may arise as to its disposition. Theoretically, it should be directed to the fund that provided the asset; but this may not always be practicable. If the asset was provided by a capital projects fund, the contributing fund may have been liquidated before the sale occurs. Unless otherwise prescribed by law, disposition of the results of a sale will be handled as decided by the legislative body having jurisdiction over the asset and will be accounted for in the manner required by the accounting system of the recipient fund. Commonly, proceeds of sales of general capital assets are budgeted as Estimated Other Financing Sources in the General Fund. In such cases, when sales actually occur, the General Fund debits Cash (or a receivable) for the selling price and credits Other Financing Sources-Proceeds of Sales of Assets.

Exercises:

Exercise 1: Assume a machine is sold for $500. The asset had originally been purchased for $8,000 using GF revenues. It was fully depreciated.

Exercise 2: Assume a building with an original cost of $100,000 (from tax-supported bonds) is demolished; cost of demolition was $5,000. It was fully depreciated.
Instruction: Record the above transaction in General Fund and at Government-wide Level

5.3) Accounting for Capital Projects

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

Capital projects funds differ from general and special revenue funds in that the latter categories have a year -to-year life, whereas **capital projects funds have a project-life focus**. In some jurisdictions governments are allowed to account for all capital projects within a single capital projects fund. In other jurisdictions laws are construed as requiring each project to be accounted for by a separate capital project fund.

Source of funding for Capital Project Funds

The financial resources of capital project funds come from several different sources, including general obligation bonds, grants from the state and federal government, and appropriations from the general or special revenue funds, gifts from individual or organizations, transfer from other funds or a combination of several of these sources. Yet a major source of funding for capital projects funds is the issuance of long-term debt.

Budgets and Capital Project Funds

Capital projects which are funded entirely from bonded indebtedness and/or from assets which have been accumulated in the capital projects fund for that project may be budgeted on a project basis. This means that the budget need only be adopted once for that project, regardless of how many fiscal years it takes to complete the project.

Budgetary accounting is not required for capital projects funds, but encumbrance accounting is used, outstanding contracts and purchase orders are reported as reservations of fund balances in the governmental fund balance sheet. Accomplishment of a capital acquisition project may be brought about in one or more of the following ways:

1. *Outright purchase from fund cash.*
2. *By construction, utilizing the governmental unit's own working force.*
3. *By construction, utilizing the services of private contractors.*
4. *By capital lease agreement.*

Illustrative Transactions—Capital Projects Funds

Proceeds of debt issues should be recorded as Proceeds of Bonds or Proceeds Long-Term Notes rater than as Revenues, and they should be reported in the Other Financing Sources section of the Statement of Revenues, Expenditures, and Changes in Fund Balance. Similarly, tax revenues raised by the General Fund, or special revenue fund, and transferred to a capital projects fund are recorded as an Inter fund Transfers in and reported in the Other Financing Sources section of the **Operating Statement**. Taxes raised specifically for a capital projects fund would be recorded as Revenues of that fund, as would special assessments to be used for the construction assets deemed to be of particular benefit to certain property owners. Grants, entitlements, or shared revenues received by a capital projects fund from another governmental unit are considered Revenues of the capital projects fund, as would be interest earned on temporary investments of the capital projects fund if the interest is available for expenditure by the capital projects fund (if, by law, the interest must be used for service of long-term capital debt the interest should be transferred to the appropriate debt service fund).

In the following illustration of accounting for representative transactions of capital projects fund, it is assumed the Council of a certain Town authorized an issue of $1,200,000 of 6% bonds as partial financing of a **Fire Station** expected to cost approximately $1,500,000; the $300,000 additional was to

be contributed by other governments. The project, to utilize land already owned by the Town, was done partly by a private contractor and partly by the Town's own workforce. Completion of the project was expected with in the current year. The $1,200,000 bond issue, which had been approved by voter referendum, was officially approved by the Town Council. No formal entry is required to record voter and Town Council approval. A memorandum entry may be made to identify the approved project and the means of financing it.

The sum of $50,000 was borrowed on a short-term basis from the National Bank for defraying engineering and other preliminary expenses. Because this transaction affects both the Fire Station Capital Projects Fund and the governmental activities at the government-wide level, the following entry is made in both journals:

Fire Station Capital Projects Fund and Governmental Activities:

1.	Cash	50,000	
	Short-term Notes Payable		50,000

The receivable from the other governments was recorded both at the fund and government-wide levels:

Fire Station Capital Projects Fund:

2a.	Due from Other Governmental Units	300,000	
	Revenues		300,000

Governmental Activities:

2b.	Due from Other Governmental Units	300,000	
	Program Revenues—Capital Grants and Contributions—Pubic Safety		300,000

Total purchase orders and other commitment documents issued for supplies, materials, items of minor equipment, and labor required for the part of the project to be performed by the Town's employees amounted to $443,000. The following budgetary control entry is made in the capital projects fund but is not recorded at the government-wide level.

Fire Station Capital Projects Fund:

3.	Encumbrances	443,000	
	Reserve for Encumbrances		443,000

A contract was let for certain work to be done by a private contractor in the amount of $1,005,000. As with Entry 3, only the capital projects fund is affected.

Fire Station Capital Projects Fund:

4.	Encumbrances	1,005,000	
	Reserve for Encumbrances		1,005,000

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

Fire Station Capital Projects Fund:

5a.	Construction Expenditures	48,000	
	Cash		48,000

Governmental Activates:

5b.	Construction Work–in–Progress	48,000	
	Cash		48,000

Entries **5a** and **5b** highlight a major difference between accounting for a governmental fund and governmental activities at the government wide level. Accounting for a governmental fund focuses on the inflows and outflows of current financial resources, on the modified accrual basis; accounting for

governmental activities focuses on the inflows and outflows of economic resources; including capital assets on the accrual basis used in accounting for business organizations.

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

Fire Station Capital Project Fund:

6a.	Reserve for Encumbrances	495,000	
	Encumbrances		495,000
6b.	Construction Expenditures	495,000	
	Contracts Payable		495,000

Governmental Activities:

6c.	Construction Work–in–Progress	495,000	
	Contracts Payable		495,000

Entries **6a** and **6b** record conversion of an estimated liability to a firm liability, eligible for payment upon proper authentication. Contracts payable records the status of a claim under a contract between the time of presentation and verification for vouchering or payment. Payment in full was received from the other governmental units that had agreed to pay part of the cost of the new fire station.

Fire Station Capital Projects Fund and Governmental Actives:

7.	Cash	300,000	
	Due from Other Governmental Units		300,000

The national Bank loan was repaid with interest mounting to $ 1,000

Fire Station Capital Projects Fund:

8a.	Construction Expenditures	1,000	
	Short–term Notes Payable	50,000	
	Cash		51,000

Government Activities:

8b.	Construction Work-in-Progress	1,000	
	Short–term Notes Payable	50,000	
	Cash		51,000

Capitalization of interest incurred during construction, in the manner required by FASB standards for business organizations, is now required by GASB Statement No. 34. The bond issue was sold at par on June 15, 2005, which is also the date of the bonds the date from which interest begins to accrue. Entries 9a and 9b below show the sharp contrast in accounting for this transaction in the capital projects fund and in the governmental activities ledger at the governmental wide level. Again, in the capital projects fund, the focus is on the inflow of current financial resources that increases the fund balance, whereas at the government wide level, the focus is on the change in economic resources. In this case, the inflow of cash produces on change in net assets since the cash inflow is offset by a long term liability.

Fire Station Capital Projects Fund:

9a.	Cash	1,200,000	
	Other Financing Sources—Proceeds of Bonds		1,200,000

Governmental Activities:

9a.	Cash	1,200,000	
	Bonds Payable		1,200,000

The contractor's initial claim was fully verified and paid (see Eateries 6b and 6c).

Fire Station Capital Projects Fund and Governmental Activities:

10.	Contracts Payable	495,000	
	Cash		495,000

Total disbursements for all costs encumbered in Transaction 3 amounted to $440,000. Although the encumbrance's entry only affects the capital projects fund, the disbursement affects both the capital projects fund and governmental activities at the government wide level.

Fire Station Capital Projects Fund:

11a.	Reserve for Encumbrances	443,000	
	Encumbrances		443,000
11b.	Construction Expenditures	440,000	
	Contracts Payable		440,000

Governmental Activities:

11c.	Construction Work–in–Progress	440,000	
	Contracts Payable		440,000

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

Fire Station Capital Projects Fund:

12a.	Reserve for Encumbrances	510,000	
	Encumbrances		510,000
12b.	Construction Expenditures	510,000	
	Contracts Payable		510,000

Governmental Activities:

12c.	Construction Work–in–Progress	510,000	
	Contracts Payable		510,000

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

Fire Station Capital Projects Fund and Governmental Activities:

13.	Contracts Payable	510,000	
	Cash		510,000

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

Fire Station Capital Projects Fund:

14a.	Revenues	300,000	
	Other Financing Sources—Proceeds of Bonds	1,200,000	
	Construction Expenditures		1,494,000
	Fund Balance		6,000

Governmental Activities:

14b.	Program Revenues–Capital Grants and Contributions–Public Safety	300,000	
	Net Assets-Invested in Capital Assets, Net of Related Debt		300,000

(Note: If the $300,000 had not yet been expended for the project, the account credited would have been Net Assets-Restricted for Capital Projects. If only part of the resources had been expended, appropriate amounts would have been credited to both accounts.)

Since the project has been completed, it is appropriate to close the Capital Projects Fund. The only asset of the fund remaining after the 14 transactions illustrated is Cash in the amount of $6,000. State laws often require that assets no longer needed in a capital projects fund be transferred to the fund that will service the debt incurred for this project, a debt service fund. Transfers of this nature are called interfund transfers and are reported as other financing uses by the transferor fund and other financing sources by the transferee fund in their Statement of Revenues, Expenditures, and Changes in Fund Balance the entries to record the transfer and the closing of the Capital Projects Fund account are:

Fire Station Capital Projects Fund:

15a.	Other Financing Uses—Interfund Transfers Out	6,000	

	Cash		6,000
15b.	Fund Balance	6,000	
	Other Financing Uses–Interfund Transfers Out		6,000

Similar entries would be required to record the Interfund Transfers In by the debt service fund. No entry is required at the government-wide level since the transfer occurs within the governmental activities category.

The Cost of the fire station constructed by the Town is recorded in the governmental activities general journal at the government-wide level. Because all capitalizable costs have previously been recorded as Construction Work in Progress during the period of construction, the only entry required is to reclassify the amount in that account to the Buildings account, as shown in the following entry.

Governmental Activities:

16.	Buildings	1,494,000	
	Construction Work–in–Progress		1,494,000

Illustrative Financial Statements for a Capital Project Fund

Inasmuch as all balance sheet accounts of the Fire Station Capital Projects Fund are closed in the case illustrated in the preceding section of this chapter, there are no assets, liabilities, or fund equity to report in a balance sheet. The operations of the year, however, should be reported in a Statement of Revenues, Expenditures, and Changes in Fund Balance. Since it is assumed the Town is not required to adopt a legal budget for its capital projects funds, there is no need to prepare a budgetary comparison schedule or statement for the capital projects fund type.

At the government-wide level, the completed fire station is reported as a capital asset, net of accumulated depreciation (if any depreciation expense is recorded in the first year in which the asset is placed into service), in the governmental activities column of the Statement of Net Assets. The $1,200,000 of tax-supported bonds issued for the project is reported as a long-term liability in the governmental activities column of the Statement of Net Assets. If any depreciation expense is recorded for the portion of a year the fire station has been in service, it would be reported as a direct expense of the Public Safety function in the Statement of Activities.

- † The CPF is included as a separate column of the governmental funds financial statements, if it meets the criteria for a "major fund"; otherwise in the "Other Governmental Funds" column
- † If non-major, financial information for the CPF is reported on the combining balance sheet and combining statement of revenues, expenditures, and changes in fund balances

TOWN OF JIMMA
FIRE STATION CAPITAL PROJECTS FUND
STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCE FOR THE YEAR ENDED DECEMBER 31, 2005

Revenues:		
From other Governmental Units		300,000
Expenditures:		
Construction		1,494,000
Excess of Revenues over (under) Expenditures		(1,194,000)
Other Financing Sources (Uses):		
Proceeds of bonds	$1,200,000	
Interfund transfer out	(6,000)	1,194,000
Change in Fund Balance for Year		–0–
Fund Balance, January, 1, 2005		–0–
Fund Balance, December 31, 2005		**$ –0–**

Alternative Treatment of Residual Equity or Deficits

If a long-term debt had been incurred for the purposes of the Capital Projects Fund; the residual equity is ordinary transferred to the fund that is to service the debt. If the residual equity was deemed to have come from grants or shared revenues restricted for capital acquisitions or construction, legal advice may indicate that any residual equity must be returned to the source(s) of the restricted grants or restricted shared revenues.

In some situations, in spite of careful planning and cost control, expenditures and other financing uses of Capital Project Fund may exceed its revenues and other financing sources, resulting in a *negative Fund balance, or deficit*. If the deficit is a relatively small amount, the legislative body of the governmental unit may be able to authorize transfers from one or more other funds to cover the deficit in the Capital Projects Fund. If the deficit is relatively large, and/or if intended transfers are not feasible, the governmental units would need to finance the deficit by issuing debt in whatever form is legally possible and salable under market conditions then existing.

Retained Percentage

It is common to require contractors on large scale contracts to give performance bonds, providing for indemnity to the governmental unit for any failure on the contractor's part to comply with terms and specifications of the agreement. Before final inspection of a project can be completed, the contractor firm may have moved its working force and equipment to another location, thus making it difficult to remedy possible objections to the firm's performance.

To provide more prompt adjustment on shortcomings not large or convincing enough to justify legal action, and not recoverable under contractor's bond as well as thus the contractor may admit but not be in a position to rectify, it is common practice to withheld a portion of the contractor’s remuneration until final inspection and acceptance have come about. The withheld portion is normally a contractual percentage of the amount due on each segment of the contract. Assuming the amount billed by Br 495,000 and the contract provided for retention of 5 percent, current settlement on the billing would be recorded as follows:

14a.	Contract Payable.....	495,000	
	Cash.....		470,250
	Contract Payable–Retained Percentage		24,750

This same entry would also be made in the governmental activities general journal at the government wide level. Alternatively, the intention of the government to retain the percentage stipulated in the contract could be recorded at the time the progress billing receives preliminary approval. In that event, the credit to contracts payable in the first entry in this section would be $470,750 is made at that time. The second entry therefore, would be a debit to Contracts payable and a credit to cash for $470,250

On final acceptance of the project, the retained percentage is liquidated by a payment of cash in the event the governmental unit that made the retention finds it necessary to spend money on correction of deficiencies in the contractor's performance, the payment is charged to contracts payable-Retained percentage. If the cost of correcting deficiencies exceeds the balance in the contracts payable Retained percentage Account, the excess amount is debited to construction Expenditures in the Capital Projects Fund and to Buildings (or other appropriate capital asset account) in the governmental activities general journal.

Multiple Period Projects and Multiple Projects

Multiple-Period Projects

- Close Encumbrances at year-end to Fund Balance
- Reestablish Encumbrances balance at the beginning of the next fiscal year (Dr. Encumbrances and Cr. Fund Balance)

Multiple-Projects Capital Projects Funds

- Use project name or other designation to identify encumbrances and expenditures accounts with the project

Special Assessment Projects

Special assessments are compulsory tax levies made against certain property to defray the cost of specific improvements:

- A special assessment district may be called a local improvement district, or some similar name
- The construction phase of the improvement project is accounted for in a CPF
- If long-term debt is issued with government commitment for the debt, then the debt service phase is accounted for in a debt service fund, as illustrated in Chapter 6 of this text
- If the government is not obligated in any manner for special assessment debt issued for the project, the receivable is accounted for in an agency fund

Chapter Six
Accounting for General Long-Term Liabilities and Debt Service Funds

Topics to Be Discussed:

- General Long-Term Liabilities
- General Long-Term Liabilities arising form Capital Lease Agreements
- Debit Limit and Debt Margin
- Direct Debt and Overlapping Debt
- Accounting for Debt Service Funds
  - Accounting for Serial Bonds
  - Debt Service Accounting for Term Bonds
- Accounting for Debt Refunding

Learning Objectives:
After studying this chapter, you should be able to:

- Explain what kinds of liabilities are classified as general long-term liabilities
- Make journal entries in the general journal of governmental activities to record the issuance and repayment of general long-term liabilities
- Make journal entries in the governmental activities general journal to record general long-term liabilities arising from capital lease agreements
- Prepare a schedule summarizing changes in general long-term liabilities
- Describe the reasons for and nature of statutory debt limits and explains the meaning of debt margin and overlapping debt
- Make appropriate journal entries to account for debt service transactions
- Describe the required fair value reporting of investments held by debt service funds
- Describe the accounting procedures and makes appropriate journal entries for special debt service transactions

6.1) General Long-Term Liabilities

The use of long-term debt is a traditional part of the fiscal policy of state and local governments, particularly for financing the acquisition of general capital assets. Although some governments have issued taxable debt, the interest earned on most debt issued by state and local governments is exempt from federal taxation and, in some states, from state taxation. The tax-exempt feature enables governments to raise large amounts of capital at relatively low cost. Because of the relative ease with which governments can issue debt, most states have acted in the public interest to impose statutory limits on the debt that can be incurred by state and local governments. Consequently, effective management of state and local governmental debt requires good legal advice and a sound understanding of public finance.

This chapter describes the kinds of debt and other long-term liabilities that are termed "general long-term liabilities." **General long-term liabilities** are those that arise from activities of **governmental funds and that are not accounted for as fund liabilities of a proprietary or fiduciary fund**. General long-term liabilities are reported as liabilities in the **governmental activities column** of the government-wide Statement of Net Assets, but are not reported as liabilities of governmental funds. This chapter also discusses the concepts of:

- Direct and Overlapping debt;
- Statutory Debt Limit; and
- Debt Margin

It also provides illustrative journal entries at the government-wide level to record increases and decreases in general long-term liabilities. Finally, the chapter explains the nature and types of **Debt Service Funds and Debt Services Accounting** for various kinds of general long-term liabilities, as well as accounting for refunding of debt. In studying this chapter, the reader should recall that the governmental fund types (General, Special Revenue, Capital Projects, Debt Service, and Permanent Funds) account for only short-term liabilities to be paid from fund assets. Although, the proceeds of long-term debt may be placed in one of these fund types (usually a **Capital Projects Fund**), the long-term debt may be placed itself must be recorded in the governmental activities accounting records at the government-wide level. Enterprise funds and perhaps certain private-purpose trust funds account for both long-tem debt serviced by the fund and short-term debt to be repaid from fund assets.

The liability of **Enterprise Funds** should be displayed on the face of the statement of the issuing fund if that fund may realistically be expected to finance the debt service; however, if the liability also is secondarily backed by the full faith and credit of the governmental unit, the contingent general obligation liability of the government should be disclosed in a note to the financial statements. The contingent obligation to assume debt service of long-term debt backed primarily by special assessments is acknowledged by reporting such debt in the government-wide financial statement as "special assessment debt with governmental commitment." Any portion of such debt that will be repaid directly by the government (for example, to finance the portion of a special assessment project deemed to have public benefit), should be reported like any other general long-term liabilities of the government

Bonds and other debt of enterprise funds issued with covenants that give the debt the status, even contingently, of **tax-supported debt** may affect the governmental unit's ability to issue additional tax-supported debt. The reason for this is discussed under the heading "Debt Limit and Debt Margin" in this chapter. If the contingency clause becomes effective because resources of the **Enterprise Fund** are insufficient for **Debt Service**, the unpaid portion of the debt is recorded as a liability of the governmental activities at the government-wide level. The enterprise fund that is relieved of the liability then removes the unpaid debt from its liability accounts and recognizes an Other Financing Sources, which is reported after the non-operating revenues (expenses) section of the proprietary funds Statement of Revenues, Expenses, and Changes in Fund Net Assets, in the GASB Statement No.34 reporting model.

General long-term liabilities that require journal entries in the governmental activities general journal at the government-wide level to reflect increases or decreases in **general long-term liabilities** also require entries in the accounts of one or more governmental funds. Most increases in general long-term liabilities arising from debt issuances are recorded as an Other Financing Source in a governmental fund and as a general long-term liability at the government-wide level. Increases in long-term liabilities that arise from operating activities, such as estimated losses from long-term claims and judgments, for example, are recorded at the government-wide level by debiting an expense and crediting a liability. Except for certain defeasances, most general long-term liabilities are settled by the payment of cash from a governmental fund. As one would expect, the entry in the governmental activities journal at the government-wide level to record the decrease in general long-term liabilities is straightforward: debit the liability account and credit Cash. At the same time the governmental fund paying the liability would debit Expenditures and credit Cash. Retirement of matured debt principal using a debt service fund is illustrated later in this chapter.

In any given year, it is common for new debt issues to be authorized, for previously authorized debt to be issued, and for older issues to be retired. When a combination of liability events takes place, a schedule detailing changes in long-term debt is needed to inform report users of the details of how long-term liabilities changed. The general long-term liability disclosures required by GASB Statement No. 34 effectively meet these needs by providing detail of beginning of period long-term liabilities, additions to and reductions of those liabilities, ending liabilities, and the portion of the liabilities

payable within one year. Illustration 6-1 presents this disclosure schedule for the hypothetical Town of JIMMA.

Illustration 6-1: Disclosures about Long-Term Liabilities, Town of JIMMA September 30, 2002					
NOTE 4 – Long-Term Debt Liabilities					
	Balance 10/1/2001	Additions	Reductions	Balance 9/30/2002	Amounts Due within One year
Governmental Activities:					
General obligation bonds	$510,000	$ —	$140,000	$370,000	$35,000
Other Long-term Bonds	11,120,000	15,830,000	1,315,000	25,635,000	2,152,185
Promissory note	213,016	—	17,917	195,099	16,410
Capital leases	155,084	41,702	76,047	120,739	73,740
Compensated absences	1,296,122	77,864	—	1,373,986	0
Total General LT liabilities	$13,294,222	15,949,566	1,548,964	27,694,824	2,227,335
Business-Type Activities:					
Utility revenue bonds	356,053,692	134,920,000	67,017,331	423,956,361	66,900,000
Utility Notes	71,361,000	—	1,700,000	69,661,000	1,680,000
Total Business-type LT Liabilities	427,414,692	134,920,000	68,717,331	493,617,361	68,580,000

6.2) General Long-Term Liabilities arising form Capital Lease Agreements

Acquisition of General Capital Assets under Lease Agreements resulted in general long-term liabilities. A brief example is given of the computation of the present value of rental under a capital lease agreement. The entry necessary in a governmental fund at the inception of the lease is illustrated in Chapter 5. The corresponding entry in the governmental activities general journal at the government-wide level is also given in Chapter 5 to show the capitalization of the asset acquired under the lease. The entry is reproduced here also in order to illustrate how the liability is recorded.

Governmental Activities:

Equipment 67,590
Capital Lease Obligations Payable..... 67,590

As shown in the preceding entry, at the inception of the lease an obligation is recognized at the government-wide level in an amount equal to the present value of the stream of annual payments. Although, the lease agreement calls for a $10,000 initial lease payment on January 1, 2001, the full present value should be recorded as the liability until the initial payment has been recorded. Accounting for the initial payment is recorded in the debt service fund is illustrated later in this chapter. When the initial payment is recorded in the debt service fund, it will be accompanied by the following entry at the government-wide level to record the reduction of the capital lease obligation.

Governmental Activities:

Capital Lease Obligation Payable 10,000
Cash..... 10,000

On January 1, 2002, the second lease rental payment of $10,000 is made. As the table given later in this chapter shows, only $4,241 of that payment applies to reduction of the principal of the lease obligation (the remaining $10,000 - $4,241, or $5,759, represents interest on the lease). Thus, the following entry is required at the government-wide level to further reduce the balance of the lease principal and to recognize the related interest expense.

Government Activities:

Capital Lease Obligations Payable..... 4,241
Interest Expense on Capital Lease..... 5,759
Cash..... 10,000

Schedule of Future Debt Service Requirements

In addition to the disclosures about long-term liabilities presented in Illustration 6-1, information about the amount of debt principal and interest falling due in future years is useful information to financial managers, bonds analysts, and others tables having an interest in assessing a governmental unit's

requirements for future debt service expenditures. The reader should note that the interest portion of the scheduled future debt service payments is not a present liability and should not be presented as such. To do so would not be in conformity with generally accepted accounting principles.

Illustration 6-2

TOWN OF JIMMA
NOTES TO FINANCIAL STATEMENTS
SEPTEMBER 30, 2002

Aggregate annual debt service requiems (excluding the Commercial paper Notes) including maturities of principal and payment of current interest are as follows.

Debt Service Requirement

Fiscal Year(s)	General	Enterprise	Internal Service	Total
2003	$2,815,299	$30,499,025	$22,273	$33,336,598
2004	2,838,305	34,499,804	22,273	37,360,382
2005	2,751,053	36,805,138	14,849	39,571,040
2006	2,693,201	39,340,417	—	42,033,618
2007	2,698,904	39,344,076	—	42,042,980
2008-2012	12,294,623	195,959,406	—	208,254,029
2013-2017	11,306,314	203,342,022	—	214,648,336
2018-2022	11,308,384	244,763,213	—	256,071,597
2023-2027	4,115,205	109,164,138	—	113,279,343
2028-2032	—	28,912,475	—	28,912,475
	52,821,288	962,629,715	59,395	1,015,510,398
Less: Interest	26,500,450	538,673,354	5,285	565,179,089
Total Principal	**$26,320,838**	**$423,956,361**	**$54,110**	**$450,331,309**

6.3) Debit Limit and Debt Margin

The debt schedules already illustrated in this chapter are primarily useful for the information of administrators, legislative bodies, and others concerned with the impact of long-term debt on the financial condition and activities of the governmental unit, particularly with reference to the resulting tax rates and taxes. Another matter of importance is the legal limit on the amount of long-term indebtedness that may be outstanding at a given time, in proportion to the assessed value of property within the jurisdiction represented. This type of restriction is of importance as a protection of taxpayers against possible confiscatory tax rates. Even though tax-rate limitation laws may be in effect for a governmental unit, the limitation on bonded indebtedness is usually needed because the prevailing practice is to exempt the claims of bondholders from the barrier of tax rates restrictions. This is to say that, even though a law establishing maxima for tax rates is in the statutes, it will probably exclude debt service requirements from the restrictions of the law. This exclusion would be reiterated, in effect, in the bond indentures. Before continuing a discussion of debt limitation, it seems well to clarify the meaning of the terms *debt limit and debt margin.*

Debt limit means the total amount of indebtedness of specified kinds that is allowed by law to be outstanding at any one time. The limitation is likely to be in terms of a stipulated percentage of the assessed valuation of property within the government's jurisdiction. It may relate to either a gross valuation or a net valuation. The latter is logical, but probably not prevalent, because debt limitation exists as a device for protecting property owners from confiscatory (very high) taxation. For that reason, tax-paying property only should be used in regulating maximum indebtedness. In many governmental jurisdictions, certain property is legally excluded even from assessment. This includes property owned by governments, churches, charitable organizations, and some others, depending on

state laws. Exemptions, which apply to property subject to assessment, are based on homestead or mortgage exemption laws, military service, economic status, and possibly some others. Both exclusions and exemptions reduce the amount of tax-paying property.

Net Valuation = All Property Value – Excluded Property Value – Exempted Property Value

Debt margin, sometimes referred to as borrowing power, is the difference between the amount of debt limit calculated as prescribed by law and the net amount of outstanding indebtedness subject to limitation. The net amount of outstanding indebtedness subject to limitation differs from total general long-term indebtedness because certain debt issues may be exempted by law from the limitation, and the amount available in debt service funds for debt repayment is deducted from the outstanding debt in order to determine the amount subject to the legal debt limit. Total general long-term indebtedness must, in some jurisdictions, include special assessment debt and debt serviced by enterprise funds if such debt was issued with covenants that give the debt tax-supported status in the event that collections of special assessments or enterprise fund revenues are insufficient to meet required interest or principal payments. Debt authorized but not issued as of the end of a fiscal year should be added to outstanding debt because it may be sold at any time. Although it would be in keeping with the purpose of establishing a legal debt limit to include the present value of capital lease obligations along with bonded debt in the computation of legal debt margin, states statutes at preset generally do not specify that the liability for capital lease obligations is subject to the legal debt limit.

Illustration:

Town of Anywhere has the following data on September 30, 2006:

Assessed value of Real Property	164,147,340
Assessed value of Personal Property	53,012,260
Debt Limit as a percent of assessed value	20%
Outstanding Debt	126,438,619
Net Assets in Debt service Funds to pay the outstanding debt	45,836,524

Instruction: Determine the Legal Debt margin

Town of Anywhere
Computation of Legal Debt Margin
September 30, 2006

Assessed value of Real Property		164,147,340
Assessed value of Personal Property		53,012,260
Total Assessed Value of Real and Personal Property		747,159,600
Legal Debt Limit, 20% of assessed value		149,431,920
Outstanding Debt	121,695,000	
Net Assets in DSFs to pay the outstanding debt	(45,836,524)	
Outstanding Debt applicable to Debt Limit		80,602,095
Legal Debt Margin		68,829,825

Exercise:

A Town had general obligation debt outstanding of Br 30,000,000 and had available resources in the amount of Br 8,000,000 to pay that debt. The assessed valuation of property in the Town is Br 600,000,000. The state applies an 8 percent debt limit, based on assessed valuation. The debt margin to be reported in the Town's statistical section of the CAFR would be:

6.4) Direct Debt and Overlapping Debt

Debt limitation laws ordinarily establish limits hat may not be exceeded by each separate governmental unit affected by the laws. This means the country government may incur indebtedness to the legal limit a township within that county may do likewise, and a Town within the township may become indebted to the legal limit, with no restriction because of debt already owed by larger territorial units in which it is located. As a result, a given parcel of real estate or object of personal

property may be the basis of debt beyond the so-called legal limit and also may be subject at a given time to assessments for the payment of taxes to retire bonds issued by two or more governmental units. When this situation exists, it is described as overlapping debt.

The extent to which debt may overlap depends on the number of units represented within an area that are authorized to incur long-term indebtedness. These may include the State, County, Township, Town, School Board, Library Board, Hospital Board, and Probably Others. To show the total amount of fixed debt against property located within a given jurisdiction, a statement of direct and overlapping debt should be prepared. To this, direct debts are added amounts owing by other units and authorities that levy taxes against the same property on which the direct debt is based. A statement of Direct or Net and overlapping Debt should be prepared to disclose the relation of direct debt and overlapping debt to assessed valuation of real property within the state and local governments. Village of Anywhere is located entirely within the boundaries of Town of Anywhere and Town of Anywhere is located entirely within the boundaries of District of Anywhere. The Village had debt of Br 370,000 and taxable property of Br 1,591,052,836; the Town had debt of 16,930,000 and taxable property of Br 3,478,806,917; and Br 69,723,480 and taxable property of Br 3,478,806,917. Determine the Direct and Overlapping Debt

VILLAGE OF ANYWHERE
FY 2002 COMPREHENSIVE ANNUAL FINANCIAL REPORT
STATISTICAL SECTION
SCHEDULE OF DIRECT DEBT AND OVERLAPPING DEBT

Taxing Authority	Taxable Property Value	General Obligation Bonded Debt	% of Debt Applicable to the village	Village's Share of Debt
Direct Debt:				
Village of Anywhere	1,591,052,836	370,000	100.00%	$370,000
Overlapping Debt:				
Town of Anywhere	3,478,806,917	16,930,000	45.74	7,743,782
District of Anywhere	3,478,806,917	69,723,480	45.74	31,891,520
Direct and Overlapping		$87,023,480	**45.97%**	**$40,005,302**

Debt per Capita

Debt per Capita is a measure of the ability of the citizens to pay general government debt; a high figure indicates that citizens of a government bear an above average burden. It is determined by dividing the net debt to the population number. According to Standard and Poor's, anything below $1,000 would indicate low fiscal stress .Determine the Debt per Capita for village of Anywhere assuming a population of 10,614

	Village's Share of Debt	Village of Population	Debt per Capita
Direct Debt:			
Village of Anywhere	$370,000	10,614	34.86
Overlapping Debt:			
Town of Anywhere	7,743,782	10,614	729.58
District of Anywhere	31,891,520	10,614	3,004.67
Direct and Overlapping	$ 40,005,302	10,614	3,769.11

Example 2: The government wide Statement of Net Assets of Village of Elizabeth indicates $1,090,800 in general obligation bonds outstanding. The Village of Elizabeth governmental funds balance sheet indicates that $36,500 is on hand for payment of debt; thus the net debt is $1,054,300. The net debt per capita assuming population of 10,000 then is:
Net debt per capita = Br 1,054,300 / 10,000 = $105.43

Exercise 1:
A Town government is located entirely within the boundaries of the county. The Town had debt of $3,000,000, assessed property value of $100,000,000, and a population of 10,000. The county had debt of $2,000,000, assessed property value of $200,000,000, and a population of 15,000. The Direct and Overlapping debt per capita for the Town would be:

6.5) Accounting for Debt Service Funds

Long-term debt incurred to provide money to pay for the construction or purchase of capital assets, or for any other purposes, can be repaid only from revenue raised in subsequent years to service the debt. Reporting Long-Term Liabilities Principle provides that the long-term liabilities to be serviced from the revenues of a proprietary fund should be accounted for by that proprietary fund and the service of such debt is also accounted for by the proprietary fund. *Debt service* includes both the payment of interest and the repayment of principal when due. Long-term debt serviced by tax levies, or by special assessments, however, is accounted for in the governmental activities category at the government-wide level. Revenue raised from taxes or from special assessments for debt service, and expenditures for debt service, are commonly accounted for by use of **a *debt service fund***, the subject of this section of the chapter.

6.5.1) Accounting for Serial Bonds

Several decades ago, governmental issues of long-term debt commonly matured in total on a given date. In that era, bond indentures often required the establishments of a "sinking fund," sometimes operated on an actuarial basis. Some sinking fund term bond issues are still outstanding, but they are dwarfed in number and amount by serial bond issues, in which the principal matures in installments. Four types of serial bond issues are found in practice:

- Regular Serial Bond,
- Deferred Serial Bond,
- Annuity Serial Bond, and
- Irregular Serial Bond

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

Budgeting for Debt Service
Whether or not additions to debt service funds are required by the bond indenture to be approximately equal year by year, good politics and good financial management suggest that the burden on the taxpayers be spread reasonably evenly rather than lumped in the years that issues or installments happen to mature. If taxes for payment of interest and principal on long-term debt are to be raised directly by the debt service fund, they are recognized as Revenues of the debt service fund. If the taxes are to be raised by another fund and transferred to the debt service fund, they must be included in the Revenues budget of the fund that will raise the revenue (often the General Fund) and also budgeted y that fund as interfund transfers to the debt service fund, and reported as an Other Financing Use by the General Fund. The transfers are reported as Other Financing Sources by the debt service fund. Since the debt service fund is a budgeting and accounting entity, it should prepare a Revenues and Other Financing Sources budget that includes interfund transfers from other funds as well as revenues it will raise directly or earn on its investments. Although the items may be difficult to budget accurately, debt

service funds can often count on receiving premiums on debt issues sold and accrued in interest on debt issues sold. Accrued interest on debt sold is commonly considered Revenues of the recipient debt service fund; premium on debt sold is an Other Financing Source. Similarly if capital projects are completed with expenditures less than revenues and other financing sources, the residual equity is ordinarily transferred to the appropriate debt service fund. Persons budgeting and accounting for debt service funds should seek competent legal advice on the permissible use of both premium on debt sold and residual equity interfund transfers. In some cases, one or both of these items must be held for eventual debt repayment and may not be used for interest payments: in other cases, both premiums and residual equity transfers-in many be used for interest payments.

The Appropriations budget of a debt service fund must provide for the payment of all interest on general long-term debt that will become legally due during the budget year, and for the payment of any principal amounts that will become legally due during the budget year. CASB standards currently require debt service fund accounting to be on the same basis as is required for general and special revenue funds. One peculiarity of the modified accrual basis used by governmental fund types is that interest on long-term debt is not accrued in the debt service fund, but is accrued at the government-wide level. For example, if the fiscal year of a governmental unit ends on December 31, 2001, and the interest on its bonds is payable on January 1 and July 1 of each year, the amount payable on January 1, 2002, would not be considered a liability in the balance sheet of the debt service fund prepared as of December 31, 2001. The rationale for this recommendation is that the interest is not legally due until January 1, 2002. The same reasoning applies to principal amounts that mature on the first day of a fiscal year; they are not liabilities to be recognized in statements prepared as of the day before. In the event 2001 appropriations include January 1, 2002, interest and/or principal payment, the appropriation and expenditures (and resulting liabilities) should be recognized in 2001.

Number of Debt Service Funds

In addition to term bonds and serial bonds, debt service funds may be required to service debt arising fro the use of notes or warrants having a maturity more that one year after date of issue. In addition, debt service funds may be sued to make periodic payments required by capital lease agreements. Although each issue of long-term or intermediate[term debt is a separate obligation and may have legal restrictions and servicing requirements that differ from other issues, GASB standards provide that, if legally permissible, a single debt service fund be used to account for the service of all issues of tax-supported and special assessment debt. Subsidiary records of that fund can provide needed assurance that restrictions and requirements relating to each issue are properly budgeted and accounted for. If legal restrictions do not allow the service of all issues of tax-supported and special assessment debt to be accounted for by a single debt service fund, as few additional debt service funds as is consistent with applicable laws should be created. In this chapter, a separate debt service fund for each bond issue is illustrated simply as a means for helping the reader focus on the different accounting procedures considered appropriate for each kind of bond issue encountered in practice.

Use of General Fund of Account for Debt Service

In some jurisdictions, laws do not require the debt service function to be accounted for by a debt service fund. Unless the debt service function is very simple, it may be argued that good financial management would dictate the establishment of a debt service fund even though not required by law. If neither law nor sound financial administration requires the use of debt service funds, the function may be performed within the accounting and budgeting framework of the General Fund. In such cases, the accounting and financial reporting standards discussed in this chapter should be followed for the debt service activities of the General Fund.

A) Debt Service Accounting for Regular Serial Bonds

Accounts recommended for use by debt service funds created to account for revenues to be used for the payment of interest and principal of serial bond issues are similar to those recommended for use by general and special revenue funds, but not exactly the same. Serial bond debt service funds should

record the budget in Estimated Revenues and Appropriations control accounts and subsidiary accounts (and Estimated Other Financing Sources and Estimated Other Financing Uses control accounts and subsidiary accounts, if needed) just as General and special revenue funds should. However, because their operations do not involve the use of purchase orders and contracts for goods and services, the Encumbrances account is not needed. Proprietary accounts of a serial bond debt service fund include Revenues and Expenditures control and subsidiary accounts (and Other Financing Sources and Other Financing Uses control and subsidiary accounts, if needed); and liquid assets, current liability, and Fund Balance accounts. Liquid assets of a serial bond debt service fund are held for the purpose of paying interest on outstanding bonds and retiring the principal installments as they fall due; for the convenience of bondholders, the payment of interest and the redemption of matured bonds is ordinarily handled through the banking system. Usually the government designates a bank as Paying Agent or Fiscal Agent, to handle interest and principal payments for each issue whether the issue is in registered or bearer form. The asserts of a debt service fund may, therefore, include "Cash with Paying Agent," and the appropriations, expenditures, and liabilities may include amounts for the service charges of paying agents. Investment management may be performed by governmental employees or by banks, brokers, or other s who charge for the service; investment management fees are a legitimate charge against investment revenues.

Accounting for debt service of regular serial bonds furnishes the simplest illustration of recommended debt service fund accounting. Assume a bond is issued by the Town of **JIMMA** as partial means of financing for the fire station construction project. The Bond is a regular serial bonds maturing in equal annual amounts over 20 years and are registered as to interest and principal. The total face value of the issue was $1,200,000; all bonds in the issue bear interest of 6 percent per year, payable semiannually on June 15 and December 15. The bonds were dated June 15, 2002, and sold on that date at par. During 2002 the only expenditure the Debt Service Fund will be required to make will be the interest payment due December 15, 2002, in the amount of $36,000 ($1,200,000 @ 0.06 @ ½ year). Assuming revenues to pay the first installment of bonds due on June 15, 2003, and both interest payments due in 2003, will be raised in 2003; the budget for 2002 need only provide revenues in the amount of the 2002 interest expenditure. The entry to record the budget for the year ended December 31, 2002 is:

Regular Serial Bond Debt Service Fund:

1.	Estimated Revenues.....	36,000	
	Appropriations		36,000

If revenues in the amount of $30,000 were collected in cash from various sources available for debt service, the entry is:

Regular Serial Bond Debt Service Fund:

2a.	Cash	30,000	
	Revenues		30,000

The corresponding entry in the governmental activities general ledger at the government-wide level is (Note: Entry 1 had no Effect at the government-wide level since budget entries are made only in governmental funds):

Governmental Activities:

2b.	Cash	30,000	
	General Revenues—Miscellaneous-Restricted for Debt Service		30,000

As illustrated in Chapter t, the $6,000 residual equity of the Fire Station Capital Projects Fund was transferred to the Debt Service Fund. The entry required in the latter fund is:

Regular Serial Bond Debt Service Fund:

3.	Cash	6,000	
	Other Financing Sources-Interfund Transfers in.....		6,000

(Note: governmental activities at the government-wide level are unaffected since the transfers are between two funds within the governmental activities category.)

On December 15, 2002, when the first interest payment is legally due, the Debt Service Fund records the expenditure of the appropriation and the corresponding entry is made to record interest at the government-wide level:

Regular Serial Bond Debt Service Fund:

4a.	Expenditures—Bond Interest	36,000	
	Interest Payable		36,000

Governmental Activities:

4b.	Interest Expenses on Long-Term Debt	36,000	
	Interest Payable		36,000

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

Regular Serial Bond Debt Service Fund and Governmental Activities:

5.	Interest Payable	36,000	
	Cash		36,000

As of December 31, 2003, an adjusting entry would be made to accrue one-half of a month's interest expense on the accrual basis at the government-wide level, as would be the case in accounting for business organizations. As was discussed earlier, interest expenditure is recognized in the period when due in the debt service fund and is not accrued at the end of the accounting period.

Governmental Activities:

6.	Interest Expenses on Long-term Debt	3,000	
	Interest Payable		3,000

The Debt Service Fund has no assets and no liabilities, therefore has no need to prepare a balance sheet at year-end; however, the budgetary and operating statement accounts have balances, which are closed by the following entry:

Regular Serial Bond Debt Service Fund:

7.	Revenues	30,000	
	Other Financing Sources—Interfund Transfers In	6,000	
	Appropriations	36,000	
	Estimated Revenues		36,000
	Expenditures–Bond Interest		36,000

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

Balance sheet and operating statement information for each debt service fund would be presented as a major *fund column* in the Balance Sheet – Governmental Funds, if they meet the major fund criteria. Each debt service fund that does not meet the major fund criteria would be included in a non-major funds combining Balance Sheet and combining Statement of Revenues, Expenditures, and Changes in Fund Balances, along with all other governmental non-major funds.

B) Debt Service Accounting for Deferred Serial Bonds

If a government issues bonds other than regular serial bonds, debt service fund accounting is somewhat more complex than that illustrated above. In the entries below, it is assumed the Town of **JIMMA** issued a total of Br 2,000,000 face value of deferred serial bonds on January 1, 1992. Each installment is in the amount of Br 200,000. The first installment matures after 10 years on January 1, 2002; the final installment after 20 years on January 1, 2011. Interest is payable on January 1 and July 1 of each year at the nominal annual rate of 5 percent. Debt service is financed from taxes levied by the Debt Service Fund and from net earnings on Debt Service Fund Investments. Taxes for this Debt Service Fund are levied in an amount equal to interest to be paid during the budget year, plus a level amount of $100,000 to be invested by the Debt Service Fund and used for principal repayment when the principal installments fall due. The trial balance of the Town of **JIMMA**'s Deferred Serial Bonds

Debt Service Fund at the end of the 10th year (year ending December 31, 2001) following the date of the deferred serial bond issued showed:

	Debits	Credits
Cash	Br 250,000	
Investment	1,298,656	
Interest Receivable	33,438	
Fund Balance	—	Br 1,582,094
Totals	Br1,582,094	Br 1,582,094

Notice the trial balance shows Cash in the exact amount of interest on this bond issue due on January 1, 2002 (Br 2,000,000 @ 5% @ ½ year = Br 50,000), plus $200,000 for the bonds that mature on January 1,2002. To ensure timely payment of interest and principal retirement, checks totaling Br 250,000, dated January 1, 2002, were written in late December and mailed to the reregistered bondholders; since the checks are dated the day after balance sheet date, they will not to be credited to Cash until that date. [Note: An alternative approach would be to debit an account such as Prepaid Interest and credit cash when the checks are issue. Then, on January 1, 2002, Interest Expenditure would be debited in the debt service fund and Prepaid Interest would be credited. This approach may be necessary if the government's procedures require a journal entry before a payment can be voucher. Because the $250,000 liability does not legally exist until January 1, 2002, it is not reported in the December 31, 2001, balance sheet for the debt service fund. But the accrued liability is reported in the governmental activities column of the government-wide Statement of Net Assets presented ad December 31, 2001, as "current portion of bonds payable," $200,000, and "interest payable," $50,000.

The budget for this fund for fiscal 2002 includes the appropriations for payment of the interest of Br 50,000 on January 1, the payment of matured bonds of Br 200,000 on January 1, and the payment of interest of Br 45,000 on bonds outstanding on July 1, 2002 ($1,800,000 @ 5% @ ½ year). It is assumed, for the sake of simplicity, that the Town will not incur any fees for paying agents or for investment management; therefore, the total of the Appropriations budget for 2002 is $295,000. As noted in the description of this deferred serial bond issue, taxes are levied each year to allow for collection of cash in the amount of interest checks to be written that year, plus an amount of $100,000 to be invested for use for bond principal payment; earnings on the investments are also accumulated for bond principal repayment. Therefore, the Revenue budget for 2002 for this fund for revenues from taxes totals $190,000 ($45,000 for the interest payment due July 1, 2002; $45,000 for the interest payment due January 1, 2003; and the $100,000 level amount to be invested); revenues from earnings on investments during 2002 are budgeted at $103,900. Total Estimated Revenues for 2002, therefore, amounts to $293,900. The entry to record the 2002 budget is:

Deferred Serial Bond Debt Service Fund:

1.	Estimated Revenues	293,000	
	Fund Balance	1,100	
	Appropriations		295,000

Subsidiary records, if needed, would be kept in the manner illustrated. Since the records, and their use, are the same, they are omitted from this chapter.

Also, as of January 1, 2002, the bond payment and interest payment due on that date should be recognized as expenditures of 2002 appropriations (Entry 2a), and the fact that checks dated January 1, 2002, have been issued in payment of the interest and bond principal should be recorded (Entry 2b). In addition, Entry 2c would be made at the government-wide level to reduce the accrued liabilities that had been recorded on December 31, 2001, in the governmental activities general journal:

Deferred Serial Bond Debt Service Fund:

2a.	Expenditure–Bond Principal	200,000	
	Expenditure–Bond Interest	50,000	
	Bonds Payable		200,000
	Interest Payable		50,000

2b.	Bond Payable	200,000	
	Interest	50,000	
	Cash		250,000

Governmental Activities:

2c.	Current Portion of Bonds Payable	200,000	
	Accrued Interest Payable	50,000	
	Cash		250,000

In an actual case it would, of course, simplify the accounting to make one entry for the net effect of Entries 2a and 2b: a debt to Expenditures and a credit to Cash. The expenditures for bond interest and the expenditures for the redemption of matured bonds should be separately reported in the operating statements. Thus, the use of separate Expenditures accounts for principal repayment and interest, as shown in Entry 2a, should be used.

Taxes levied for debt service on the deferred serial bond issue are levied in the amount of $195,000; $5,000 of the levy is expected to be uncollectible:

Deferred Serial Bond Debt Service Fund:

3a.	Taxes Receivable–Current	195,000	
	Estimated Uncollectible Current Taxes		5,000
	Revenues		190,000

Government Activities:

3b.	Taxes Receivable–Current	195,000	
	Estimated Uncollectible Current Taxes		5,000
	General Revenues–Property taxes–Restricted for Debt Service		190,000

Entry 4a summarizes the collection of taxes during the first half-year (assumed to amount to $100,000), the collection of interest receivable as of December 31, 2001 ($33,438,per the trial balance), and the collection of $51,100 interest earned during the first half-year on investments of this fund. Entry 4b records the government-wide effect of the same transactions. Cash in the amount of $139,500 was promptly invested, as shown by Entry 4c; the entry being the same in both the debt service fund and the governmental activities category.

Deferred Serial Bond Debt Service Fund:

4a.	Cash	184,538	
	Taxes Receivable – Current		100,000
	Interest Receivable		33,438
	Revenues		51,100

Government Activities:

4b.	Cash	184,538	
	Taxes Receivable – Current		100,000
	Interest Receivable		33,438
	General Revenues – Investment Earnings – Restricted for Debt Service		51,100

Deferred Serial Bond Debt Service Fund and Governmental Activities:

4c.	Investments	139,500	
	Cash		139,500

Interest payable on July 1, 2002, is recorded as expenditure, and checks are written and mailed in the amount of interest payable July 1:

Deferred Serial Bond Debt Service Fund:

5a.	Expenditures–Bond Interest	45,000	
	Interest Payable		45,000
5b.	Interest Payable	45,000	
	Cash		45,000

Government Activities:

5c.	Interest Expense on Long-term Debt	45,000	
	Cash		45,000

Tax collections during the second half of 2002 totaled $85,000; interest earnings received in cash during that period amounted to $ 32,500.Cash in the amount of $117,500 was invested:

Deferred Serial Bond Debt Service Fund:

6a.	Cash	117,500	
	Taxes Receivable – Current		85,000
	Revenues		32,500

Governmental Activities:

6b.	Cash	117,500	
	Taxes Receivable – Current		85,000
	General Revenues–Investment Earnings–Restricted for Debt Service		32,500

Deferred Serial Bond Debt Service Fund and Governmental Activities:

6c.	Investments	117,500	
	Cash		117,500

Taxes not collected during 2002 must be classified as delinquent, as required by the laws of the state in which the Town of JIMMA is located. Administrators estimate that $5,000 of taxes levied in 2002 will be collected before March 1, 2003, and the remainder of that levy, $5,000, will be uncollectible. Since the original estimate of uncollectible taxes was $5,000, no further adjustment to Revenues is required. Entry 7 accomplishes the necessary reclassifications for both the debt service fund and governmental activities:

Deferred Serial Bond Debt Service Fund and Governmental Activities:

7.	Taxes Receivable – Delinquent	10,000	
	Estimated Uncollectible Current Taxes	5,000	
	Taxes Receivable – Current		10,000
	Estimated Uncollectible Delinquent Taxes		5,000

Bonds in the amount of $200,000 will mature on January 1, 2003, and interest in the amount of $45,000 will be payable on that date. Investments in the amount of $245,000 are converted to cash as of December 31, 2002, so that checks dated January 1, 2003, may be mailed. In addition, the bonds due on January 1, 2003, are accrued at the government-wide level, in conformity with standard accrual accounting practices. The required entries on December 31, 2002, are given as:

Deferred Serial Bond Debt Service Fund and Governmental Activities:

8a.	Investments	245,000	
	Cash		245,000

Governmental Activities:

8b.	Bonds Payable	200,000	
	Interest Expense on Long-term Debt	45,000	
	Current Portion of Long-term Debt		200,000
	Accrued Interest Payable		45,000

Interest receivable on investments accrued at year-end, December 31, 2002, amount to $20,500. This accrual is recorded both in the debt service fund and governmental activities:

Deferred Serial Bond Debt Service Fund:

9a.	Interest Receivable on Investments	20,500	
	Revenues		20,500

Governmental Activities:

9b.	Interest Receivable on Investments	20,500	
	General Revenues–Investment Earnings–Restricted for Debt Service		20,500

Budgetary and operating statement accounts of the debt service fund for 2002 are closed (Entry 10a) on December 31, 2002. As noted previously, there are many additional operating statement accounts of the governmental activities besides debt service – related items that would need to be closed. A partial closing entry is presented here for illustrative purposes only:

Deferred Serial Bond Debt Service Fund:

10a.	Revenues	294,100	
	Appropriations	295,000	
	Estimated Revenues		293,900
	Expenditures–Bond Principal		200,000
	Expenditures–Bond Interest		95,000
	Fund Balance		200

Governmental Activities:

10b.	General Revenues–Property Taxes–Restricted for Debt Service	190,000	
	General Revenues–Investment Earnings–Restricted for Debt Service	194,100	
	Interest Expense		95,000
	Net Assets–Restricted for Debt Service		199,100
10c.	Net Assets – Restricted for Debt Service	200,000	
	Net Assets – Invested in Capital Assets, Net of Related Debt		200,000

Entry 10c reflects the fact that net assets restricted for debt service were consumed on January 1, 2002, when the current position of long-term debt was paid in the amount of $200,000. Presumably the $2,000,000 of deferred serial bonds were issued for a capital project that was long ago completed and for which general capital asses were recorded at the government-wide level. Thus, the credit to Net Assets – Invested in Capital Assets, Net of Related Debt would be appropriate to the extent the related debt has been retired. Recall also that Net Assets – Restricted for Debt Service would have an accumulated balance for the year 1992 through 2001 when taxes were levied and invested during the deferral period of the debt.

After recording the entries for 2002, the Town of JIMMA Deferred Serial Bonds Debt Service Fund Balance Sheet would be as presented in Illustration 6-8, the combining balance sheet for all debt service funds of the Town of JIMMA. (Recall that the Regular Serial Bond Debt Service Fund discussed in the preceding section would not be included in the combining balance sheet at it had no assets or liabilities at year-end.) In addition to be balance sheet, the revenues, expenditures, and changes in fund balance during the fiscal period should be reported for each debt service fund, as shown previously in Illustration 6-6 which presents the Combining Statement of Revenues, Expenditures, and Changes in Fund Balances for the Town of JIMMA Deferred Serial Bonds Debt Service Fund for the year ended December 31, 2007, as well as the other debt service funds of the Town. Since the funds are assumed to operate under legally required budgets, a Combining Statement of Revenues, Expenditures, and Changes in Fund Balances – Budget and Actual for the year should be prepared for internal management purposes.

TOWN OF JIMMA
COMBINING BALANCE SHEET
AS OF DECEMBER 31, 2002

	Deferred Serial bonds	Term Bonds	Total Debt Service Funds
Assets:			
Cash	$245,038	$613	$245,651
Investments	1,310,656	83,316	1,393,972
Taxes receivable, net	5,000	1,600	6,600
Interest receivable	20,500	0	20,500
Total Assets	$1,581,194	$85,529	$1,666,723
Liabilities and Fund Equity:			
Fund Balance – Unreserved	$1,581,194	$85,529	$1,666,723
Total Fund Equity	$1,581,194	$85,529	$1,666,723

6.5.2) Debt Service Accounting for Term Bonds

Term bond issues mature in their entirety on a given date, in contrast to serial bonds, which mature in installments. Required revenues of term bond debt service funds may be determined on an "actuarial" basis or on less sophisticated bases designed to produce approximately level contribution during the life of the issue. If an actuarial basis is not used, accounting procedures and statements illustrated for the deferred serial bond issue of the Town of JIMMA are appropriate for use by term bond debt service funds. In order to illustrate the differences that exist when an actuarial basis is used, the following example is based on the assumption that the Town of JIMMA has a term bond issue amounting to $1,500,000 with a 20-year life. The term bonds bear semiannual interest coupons with a nominal (or stated) annual rate of 5 percent, payable on January 1 and July 1. Revenues and other financing sources of this particular debt service fund are assumed to be taxes levied directly for this debt service fund and earnings on investments of the debt service fund. The amount of the tax levy is computed in accord with annuity tables on the assumption that revenues for principal repayment will be invested and will earn 6 percent per year, computed semiannually. (Actuaries are usually very conservative in their assumptions because they are concerned with a long time span.) Using either the annuity tables found in most intermediate accounting taxes or a calculator, one will find that the future amount of $1 invested at the end of each period will amount to $75.4012597 at the end of 40 periods, if the periodic confound interest is 3 percent (as specified in the Town of JIMMA example). Since the amount needed for bond repayment at the end of 40 six-month periods is $1,500,000, the tax levy for bond principal repayment must yield $1,500,000 divided by 75.4012597, or $19,893.57 at the end of each six-month period throughout the life of the bonds. Revenue for each bond interest payment must be $37,500 ($1,500,000, the face of the bonds, @ 5 percent, the annual nominal interest rate, @ ½ year).

Assuming the bonds were issued on January 1, 2001, and actual additions and actual earnings were both exactly as budgeted, the Term Bonds Debt Service Fund would have the following trial balance as of December 31, 2001.

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

For every year of the life of the issue, the budget for the Term Bonds Debt Service Fund of the Town, reflecting the conditions described above, will include two required additions of $19,893.57 each for investment for eventual principal repayment, and two amounts of $37,500 each for interest payment, for a total of $114,787.14. The budget will also include earnings on debt service fund investments

computed in accord with actuarial requirements. For 2002, the second year of the Term Bonds Debt Service Fund's operation, the actuarial assumption is that the fund will earn 6 percent per year, compounded semiannually; the required earnings for the year amount to $3,056.19. Therefore, Estimated Revenues is debited for $117,843.33 ($114,787.14 + $3,056.19). The Appropriations budget would include only the amounts becoming due during the budget year, $75,000 (two interest payments, each amounting to $37,500). Then entry to record the budget for fiscal year 2002 is shown below. (Note: Entries at the government-wide level are omitted here as they would be essentially the same as illustrated for the deferred serial bond example provided in the preceding chapter.)

1.	Estimated Revenues–DSF	117,843.33	
	Fund Balance—DSF		42,843.33
	Appropriations—DSF		75,000.00

If the debt service fund is to accumulate the amount needed to retire the term bond issue at maturity, both additions and earnings must be received, and invest, in accord with the actuarial assumptions. Therefore, the tax levy for this fund must yield collections in the first six months totaling $57,393.57, at least. So that $19,893.57 can be invested and $37,500 interest paid to bondholders, both as of the end of the first six-month period. Collections during the second six months must also total $57,393.57, for the same reason. In the real world it is unlikely that collections would ever total $57,393.57, to the penny, in either six-month period. If collections are less than that amount in either period, it should be obvious that this fund would have to borrow enough to make the required investments – there is no question that the interest would have to be paid when due, as discussed in an early section of this chapter. Assuming collection experience of the Town of JIMMA indicates that a tax levy in the amount of $120,000 is needed in order to be reasonably certain that collections during each six-month period will equal the needed amount, the entry to record the levy and the expected uncollectible amounting to $3,000 is:

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

If actual collections during the first six months of 2002 were $57,400, Entry 3 records that fact.

3.	Cash	57,400	
	Taxes Receivable—Current		57,400

Entry 4 records the investment of the required $19,893.57 and the payment of interest of $37,500.

4.	Expenditures—Bond Interest	37,500.00	
	Investments	19,893.57	
	Cash		57,393.57

Entry 5 records the addition of interest on June 30 in the amount of $1,261.99 to the investments of $40,383.95 invested for the entire first six months of 2002. Note the actual interest for this period is $50.47 greater than the required earnings of $1,211.52 for the period, because the actual rate was slightly greater than the rate used in actuarial computations.

5.	Investments	1,261.99	
	Interest Earnings		1,261.99

During the second six months, tax collections for the Term Bonds Debt Service Fund totaled $58,000 (Entry 6a). The required addition to the Investments account was made, and interest of $37,500 was paid, both actions as of December 31, 2002 (Entry 6b).

6a.	Cash	58,000	
	Taxes Receivable—Current		58,000
	Interest Expense		95,000
	Net Assets–Restricted for Debt Service		199,100
6b.	Expenditures—Bond Interest	37,500.00	
	Investments	19,893.57	
	Cash		57,393.57

Interest earnings during the last six months on the $61,539.51 invested since July 1, 2003, totaled $1,883.10; this amount was added to the Investments account:

7.	Investments	1,883.10	
	Interest Earnings		1,883.10

Taxes levied for 2003 but not collected during the year are recorded as delinquent; the amount in the related Estimated Uncollectible accounts is reviewed and determined to be reasonable.

8.	Taxes Receivable—Delinquent	4,600.00	
	Estimated Uncollectible Current Taxes	3,000.00	
	Taxes Receivable—Current		4,600.00
	Estimated Uncollectible Delinquent Taxes		3,000.00

As of December 31, 2002, the budgetary accounts and operating statement accounts were closed.

9.	Appropriations	75,000.00	
	Revenues	117,000.00	
	Interest Earnings	3,145.09	
	Estimated Revenues		117,843.33
	Expenditures—Bond Interest		75,000.00
	Fund Balance		3,301.76

Assets, liabilities, and Fund Balance of the Term Bonds Debt Service Fund as of December 31, 2002 (all rounded to the nearest dollar), are shown in one column of the combining balance sheet of all debt service funds of the Town of JIMMA. Similarly, revenues, expenditures and changes in fund balance of the Term Bonds Debt Service Fund are shown in the Combining Statement of Revenues, Expenditures, and Changes in Fund Balances.

Disclosures in Notes to the Financial Statements

Any information in addition to the financial statements shown as Illustrations 6-6, 6-7, and 6-8 that would be helpful to administrators, members of the legislative body, interested residents, creditors, or any other category of person who uses the financial reports of a governmental reporting entity should, of course, be provided. GASB standards require disclosure in the notes to the financial statements (the notes are an integral part of the basic financial statements and are covered by the auditor's report) of specific data about deposits with financial institutions and investments. Disclosures are required for the entity as a whole, not just for debt service funds. However, since the Town of JIMMA's debt service funds hold over $1.6 million in cash and investments, it is appropriate to mention required note disclosures at this point.

GASB standards require disclosure in the notes of the types of deposits and investments authorized by legal and contractual provisions. Any significant violations during the period of legal or contractual provisions should, of course, be disclosed. If bank balances as of balance sheet date are entirely insured or collateralized with securities held by the entity or it agent in the entity's name, that fact should be mentioned. If not, the amount of the total bank balance should be classified and reported in the three categories of credit risk specified in the standards. Similarly, the fair value of investments as of balance sheet dare should be disclosed in total and for each type of investment. The disclosure of carrying amounts by type of investment should be classified in the three categories of credit risk specified in the standards.

GASB standards apply to all state and local governmental reporting entities' financial reports that are intended to conform with generally accepted accounting principles. A number of states have established by law reporting requirements for the state government itself and for local governments within the state. It is common for financial reports prepared in compliance with state laws to include a list of the amounts on deposit in named banks, a list of securities held, and their fair value as of the balance sheet date. Supplementary schedules presented in order to conform with laws, or presented because administrators feel the disclosures should be made, are not covered by the independent auditor's

report unless the audit engagement specifically extends the scope of the audit to the supplementary schedules.

Debt Service Fund Investments

As shown in the Deferred Serial Bond Debt Service Fund and the Term Bond Debt Service Fund examples in this chapter, financial resources typically are accumulated in these types of debt service funds for eventual repayment of principal. Such resources should be invested prudently until they are needed for principal repayment. Interest earnings on investments in bonds and other securities purchased at a premium or discount generally would not be adjusted for amortization of any premiums or discounts. As noted in Footnote 6, current GASB standards require fair value accounting and reporting for most investments, except for certain money market investments with maturities of less than one year. The latter may be accounted for at amortized cost (interest earnings adjusted for amortization of premium or discount).' Often, however, premiums and discounts are not amortized for short-term investments. All long-term investments in debt and equity securities held for repayment of general long-term debt principal are reported at fair value in the debt service fund balance sheet. All changes in the fair value of investments during the period, both realized and unrealized, are reported as revenue in the Statement of Revenues, Expenditures, and Changes in Fund Balances.

Debt Service Accounting for Special Assessment Debt

Special assessment projects typically follow the same pattern as transactions of other capital projects. Specifically, construction activities are usually completed in the first year or so, using either interim *financing* from the governmental unit or proceeds of special assessment debt issuances (bonds or notes) to pay construction costs to contractors. Either at the beginning of the project or, more commonly, when construction is completed, assessments for debt service is levied against property owners in the defined special benefit district. Annual assessment installments receivable, and interest on deferred installments, usually approximate the amount of debt principal and interest payable during the same year. If the governmental unit is obligated in some manner to make the debt service payments in the event amounts collected from benefited property owners are insufficient, the debt should be recorded in the governmental activities ledger at the government-wide level and a debt service fund should be used to account for debt service activities. If the governmental unit is not obligated in any manner for special assessment debt, the debt should not be recorded in any accounting records of the government. In the latter case, which is relatively rare, debt service transactions should be accounted for in an *agency fund*.

Assume that special assessment bonds, secondarily backed by the general taxing authority of the Town of X, were issued to complete a street-widening project. Upon completion of the project the Town levied assessments amounting to $480,000, payable in 10 equal installments with 5 percent interest on deferred installments, on owners of properties fronting on the improved streets. As shown in Entry, 1 all receivables are recorded at the time of the levy, but Revenues is credited only for the amount expected to be collected within one year from the date of the levy; Deferred Revenues is credited for the amount of deferred installments. Because the entries at the government-wide level would be similar, except that interest Expense would be reported rather than Expenditures, those entries are omitted for the sake of brevity. Required budgetary entries, as shown earlier in this chapter for serial bond and term bond debt service funds, are omitted.

1.	Assessments Receivable—Current.....	48,000	
	Assessments Receivable—Deferred.....	432,000	
	Revenues.....		48,000
	Deferred Revenues		432,000

All current assessments receivable, due at year-end, were collected along with interest of $24,000 (see Entry 2). Any amounts not collected by the due date should be reclassified by a debit to Assessments Receivable – Delinquent and a credit to Assessments Receivable—Current.

2.	Cash	72,000	
	Assessments Receivable—Deferred		48,000

Revenues 24,000

Matured special assessment bond principal in the amount of $48,000 and matured bond interest of $24,000 payable were recorded and paid on schedule.

3a. Expenditures—Bond Principal 48,000
Expenditure—Bond Interest 24,000
Bonds Payable 48,000
Interest Payable 24,000

3b. Bonds Payable 48,000
Interest Payable 24,000
Cash..... 72,000

The second installment of assessments receivable was reclassified from the Deferred category to the Current category. A corresponding amount of Deferred Revenues was reclassified as Revenues.

4a. Assessments Receivable—Current 48,000
Assessments Receivable—Deferred..... 48,000

4b. Deferred Revenues 48,000
Revenues 48,000

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

Use of Debt Service Funds to Record Capital Lease Payment

In Chapter 5, under the heading "General Capital Assets Acquired under Capital Lease Agreements," an example is given of the computation of the amount to be recorded in a governmental fund at the inception of a capital lease. The example illustrates the entry required at the government-wide level when an asset is acquired by a capital lease agreement. The example presented in Chapter 5 specified that the first payment of $10,000 was due on January 1, 2001, the inception of the lease. Governmental units commonly use a Debt Service Fund to record capital lease payments because the annual payments are merely installment payments of general long-term debt. The first payment, since it is on the first day of the lease, is entirely a payment on the principal of the lease obligation. Accordingly, the payment would be recorded as:

Expenditures—Principal of Capital Lease Obligation 10,000
Cash..... 10,000

The Expenditure detail record would show that the entire amount of the first payment was a payment on the principal. The payment due on January 1, 2002, and the payment due each year thereafter, however, must be considered a partial payment on the lease obligation and a payment of interest on the unpaid balance of the lease obligation. GASB standards are consistent with the FASB's SFAS No. 13; both specify that a constant periodic rate of interest must be use. In the example started in Chapter 5, the present value of the obligation is computed using the rate of 10 percent per year. It is reasonable to use the same interest rate to determine what part of the annual $10,000 payment is payment of interest, and what part is payment of principal. The following table shows the distribution of the annual lease rental payments:

Payment Date	Amount of Payment	Interest on Unpaid Balance at 10%	Payment on Principal	Unpaid Lease Obligation
				$67,590
1/1/01	$10,000	$–0–	$10,000	57,590
1/1/02	10,000	5,759	4,241	53,349
1/1/03	10,000	5,335	4,665	48,684
1/1/04	10,000	4,868	5,132	43,552
1/1/05	10,000	4,355	5,645	43,552
1/1/06	10,000	3,791	6,209	37,907
1/1/07	10,000	3,170	6,830	31,698
1/1/08	10,000	2,487	7,513	24,868
1/1/09	10,000	1,736	8,264	17,355
1/1/10	10,000	909	9,091	–0–

As shown by the table above, although the total expenditure recorded each year, January 1, 2001, through January 1, 2010, is $10,000, the detail records for each year should show how much of the expenditure was for interest on the lease obligation and how much was payment on the obligation itself. As noted earlier in this chapter, the unpaid balance of the capital lease obligation is carried in the governmental activities general ledger at the government-wide level.

6.6) Accounting for Debt Refunding

If debt service fund assets accumulated for debt repayment are not sufficient to repay creditors when the debt matures, or if the interest rate on the debt is appreciably higher than the governmental unit would have to pay on a new bond issue, or if the covenants of the existing bonds are excessively burdensome, the governmental unit may issue refunding bonds.

The proceeds of refunding bonds issued at the maturity of the debt to be refunded are accounted for as Other Financing Sources of the debt service fund that is to repay the existing debt. The appropriation for debt repayment is accounted for as illustrated in the Town of JIMMA Deferred Serial Bond Debt Service Fund example (see Entries 1,2a and 2b)

If a governmental unit has accumulated no assets at all for debt repayment, if is probable that no debt service fund exists. In such a case, a debt service fund should be created to account for the proceeds of the refunding bond issue and the repayment of the old debt. When the debt is completely repaid, the debt service fund relating to the liquidated issue should be closed, and a debt service fund for the refunding issue should be created and accounted for as described in this chapter. If the refunding bond issue is not sold but is merely given to the holders of the matured issue in an even exchange, the transaction would not require entries in a debt service fund or at the government-wide level but should be disclosed adequately in the Note to Financial Statements.

Advance Refunding of Debt

Advance refunding of tax-exempted debt are common during periods when interest rates are falling sharply. Complex accounting and reporting issues have surfaced relating to legal questions such as, “Are both issues still the debt of the issuer?” “If the proceeds of the new issue are to be held for the eventual retirement of the old issue, how can the proceeds be invested to avoid conflict with the Internal Revenue Service over the taxability of interest on the debt issue?” (compliance with the arbitrage rules under the Internal Revenue Code Sec. 148 and related regulations is necessary for the interest to be exempt form federal income tax and, possibly, from state and local taxes.) Full consideration of the complexities of accounting for advance refunding resulting in defeasance of debt is presented in the GASB Codification Section D20. Defeasance of debt can be either “legal” or “in substance.” **Legal defeasance** occurs when debt is legally satisfied based on certain provisions in the debt instrument even though the debt is not actually paid. **In-substance defeasance** occurs when debt is considered defeasance for accounting and financial reporting purpose even though legal defeasance has not occurred. GASB Codification Section D20.103 sets forth in detail the circumstances for in-substance defeasance. Briefly, the debtor must irrevocably place cash or other assets in trust with an escrow agent to be used solely for satisfying scheduled payments of both interest and principal of the defeasance debt. The amount placed in escrow must be sufficiently large so that there is only a remote possibility that the debtor will be required to make future payments on the defeased debt. 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.

To illustrate accounting for advance refunding resulting in defeasance of debt reported in the governmental activities ledger at the government-wide level, assume the proceeds from the sale of the refunding issue amount of $2,000,000, and assumed debt to be defeased amount to $2,500,000. The proceeds are recorded in the fund receiving the proceeds (normally, *a debt service fund*) by an entry such as:

Cash	2,000,000	
Other Financing Source—Proceeds of Refunding Bonds		2,000,000

Payments to the escrow agent from resources provided by the new debt should be recorded in the debt service fund as an Other Financing Use; payments to the escrow agent from other resources are recorded as debt service expenditures. Therefore, assuming $500,000 has previously been accumulated in the debt service fund for payment of the $2,500,000 bond issue, the entry to record the payment to the escrow agent would be:

Other Financing Uses—Payment to Refunded Bond Escrow Agent	2,000,000	
Expenditure—Payment to Refunded Bond Escrow Agent	500,000	
Cash		2,500,000

The Disclosure about Advance Refunding

The disclosure guidance on debt refunding in GASB Codification Section D20 is applicable to state and local governments, public benefit corporations and authorities, public employee retirement systems, and governmental utilities, hospitals, colleges and universities, and to all funds of those entities.

Detailed disclosure guidance is set forth in Section D20.111 – 114. Briefly, all entities subject to GASB jurisdiction are required a general description of any advance refunding resulting in defeasance of debt. At a minimum the disclosures must include (1) the difference between the cash flows required to service the new debt and complete the refunding and (2) the economic gain or loss resulting from the transaction. Economic gain or loss is the difference between the *present value* of the old debt service requirements and the *present vale* of the new debt service requirements, discounted at the effective interest rate and adjusted for additional cash paid. Section D20.901 - 915 provides examples of effective interest rate and economic gain calculations and of note disclosures.

Chapter 7
Accounting For the Business–Type Activities of State and Local Governments

Topics to Be Discussed:

- Proprietary Funds
- Internal Service Funds
- Illustrative Case: Supplies Fund (ISF)
- Enterprise Funds
- Illustrative Case: Water Utility Fund (EF)

Learning Objectives:

After studying this chapter, you should be able to:

- Distinguish between the purposes of internal service funds and enterprise funds.
- Describe the characteristics of proprietary funds, including those unique to internal service and enterprise funds.
- Explain the financial reporting requirements, including the differences in reporting of internal service and enterprise funds in the government-wide and fund financial statements.
- Describe accounting procedures and prepare journal entries and financial statements for an internal service fund.
- Describe accounting procedures and prepare journal entries and financial statements for an enterprise fund.

7.1) Proprietary Funds

The funds discussed in previous chapter (general, special revenue, capital projects, debt service funds, and permanent funds) owe their existence to legal constraints placed on the raising of revenue and/or the use of resources for the provision of services to the public or segments thereof, and for the acquisition of facilitates to aid in the provision of services. As governmental units became more complex, it became apparent that efficiency should be improved is services used by several departments or funds, or even several governmental unit, were combined in a single administrative unit. Purchasing is a common example, as is a motor pool. A logical name for a fiscal and accounting entity created t account for resources used for providing centralized services is *internal service fund*. Traditionally, the reason for the creation of funds in this category was to improve the management of resources. In recent years, large numbers of governmental units have experienced a shortfall of revenues with an increase in the demand for governmental services. Consequently, many governmental units have turned to user charges as a means of financing operations formerly financed by tax revenues and intergovernmental revenues. In order to determine whether user charges are commensurate with operating costs, and to improve the ability of administrators and governing bodies to determine that costs are reasonable in relation to benefits, it is desirable for the activities to be operated and accounted for on a business basis. Thus many activities formerly operated on a purely noncommercial basis and accounted for by governmental funds are now accounted for by proprietary funds: *enterprise funds and internal service funds.* Activities that produce goods or services to be sold to the general public are accounted for by enterprise funds. Activities that produce goods or services to be provided to departments or agencies or a governmental unit, or to other governmental units, on a cost-reimbursement basis are accounted for by internal service funds. (Internal service funds are sometimes called intergovernmental service funds, working capital funds, revolving funds, and other similar names.)

Activities accounted for in enterprise funds are referred to as *business-type activities* for purpose of financial reporting at the government-wide level. Although internal service funds are accounted for *internally* as business type activities, their transaction predominantly involve sales of goods or services to, or interfund transactions with, the General Fund and other funds that comprise the governmental activities of a government. For this reason, GASB Statement No. 34 requires that the financial balances of internal service funds be reported in the governmental activities category at the government-wide level. Nevertheless, internal service funds are properly classified as proprietary funds and are reported in a separate column of the proprietary fund financial statements.

Financial Reporting Requirement

Proprietary funds are accounted for in a manner similar to investor-owned business enterprises of the same type. An enterprise fund established to account for a government-owned electric utility, for example, should follow accounting principles similar to those of investor-owned electric utilities. Accordingly, proprietary funds focus on the flow of economic resources recognized on the accrual basis, both within the fund and at the government-wide level. Thus, these funds account for all capital assets used in their operations and for all long-term liabilities to be paid from the revenues generated frothier operations, as well as for all current assets and current liabilities. Because proprietary funds follow business-type accounting principles, one should not be surprised that these funds prepare essentially the same financial statements that businesses do: a Balance Sheet (called either a Statement of Net Assets or a Balance Sheet); a Statement of Revenues, Expenses, and Changes in Fund Net Assets (equivalent to an income statement); and a Statement of Cash Flows. These statements are prepared according to GASB standards, however, which differ in some respects from the equivalent statements prescribed by FASB standards for business organizations. These differences are discussed at various points in this chapter. Illustrative financial statements for the Town of JIMMA Supplies Fund (at internal service fund) are displayed in Illustrations 7-2, 7-3, and 7-4, later in this chapter. The corresponding financial statements for the Town of JIMMA Water Utility Fund (and enterprise fund) are provided in Illustration 7-6 through 7-8.

Unlike the General fund and other major governmental funds for which a budget is legally adopted, proprietary funds are not required by GASB standards to record budgets in their accounting systems. Some governmental units do, however, require all funds to operate under legally adopted budgets. In such cases, GASB standards permit , but do not require, the integration of budgetary accounts in the manner described in Chapter 3 and 4 general and special revenue funds.

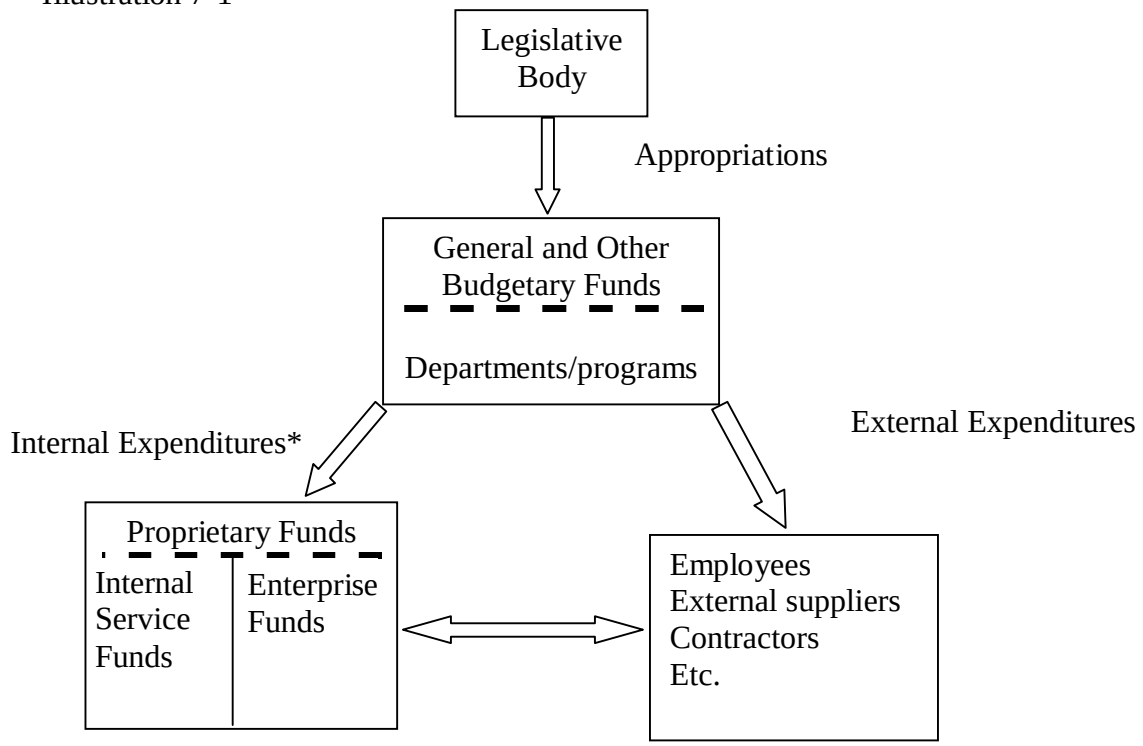
7.2) Internal Service Funds

Although the reason for the establishment of an internal service fund is to improve financial management of scarce resources, it should be stressed that a fund is a fiscal entity well as an accounting entity; consequently, establishment of a fund is ordinarily subject to legislative approval. The ordinance, or other legislative action, that authorizes the establishment of an internal service fund should also specify the source, or sources, of financial resources to be used for fund operations. The original allocation of resources to the fund may be derived from transfer of assets of another fund, such as the General Fund or an Enterprise Fund, intended as a *contribution* not to be repaid, or a transfer in the nature of a long-term interfund loan to be repaid by internal service fund over a period of years. Alternatively, or additionally, the resources initially allocated to an internal service fund may be acquired from the proceeds of a tax-supported bond issue or transfer form other governmental units that anticipate utilizing the service to be rendered by the internal service fund. Since internal service funds are established to improve the management of resources, it is generally considered that they should be operated, and accounted for, on a business basis. Application of this general truth to a specific case can lead to conflict between managers who wish the freedom to operate the fund in accord with their professional judgment, and legislators who wish to exercise considerable, control over the decisions of the internal service fund managers.

For example, assume that administrators request the establishment of a fund for the purchasing, warehousing, and issuing of supplies used by a number of funds and departments. At the time of the request, since on internal service fund exists, each fund or department must include in its budget its requested appropriation for supplies, its requested appropriation for salaries and wages of personnel engaged in purchasing and handling the supplies, and its requested appropriation for any operating expense or facility costs associated with the supply function. Accordingly, legislators tend to fell that through their control over budgets they are controlling the investment in supplies and the use of supplies by each fund and department. Legislator may feel that if they approved the establishment of an internal service fund that had authority to generate operating revenues sufficient to perpetuate the fund without annual appropriations, the supply function would no longer be subjected to annual legislative budget review, and the legislature would "lose control" after the initial allocation of resources to the fund. Administrators are more likely to feel that if an internal service fund did not have authority to generate operating revenues sufficient to perpetuate the fund, and to spend those revenues at the discretion of fund management rather than at the discretion of persons possibly more concerned with reelection than with financial management, there would be little gained by establishment of the internal service fund.

The two opposing views should be somewhat balanced by the fact that, as shown in Illustration 7-1, the customers of an internal service fund are, by definition, other funds and departments of the governmental entity, or of other governmental entities; therefore, each using fund and department must include in its Appropriations budget request justification for the amount to be spent (i.e., paid to the internal service fund) for supplies, so the legislative branch continues to exercise budgetary review over the amount each fund and department budgets for supplies

Illustration 7-1



Internal Expenditures Are More Formally Referred To As Interfund Services Provided and Used, or Internal Exchange Transactions

As shown in Illustration 7-1, departments and programs that require legislative appropriations to expend resources for goods and services should account for purchases of goods or services from internal suppliers (i.e., internal service funds or enterprise funds) in essentially the same manner as goods and services purchased from external suppliers. If the legislative branch were to set pricing

policies for the internal service fund, and policies governing the use of current earnings, and retention of earnings, and require the submission of periodic financial statements to evidence that its policies were followed, the legislature would be able to maintain considerable control over the function performed by the internal service fund, yet leave the fund managers freedom to operate at their discretion within the policies set by the legislative branch.

One of the more difficult problems to resolve to the satisfaction of persons with opposing views is the establishment of pricing policy. "Cost" is obviously an incomplete answer: Historical cost of the supplies themselves, whether defined as FIFO, LIFO, average, or specific identification, will not provide sufficient revenue to replace supplies issued if replacement prices have risen since the last purchase, or to increase the inventory quantities if the scale of governmental operations is growing. Payroll and other cash operating expenses of the internal service fund must be met; and if the internal service fund has received a loan from anther fund or another governmental unit, prices must be set at a level that will generate cash needed for debt retirement. If the internal service fund is to be operated on a true business basis, it must also be able to finance from its operations replacement, modernization, and expansion of plant and equipment used in fund operations. Prices charged by the internal service fund, however, should be less than the using funds and departments would have to pay outside vendors for equivalent products and services, if the existence and continued operation of the internal service fund is to be justified.

Because of the considerations mentioned in preceding paragraphs, many different approaches to internal service fund operations may be found in practice. Since accounting systems should give appropriate recognition to operating policies, as well as to legal requirements, practices vary from those of profit-seeking businesses at one extreme, to those discussed in this text in the chapters relating to general and special revenue funds at the other extreme. In the illustrations given in following sections of this chapter, it is assumed the financial objective of an internal service fund is to recover from operating revenues the full cost of operations, with enough net income to allow for replacement of inventories in periods of rising prices, and enough increase in inventory quantities to meet the needs of using funds and departments whose scale of operations is increasing. Similarly, it is assumed net income should be sufficient to allow for replacement of capital assets used by the internal service fund, but expansion of the facilities must be financed through contributions from other funds authorized in their Appropriations budgets. Managers of internal service funds must prepare operating plans – budget – as a management tool. In the illustrations it is assumed budgets of internal service funds are submitted to the legislative body, or bodies, and to the public for information but not for legal action, and therefore the budget is not formally recorded in internal service fund accounts. Similarly, managers of business must be kept informed of the status of outstanding purchase orders and contracts, but encumbrances need not be recorded in the accounts in order to accomplish this.

Accounting for an internal service fund concerned with the functions of purchasing, warehousing, and issuing supplies is illustrated in the following section.

7.3 Illustrative Case: Supplies Fund

Assume that the administrators of the Town of JIMMA obtain approval from the Town Council to centralize the purchasing, storing, and issuing functions as of January 1, 2003, and to administer and account for these functions in a Supplies Fund. The town's General Fund is to transfer to the new fund its December 31, 2002, inventory of supplies ($61,500) and $30,000 in cash to be used for working capital; these transfers are intended as contributions to the Supplies Fund and are not to be repaid. Transfers of this nature are initially accounted for by the recipient fund as interfund transfers in, as shown in Entry 1. The Interfund Transfers In account is closed at the end of the fiscal period to Net Assets – Unrestricted. The interfund transfer is reported below the non-operating revenues/expense section of the Statement of Revenues, Expenses, and Changes in Net Assets.

1.	Cash	30,000	
	Inventory of Supplies	61,500	
	Interfund Transfers–In		91,500

In order to provide cash to be used for acquisition of a building and equipment needed to handle the supply function efficiently, the town's Water Utility Fund is to provide a long-term interfund loan of $130,000 to the Supplies Fund. The loan is to be repaid by the Supplies Fund in 20 equal annual installments. Entry 2 illustrates the entry to be made by the Supplies Fund for the receipt of the interfund loan; Water Utility Fund entries of this transaction are illustrated later in this chapter.

		Debits	Credits
2.	Cash	130,000	
	Interfund Loan from Water Utility Fund—Current		6,500
	Interfund Loan from Water Utility Fund—Non-current		123,500

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

		Debits	Credits
3.	Land	25,000	
	Building	70,000	
	Machinery and Equipment—Warehouse	25,000	
	Equipment—Delivery	10,000	
	Cash		130,000

Additional supplies would need to be ordered to maintain inventories at a level commensurate with expected usage. Encumbrances need not be recorded for purchase orders issued, and so information about the dollar value of purchase orders is omitted form this illustration. During 2003, it is assumed supplies are received and related invoices are approved for payment in the amount of $192,600; the entry needed to record the asset and the liability is:

		Debits	Credits
4.	Inventory of Supplies	192,600	
	Vouchers Payable		192,600

The General Fund of the Town of JIMMA (See Chapter 4) accounted for supplies on the periodic inventory basis. The Supplies Fund, however, should account for its inventories on the perpetual inventory basis since the information is needed for proper performance of its primary function. Accordingly, when supplies are issued, the inventory account must be credited for the cost of the supplies issued. Since the using fund will be charged an amount in excess of the inventory carrying value, the receivable and revenue accounts must reflect the selling price. The markup above cost should be determined on the basis of budgeted expenses and other items to be financed from net income, in relation toe expected requisitions by using funds. If the budget for the Town of JIMMA's Supplies Fund indicates a markup of 35 percent on cost is needed, issues to General Fund departments of supplies costing $185,000 would be recorded by the following entries.

		Debits	Credits
5a.	Cost of Supplies Issued	185,000	
	Inventory Supplied		185,000
5b.	Due from General Fund	249,750	
	Billing to Departments		249,750

If collections from the General Fund during 2003 totaled $231,000, the entry should be:

		Debits	Credits
6.	Cash	231,000	
	Due from General Fund		231,000

Assuming that payrolls and fringe benefits during the year were all paid in cash and were distributed to the functional expense accounts in the amounts shown below, Entry 7 is appropriate.

		Debits	Credits
7.	Administrative Expenses	11,000	
	Purchasing Expenses	19,000	
	Warehousing Expenses	12,000	
	Delivery Expenses	13,000	
	Cash		55,000

If payment on vouchers during the year totaled $164,000, the entry is:

		Debits	Credits
8.	Vouchers Payable	164,000	
	Cash		164,000

The interfund loan from the Water Utility Fund is to be repaid in 20 equal annual installments; repayment of one installment at the end of 2002 and reclassification of the next installment are recorded as:

		Debits	Credits
9a.	Interfund Loan from Water Utility Fund—Current	6,500	
	Cash		6,500
9b.	Interfund Loan from Water Utility Fund—Noncurrent	6,500	
	Interfund Loan from Water Utility Fund—Current		6,500

It is assumed the building used as a warehouse was estimated at the time of purchase to have a remaining useful life of 20 years; the warehouse machinery and equipment was estimated to have a useful life of 10 years, and the delivery equipment to have a useful life of 5 years. If the administrative and clerical office space occupies 10 percent of the area of the warehouse, 10 percent of the depreciation of the warehouse, $350, may be considered administrative expense; similarly, if the purchasing office occupies 10 percent of the space in the warehouse building, 10 percent of the building depreciation, $350, may be considered purchasing expense. The remainder of the building is devoted to warehousing; therefore, 80 percent of the total building depreciation, $2,800, is to be charged to warehousing expense. The latter account is also charged $2,500 for machinery and equipment depreciation expense. Delivery expense is charged $2,000 for depreciation of equipment during the year.

		Debits	Credits
10.	Administrative Expenses	350	
	Purchasing Expenses	350	
	Warehousing Expenses	5,300	
	Delivery Expenses	2,000	
	Allowance for Depreciation—Building		3,500
	Allowance for Dep–Machinery & Equipment–Warehouse		2,500
	Allowance for Depreciation—Equipment Delivery		2,000

Organizations that keep perpetual inventory records must adjust the records periodically to reflect shortages, overages, or out-of-condition stock disclosed by physical inventories. Adjustments the

Inventory account are also considered adjustments to the warehousing expenses of the period. In this illustrative case, it is assumed no adjustments were found necessary art year-end. Assuming all revenues and expenses applicable to 2003 have been properly recorded by the entries illustrated above, the operating statement accounts should be closed as of December 31, 2003:

		Debits	Credits
11.	Billings to Departments	249,750	
	Cost of Supplies Issued		185,000
	Administrative Expenses		11,350
	Purchasing Expenses		19,350
	Warehousing Expenses		17,300
	Delivery Expenses		15,000
	Excess of Net Billings to Departments over Cost		1,750

Excess of Net Billings to Departments over Costs (or Excess of Costs over Net Billings to Departments, if operations resulted in a loss) is the account title generally considered more descriptive of the fund's results than Income Summary or Current Earnings – the titles commonly found in profit-seeking businesses. Whatever title is used for the account summarizing the results of operations for the period, the account should be closed at year-end. He title of the account that records earnings retained in an internal service fund, as well as contribution to equity, are recorded in the account Net Assets – Unrestricted.

		Debits	Credits
12.	Excess of Net Billings to Departments over Costs	1,750	
	Net Assets—Unrestricted		1,750

The Interfund Transfers In account represents other financing source and is closed to Net Assets – Unrestricted as shown in Entry 13:

		Debits	Credits
13.	Internal Transfers–In	91,500	
	Net Assets—Unrestricted		91,500

Required Financial Statements: Internal Service Funds

1. Statement of Net Assets

As one would expect of funds accounted for in a manner similar to profit-seeking businesses, the statement of net assets (or, alternatively, a traditional classified balance sheet) of proprietary funds is classified; that is, current assets are segregated from capital assets and other assets, and current liabilities are segregated from long-term debt. The statement of net assets for the Supplies Fund of the Town of JIMMA as of December 31, 2003, is shown in Illustration 7-2.

GASB Statement No. 34 requires that net assets be reported in three components, invested in capital assets, net of related debt; restricted; and unrestricted. As of December 31, 2003, the Supplies Fund investment in capital assets of $122,000 is less than the balance of the interfund loan of $123,500 ($117,000 long-term liability plus $6,500 current portion due within one year). Thus, there is no investment in capital assets to be reported. There also are no assets restricted as to use by external resources providers or legislative action. As a result, the Supplies Fund has only unrestricted net assets as of December 31, 2003.

Illustration 7-2

TOWN OF JIMMA
SUPPLIES FUND
STATEMENT OF NET ASSETS
AS OF DECEMBER 31, 2003

ASSETS :			
Current Assets			
Cash			$35,500
Due from General Fund			18,750
Inventory of Supplies, at average cost			69,100
Total current assets			123,350
Capital assets:			
Land		$25,000	
Building	$70,000		
Less: Allowance for depreciation	3,500	66,500	
Machinery and equipment – warehouse	25,000		
Less: Allowance for depreciation	2,500	22,500	
Equipment – delivery	10,000		
Less: Allowance for depreciation	2,000	8,000	
Total capital assets			122,000
Total Assets			245,350
LIABILITIES :			
Current Liabilities:			
Vouchers Payables		$28,600	
Current portion of long-term liabilities		6,500	
Total current liabilities			35,100
Long-term liabilities:			
Interfund loan from water utility			117,000
Total liabilities			152,100
NET ASSETS :			
Unrestricted			**$93,250**

2. Operating Statements

The results of operations of an Internal Service Fund for a period should be reported in a Statement of Revenues, Expenses, and Changes in Net Assets, which is the equivalent of an income statement for a profit-seeking entity. In the reporting model being superseded by Statement No. 34, the statement is called a Statement or Revenues, Expenses, and Changes in Retained Earnings, since the fund equity (rather than net assets) under the previous model was reported in two components, contributed capital and retained earnings. Illustration 7-3 presents a Statement of Revenues, Expenses, and Changes in Net Assets for the year ended December 31, 2003, for the Town of JIMMA Supplies Fund.

Illustration 7-3

TOWN OF JIMMA
SUPPLIES FUND
STATEMENT OF REVENUES, EXPENSES, AND CHANGE IN NET ASSETS
FOR THE YEAR ENDED DECEMBER 31, 2003

Operating revenues:		
Billing to departments		$249,750
Less: Cost of supplies issued		185,000
Gross Margin		64,750
Operating Expenses:		
Purchasing expenses	$19,350	
Administrative expenses	11,350	
Warehousing expenses	17,300	
Delivery expenses	15,000	
Total Operating Expenses		63,000
Operating Income		1,750
Interfund transfer in		91,500
Change in net assets		93,250
Net assets – January 1, 2003		-0-
Net assets – December 31, 2003		$93,250

3. Statement of Cash Flows

GASB financial reporting standards require the preparation of a statement of Cash Flows as a part of full set of financial statements for all proprietary funds. Categories of cash flows provided by FASB Statement No. 95 were deemed insufficient to meet the needs of users of governmental financial reports. Consequently, GASB standards provide four categories of cash flows: Operating, Non-capital Financing, Capital and Related Financing, and Investing. In each category, the term cash also includes **Cash Equivalents** (defined as short-term, highly liquid investments).

Cash flows from operating activities include receipts found customers, receipts from sales to other funds, payments to suppliers of goods or services, payments to employees for services, payments for purchases from other funds (including payments in lieu of taxes), and other operating cash receipts and payments. The transactions of the Town of JIMMA's Supplies Fund recorded in Entries 6, 7, and 8 are classified as operating activities and are reported in the first section of the Statement of Cash Flows (see Illustration 7-4). As required by GASB standards the Statement of Cash Flows is accompanied by a reconciliation of operating income with the net cash flow from operating activities.

Cash flows from *non-capital financing* activities include proceeds from debt not clearly attributable to acquisition, construction, or improvement of capital assets; receipts from grants, subsidies, or taxes other than those specifically restricted for capital purposes or those for specific operating activities; payment of interest on, and repayment of principal of, non-capital financing debt; grants or subsidies paid to other governments, funds, or organizations, except payments for specific operating activities of the grantor government. The contribution from the General Fund to the Supplies Fund of the Town of JIMMA (see Entry 1) is reported in the cash flows from non-capital financing activities section of the Statement of Cash Flows (Illustration 7-4).

Cash flows from *capital and related financing* activities include proceeds of debt and receipts from special assessments and taxes specifically attributable to acquisition, construction or improvement of capital assets; receipts from capital grants; receipts from the sale of capital assets; proceeds of insurance on capital assets that are stolen or destroyed; payments to acquire, construct, or improve capital assets; payment of interest on, and repayment or refunding of, capital and related financing

debt. The transactions of the Town of JIMMA's Supplies Fund recorded in Entries 2, 3, and 4 are classified as capital and related financing activities and are reported in that section of the Statement of Cash Flows (Illustration 7-4).

Cash flows from investing activities include receipts from collection of loans; interest and dividends received on loans, debt instruments of other entities, equity securities, and cash management and investment pools; receipts from the sales of debt or equity instruments; withdrawals from investment pools not used as demand accounts; disbursements for loans; payments to acquire debt or equity instruments; and deposits into investment pools not used as demand accounts. None of the transactions of the Town of JIMMA's Supplies Fund during 2003 are in the nature of investing activities.

Illustration 7-4

TOWN OF JIMMA
SUPPLIES FUND
STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED DECEMBER 31, 2003

Cash flows from operating activities:		
Cash received from customers	$231,000	
Cash paid to employees for services	(55,000)	
Cash paid to suppliers	(164,000)	
Net cash provided by operating activities		$12,000
Cash flows from non-capital financing activities:		
Interfund transfer from General Fund	30,000	
Net cash provided by non-capital financing activities		30,000
Cash flows from capital and related financing activities:		
Advance from Water Utility Fund	130,000	
Partial repayment of advance from Water Utility Fund	(6,500)	
Acquisition of capital assets	(130,000)	
Net cash used for capital and related activities		(6,500)
Net Increase in Cash and Cash Equivalents		35,500
Cash and Cash Equivalents, 1/1/2003		-0-
Cash and Cash Equivalents, 12/31/2003		$35,500

Reconciliation of Operating Income to Net Cash Provided by Operating Activities

Operating Income		$1,750
Adjustments:		
Depreciation expense		8,000
Increase in receivables from other funds		(18,750)
Increase in inventory	$69,100	
Less: contributed inventory	61,500	(7,600)
Increase in vouchers payable		28,600
Net Cash Provided by Operating Activities		$12,000

External Financing Reporting of Internal Service Funds

The financial statements presented in Illustrations 7-2, 7-3, and 7-4 should be prepared for internal management purposes. For *external* financial reporting purposes, the Supplies fund financial information reported in each of those statements would be reported as a separate column of the Statement of Net Assets – Proprietary Funds; Statement of Revenues, Expenses, and Changes in Net Assets – Proprietary Funds; and Statement of Cash Flows – Proprietary Funds, each of which is prepared for all proprietary funds (see Illustration 2-6, 2-7, and 2-8 for examples). In the government-wide Statement of Net Assets and Statement of Activities, internal service fund financial information

is "collapsed" into the governmental activities and reported in that column of both government-wide financial statements. Various reclassifications, eliminations, and allocations may be required to avoid what Statement No. 34 refers to as "doubling up" – that is, reporting internal service fund financial information once as part of the governmental activities and then again as part of internal service funds. As recommended by GASB Statement No. 34, the discussion that follows assumes that all internal service fund transactions occurred with governmental funds. Internal service fund financial information should be reported in the business-type activities column of the government-wide financial statements only if an enterprise fund is the predominant participant in the internal service fund.

To permit reporting of the Town of JIMMA's Supply Fund activities in the governmental activities category of the government-wide financial statements certain journal entries should be made in the governmental activities general journal, one that records the balance sheet effects and one that eliminates any net income recognized by the internal service fund.

The entry to record the balance sheet effects in the governmental activities general journal should record the *change* during the year in each internal service fund balance sheet account. Because this is the first year of operation of the Town of JIMMA's Supplies Fund, the journal entry to record its balance sheet information (See Illustration 7-2) simply records the year-end amounts.

		Debits	Credits
1.	Cash	35,500	
	Intra-activities Balance	18,750	
	Inventory of Supplies	69,100	
	Land	25,000	
	Buildings	70,000	
	Machinery and Equipment	35,000	
	Allowance for Depreciation—Building		3,500
	Allowance for Dep–Machinery & Equipment		4,500
	Vouchers Payable		28,600
	Intra-activities Balance		18,750
	Current Portion of Long-term Liabilities		6,500
	Interfund Loan from Business Activities		117,000

In comparing Entry 1 to Town JIMMA Supplies Fund Balance Sheet (Illustration 7-2), one will note that the amount shown as Due from General Fund in the balance sheet is debited to *Intra-activities* Balance in Entry 1, an amount that will be offset by credit in the same total amount to Intra-activities Balance at the government-wide level when expenses were recorded for prior billings from the internal service fund. This interfund receivable/liability has no net effect on the governmental activities column as both the General Fund and the Supplies Fund are part of the governmental activities category.

Although it may not apparent, unless additional adjustments are made the balance of Cash and Inventory of Supplies will be overstated at the government-wide level. Why is this case? The reason is that the interfund transfer from the General Fund to the Supplies Fund (see illustrative transaction Entry 1 earlier in this chapter) has no effect at the government-wide level since both funds are considered to be governmental activities. Thus, the interfund transfer did not result in a net reduction of Cash and Inventory of Supplies at the government-wide level. Accordingly, cash in the amount of $30,000 and supplies in the amount of $61,500 must be eliminated or else they will be counted twice at the government-wide level. Similarly, although the interfund transfer increased the unrestricted net assets of the Supplies Fund by $91,500, it had no effect on the net assets of *governmental activities* at the government-wide level. As shown in the Town of JIMMA operating statement presented in

Illustration 7-3, the Interfund Transfers In from the General Fund is also reported as a component of "net income" or, more formally, *change in net assets*. As just discussed, this component of change in net assets has no effect at the government-wide level. The required journal entry in the governmental activities general journal to eliminate the effects of the interfund transfer is:

		Debits	Credits
2.	Net Assets–Unrestricted	91,500	
	Inventory of Supplies		61,500
	Cash		30,000

Another component of the change in net assets that must be eliminated is the operating income, shown as $1,750 in Illustration 7-3. Elimination of these components prevents double counting of net assets at the government-wide level. As governmental funds purchase supplies throughout the year form the internal service fund, the purchases are recorded as expenditures of the governmental fund and as direct expenses of the appropriate functions at the government-wide level. Because operating income results from billings that exceed the internal service fund's operating costs, the cost of functions (or programs) at the government-wide level would be overstated if the operating income were not eliminated from the amounts billed. If substance, the elimination of change in net assets adjusts the internal service fund information as the governmental funds purchased their own supplies from external sources without using an internal service fund. Or, viewed alternatively, the elimination presents the internal service fund financial information as if the fund operated on a break-even basis, just covering its accrual basis operating costs. Entry 3 gives the journal entry needed to remove the operating income effects of the Town of JIMMA's Supplies Fund, assuming a particular allocation of functions at the government-wide level:

		Debits	Credits
3.	Net Assets—Unrestricted	1,750	
	Expenses—General Government		175
	Expenses—Public Safety		525
	Expenses—Public Works		700
	Expenses—Parks and Recreation		263
	Expenses—Health and Welfare		87

Note that Entry 3 affects only the government-wide financial statements; expenditures would be reported in the governmental funds Statement of Revenues, Expenditures, and Changes in Fund Balances for the full amount billed by the Supplies Fund. The reader should also note that any internal service fund operating loss would have the opposite effect; it would increase the direct expenses of functions and net assets at the government-wide level.

After the eliminations in entries 2 and 3 are recorded, only cash in the net amount of $5,500 and supplies in the amount of $7,600 related to transactions of the internal service fund are reported as additions to those accounts at the government-wide level. Interestingly, during the cost 2003 fiscal year the operations of the Supplies Fund have no effect on net assets at the government-wide level. This is apparent from the fact that the $93,250 credit to Net Assets – Unrestricted in Entry 1 (as reported in the Supplies Fund Balance Sheet) is completely offset by the debits of $91,500 in Entry 2 and $1,750 in Entry 3.

If a portion of an internal service fund's operating income results from billings to enterprises funds, Statement No. 34's requirement to report internal service fund financial information in the governmental activities category tends to understate unrestricted net assets in that category and overstate unrestricted net assets in the business-type category. Usually this effect should not be material, particular if the internal service fund pricing is set to cover approximately the full cost of its operations.

Because internal service fund financial information is reported in most cases in the governmental activities column of the government-wide financial statements, the financial information reported in the business-type activities column will usually be that for enterprise funds only. If this is the case, there is no need to maintain a separate set of accounting records for the business-type activities at the government-wide level. Rather, the financial records of the enterprise funds can simply be added together for financial reporting purposes at the government-wide level. Any interfund transactions between enterprise funds would be eliminated as they would have no net effect on the overall business-type activities. Enterprise fund accounting and financial reporting are discussed later in this chapter.

Assets Acquired under Lease Agreements

The acquisition of general capital assets under lease agreements is discussed in Chapter 5. Assets for use by proprietary funds may also be acquired under lease agreements. The criteria set forth in FASB SFAS No. 13 (these criteria are itemized in Chapter 5) are used to determine whether the lease is an operating lease or a capital lease.

Assets acquired under an operating lease belong to the lessor and not to be internal service fund; accordingly, the annual lease payment is recorded as a rental expense of the internal service fund, and there is no depreciation expense on the assets acquired under an operating lease agreement. Assets acquired under a capital lease agreements by an internal service fund, or an enterprise fund, should be capitalized by that fund. The amount to be recorded by a proprietary fund as the cost of the assets acquired under a capital lease, and as the related liability, is the lesser of (a) the present value of the rental and other minimum lease payments or (b) the fair value of the leased property. The amount recorded as the cost of the asset is amortized in a manner consistent with the government's normal depreciation policy for owned assets of proprietary funds. The amortization period is restricted to the lease term, unless the lease (a) provides for transfer of title or (b) includes a bargain purchase operation, in which case the economic life of the asset becomes the amortization period. During the lease term, each minimum lease payment by an internal service fund is to be allocated between a reduction of the obligation under the lease and as interest expense in a manner that produces a constant periodic rate of interest on the remaining balance of the obligation. This allocation and other complexities that arise in certain events are described and illustrated in various paragraphs of SFAS No. 13 and in many intermediate accounting texts. These complexities are beyond the scope of this text.

Internal Service Funds with Manufacturing Activities

The Supplies Fund of the Town of JIMMA, for which journal entries and statements are illustrated in a preceding section of this chapter, is responsible for purchasing, storing, and issuing supplies used by other funds and departments of the town. Many states and local governmental units have funds similar to that of the Town of JIMMA. It is also common to find printing shops, asphalt plants, or other service units that produce a physical product to be used by funds and departments, or that facilitates the operations of the other funds and units by performing maintenance or repair jobs, or even perform a temporary financing function.

If an internal service fund performs a continuous process manufacturing operation, its accounting system should provide process cost accounts. If a service fund performs a manufacturing, maintenance, or repair operation on a job-order basis, the fund's accounting system should provide appropriate job-order cost accounts. To the extent that operations, processes, or activities are capable of being standardized, cost standards for materials, direct labor, and overhead should be establish; in such cases, the accounting system should provide for the routine measurement and reporting of significant variances from the standards.

Internal Service Funds as Financing Devices

Governmental units may utilize internal service funds as devices to finance risk management, equipment purchases and operations (including centralized computer operations), and other functions

that are facilitated by generating revenues from user charges to cover costs and expenses computed on a full accrual basis. In the case of funds to finance equipment purchases and operations, including the operations of computers owned by the governmental unit, an internal service fund can include depreciation and, perhaps, expected increases in the cost of replacing assets, in the charge to the using funds – thus incorporating these costs in current appropriation of governmental funds, rather than budgeting the estimated cost of equipment expected to be replaced. If internal service funds are used to finance equipment purchases and operations, therefore, the appropriations and expenditures of governmental funds more nearly approximate costs that would be reported by entities using full accrual accounting than is true under the procedures discussed in Chapter 3 and 4.

GASB has issued accounting and financial reporting standards for risk financing and related insurance activities. Government entities that use internal service funds to account for risk financing activities are required to recognize revenues and claims expenses and liabilities in essentially the same manner as public entity risk pools (cooperative groups of governmental entities jointed together to finance risks of loss to property, workers' compensation, employee health care, and similar risks or exposures). Briefly, the internal service fund should recognize claims expense and liability when a claim is asserted, it is probable that an asset has been impaired or a liability has been incurred, and the amount of the loss is reasonably estimable; or if an estimable loss has been incurred and it is probable that a claim will be asserted. Reasonably possible (but not probable) loss contingencies, probable losses that are not reasonably measurable, and loss exposure in excess of the accrued liability should be disclosed in the Notes to the Financial Statements. The disclosure should explain the nature of the contingency and an estimate of the possible loss or range of the loss, or a statement that the amount is not estimable.

Internal service fund charges to other funds for risk financing activities should be sufficient to recover the total amount of claim expenses recognized for the period or, alternatively, may be based on an actuarial method so that internal service fund revenues and expenses over time are approximately equal. Charges to other funds may also include a reasonable provision for expected future catastrophe losses. Internal service fund charges to other funds are recognized as revenues by the internal service fund and as expenditures by governmental funds or expenses by proprietary and nonexpendable trust funds. Internal service fund charges in excess of the full cost amount determined as above should be reported as an other financial source by the internal service fund and an other financing use by the other funds. If the internal service fund fails to recover the full cost of claims over a reasonable period of time, the accumulated fund deficit should be charged to the other funds and reported by other funds as an expenditure or expense, as appropriate.

Dissolution of an Internal Service Fund

When an internal service fund has completed the mission for which it was established, or when its activity is terminated for any other reason, dissolution must be accomplished. Liquidation may be accomplished in any one of three ways or in combinations thereof. The three ways are: (1) transfer of the fund's assets to another fund that will continue the operation as a subsidiary activity, for example, a supply fund becoming a department of the General Fund; (2) distribution of the fund's assets in kind to another fund or to another governmental unit; (3) conversion of all its non-cash assets to cash and distribution of the cash to another fund or other funds. Dissolution of an internal service fund, as for a private enterprise, would proceed by prior payments to outside creditors, followed by repayment of long-term interfund loans not previously amortized, and finally, liquidation of remaining net assets. The entire process of dissolution should be conducted according to pertinent law and the discretion of the appropriate legislative body. Net assets contributed by another fund or governmental unit, but law or other regulations may dictate otherwise. If net assets have been built up out of charges in excess of costs, then liquidation will follow whatever regulations may govern the case; and if not exist, then the appropriate governing body must decided on the recipient or recipients.

7.4) Enterprise Funds

Enterprise fund and internal service funds are both classified by the GASB as proprietary funds, although as discussed previously, internal service fund financial information is reported as part of the governmental activities category at the government-wide level. Whereas internal service funds, discussed earlier in this chapter, are used primarily to account for services provided by one department or agency of a governmental unit to other departments or agencies of the same government, enterprise funds are used by governmental units to account for services provided to the *general public* on a user charges basis. Under the GASB Statement No. 34 model, a governmental unit must report certain activities in an enterprise fund if the following criteria are met.

1. The activity is financed with debt that is secured *solely* by a pledge of the revenues from fees and charges of an activity. [Emphasis added by authors.]
2. Laws or regulations require that the activity's costs of providing services, including capital costs (such as depreciation or debt service), be recovered with fees and charges, rather than with taxes or similar revenues.

These criteria are quite specific regarding when an enterprise fund must be used. For example, if debt is issued that is also backed by the full faith and credit of the governmental unit, even though it is intended to be repaid from revenues of a particular activity, that activity need not be reported in an enterprise fund. Similarly, if an activity is subsidized by a governmental unit's General Fun, rather than fully covering its costs of providing services with fees or charges, that activity need not be reported in an enterprise fund. In either of these examples, however, the governmental unit could opt to report the activities in an enterprise fund.

From this description, and from the fact that the word *enterprise* is often used as a synonym for "business-type activity," it is apparent that enterprise funds should use full accrual accounting and account for all assets used in the production of goods or services offered by the fund. Similarly, if long-term debt is to be serviced by the fund, it is accounted for by the fund.

The most common examples of governmental enterprises are public utilities, notably water and sewer utilities. Electric and gas utilities, transportation systems, airports, ports, hospitals, toll bridges, produce markets, parking lots, parking garages, liquor store, and public housing projects are other examples frequently found. Services of the kinds mentioned are generally accounted for by enterprise funds because they are intended to be largely self-supporting. However, they are properly accounted for by a general or special revenue fund by those governments that support the activities largely from general or special revenue sources other than user charges and are not concerned with measuring the costs of the activities.

Almost every kind of enterprise operated by a government has its counterpart in the private sector. In order to take advantage of the work done by regulatory agencies and trade associations to develop useful accounting information systems for the investor-owned enterprises, *it is recommended that governmentally owned enterprises use the accounting structures developed for investor-owned enterprises of the same nature.* Budgetary accounts should be used only if required by law. Debt service and construction activates of a governmental enterprise are accounted for within the enterprise fund, rather than by separate debt service and capital projects funds. Thus, the financial statements of enterprise fund are self-contained; and creditors, legislators, or the general public can evaluate the performance of a governmental enterprise on the same bases as they can the performance of investor-owned enterprises in the same industry. By far the most numerous and important enterprise services rendered by local governments are public utilities. In this chapter, therefore, the example used is that of a water utility fund.

7.5) Water Utility Fund: Illustrative Case

The Balance Sheet as of December 31, 2001, for the Town of JIMMA Water Utility Fund is shown in Illustration 7-5. While the Balance Sheet appears fairly conventional, terminology peculiar to utilities warrants discussion prior to proceeding to the illustrative transactions for the year ending December 31, 2002.

Current and Accrued Assets

Cash and Materials and Supplies shown in Illustration 7-5 in the Current and Accrued Assets section are not peculiar to utilities and need not be discussed here. The other two asset accounts in this section – Customer Accounts Receivable and Accrued Utilities Revenues – are related. The former represents billings to customers that are outstanding at year-end (and are reduced, as one would expect, by an Accumulated Provision for Uncollectible). The latter results from the fact that utilities generally prepare billings to customers on the basis of meter readings, and it is not practical for utilities to read all meters simultaneously at year-end and bill all customers as of that time. Utilities that meter their service make extensive use of cycle billing, which, in substance, consist of billing part of their customers each day instead of billing by calendar months.

Under this plan, meter reading is a continuous day-by-day operation, with billings following shortly after the filing of the meter readers' reports. Individual meters are read on approximately the dame day each month, or every other month, in order that each bill covers approximately the same number of days of usage. Cycle billing eliminates the heavy peak load of accounting and clerical work that result from uniform billing on a calendar month basis. It does, however, result in a sizable amount of unbilled receivables on any given date, thus requiring accrual of unbilled receivables (Accrued Utilities Revenues, in regulatory terminology) as of the financial statement date in order to state assets and sales properly.

Restricted Assets

The section below Current and Accrued Assets in Illustration 7-5 is captioned Restricted Assets, the caption most commonly used when the use of assets is restricted by contractual agreements or legal requirements. Some governments that use regulatory terminology report restricted assets of utilities under the broader caption, Other Property and Investments. Other Property and Investments may include, in addition to restricted assets, the carrying value of property not being used for utility purposes or being held for future utility use.

Cash and Investments are the only two items reported under the Restricted Assets caption of the balance sheet shown in Illustration 7-5. Those items are restricted for return of customer deposits and for retirement of revenue bonds pursuant to the bond covenants. The amount of assets segregated, $562,600, is offset by liabilities currently payable from restricted assets (in the case of the Town of JIMMA, Customer Deposits of $23,700) and restrictions of net assets (in this case, restricted for payment of debt service, $538,900). This fund within a fund approach permits segregation of assets, related liabilities, and restricted net assets within a single enterprise fund. Net assets should be restricted in the amount of the net assets of each restricted "fund" within the Enterprise Fund, as shown in Illustration 7-5. Other items commonly reported in Restricted Assets include assets set aside to fund depreciation for capital improvements or grants and contributions restricted for capital acquisition or improve

Utility Plant

Utility Plant in Service is a control account, supported in whatever detail is required by regulatory agencies and by management needs. For example, water utilities commonly have six subcategories of plant assets: intangible plant, source of supply plant, pumping plant, water treatment plant, transmission and distribution plant, and general plant each of the six subcategories is supported by appropriate subsidiary accounts. For example, intangible plant consists of the costs of organization, franchises and consents, and any other intangible costs "necessary and valuable in the conduct of

utility operations." Sources of supply plant consists of land and land rights; structures and improvements; collecting and impounding reservoirs; lake, river, and other intakes; well and springs; infiltration galleries and tunnels; supply mains; and other water source plant. Each of the accounts within each subcategory is supported by necessary subsidiary records for each individual asset detailing its description, location, cost, date of acquisition, estimated useful life, salvage value, depreciation charges, and any other information needed for management planning and control, regulatory agency reports, financial statements, or special reports to creditors.

Illustration 7-5

TOWN OF JIMMA
WATER UTILITIES FUND
STATEMENT OF NET ASSETS
AS OF DECEMBER 31, 2001

ASSETS :			
Current and Accrued Assets:			
Cash		$126,000	
Customer accounts receivable	$69,000		
Less: Accumulated provision for uncollectible	2,900	66,100	
Accrued utilities revenues		14,800	
Materials and supplies		28,700	
Total Current and Accrued Assets			$235,600
Restricted Assets:			
Cash		6,600	
Investments		556,000	562,600
Utility Plant:			
Utility plant in service		3,291,825	
Less: Accumulated depreciation		440,325	
Utility Plant – Net		2,851,500	
Construction work in progress		125,000	
Net Utility Plant			2,976,500
Total Assets			**3,774,700**
LIABILITIES			
Current Liabilities:			
Accounts payable		33,200	
Customer advances for construction		21,000	
Total Current Liabilities			54,200
Liabilities Payable from Restricted Assets:			
Customer deposits			23,700
Long-Term Liabilities:			
Revenue bonds payable (net of unamortized Discount of $5,300)			1,744,700
Total Liabilities			**1,822,600**
NET ASSETS			
Invested in capital asses, net of related debt			1,231,800
Restricted for payment of debt service			538,900
Unrestricted			181,400
Total Net Assets			**$1,952,100**

Construction Work in Progress

The other Utility Plant item shown on the Balance Sheet, Illustration 7-5, is Construction Work in Progress. This account represents the accumulated costs of work orders for projects that will result in items reportable as Utility Plant when completed and is, of course, supported y the work orders for projects in progress. Each work order, in turn, is supported by documents supporting payments to contractors and to suppliers, or supporting charges for materials. Labor, and overhead allocable to the project.

The Uniform System of Accounts for water, sewer, gas, and electric utilities published by NARUC all contain a section on Utility Plant Instructions that, among other items, specifies the components of

construction cost. Generally, the components are in agreement with those listed in any intermediate accounting text. One item long recognized in utility accounting and accepted by the FASB is the Allowance for Funds Used During Construction (AFUDC).

AFUDC includes the net cost for the period of construction of borrowed funds used for construction purposes *and a reasonable rate on other funds so use*. This, interest paid, accrued, or imputed during the period of construction o a utility plant asset is included as a cost of the asset. Interest paid of construction of a utility plant asset is included as a cost of the asset. Interest paid or accrued, known as the debt component of AFUDC, is deducted from Interest on Log-Term Debt in the Other Income and Deductions section of the utility's operating statements (see Illustration 7-7). This practice accomplishes two things; (1) it discloses to financial statement readers the amount of interest that was capitalized during the year, and (2) it reduces the reported interest expense, thus increasing reported net income for the period (presumably showing down utility's' requests for rate increases). If construction is financed, in part, by use of resources generated by operations of the utility, regulatory authorities allow interest to be imputed on these "equity" funds and capitalized. Since imputed interest is not viewed by accountants as an expense, it is offset by reporting the *equity component* of AFUDC as non-operating income.

Current Liabilities

Items commonly found in the Current Liabilities section of a Utility Balance Sheet are shown under that caption in Illustration 7-5. Accounts Payable needs no comment here. The other item, **Customer Advances for Construction**, results from the practice of utilities of requiring customers to advance to the utility a sizable portion of the estimated cost of construction projects to be undertaken by the utility at the request of the customer. If the advances are to be refunded, either wholly or in part, or applied against billings for service rendered after completion of the project, they are classified as shown in Illustration 7-5. When a customer is refunded the entire amount to which he or she is entitled according to the agreement or rule, under which the advance was made, the balance, if any, is reported as contributions from Customers in the Statement of Revenues, Expenses, and Changes in Net Assets. Other items commonly reported under Current Liabilities include accrued expenses, amounts due to other funds, and current portions of leg-term liabilities. Some governments also report customer deposits under the Current Liabilities caption.

Liabilities Payable from Restricted Assets

Liabilities payable from restricted assets should be displayed separately from current liabilities as shown in Illustration 7-5. In addition to customer deposits, the current portion of revenue bonds payable, if any, would be reported here since restricted assets have been set aside for that purpose. The Town of JIMMA follows the common practice of most utilities and requires all new customers to deposit a sum of money with the utility as security for the payment of bills. In many, but not all, jurisdictions utilities are required to pay interest on customer deposit at a nominal rate. Regulatory authorities or local policy may require utilities to refund the deposits, and interest, after a specified period of time if the customer has paid all bills on time. The utility may be required, as was the Town of JIMMA Water Fund, to segregate cash or investments in an amount equal to the liability for Customer Deposits. Customer Advances for Construction are contractually different from Customer Deposits and are less likely to be reported separately as restricted assets and liabilities, unless agreements with developers make it necessary to restrict assets for this purpose.

Long-Term Liabilities

Bonds are the customary form of long-term liabilities. Bonds issued by a utility are usually secured by the pledge of certain portions of the utility's revenue, the exact terms of the pledge varying with individual cases; bonds of this mature are called **revenue bonds**. Some utility bonds are secured not only by a pledge of a certain portion of the utility's revenues but also by an agreement on the part of the town's or Town's general government to subsidize the utility in any year in which its normal revenue is inadequate for compliance with the terms of the and indenture. Other utility bonds carry the pledge of the governmental unit's full faith and credit, although the intent is to service them for utility

revenues rather than general taxes. The latter are, therefore, technically **general obligation bonds**. GASB standards provide that general obligation bonds intended to be serviced from utility revenues be reported as a liability of the enterprise fund. Similarly, special assessment debt may be assumed by an enterprise fund if the assets constructed by special assessment financing are used in enterprise fund operations.

Governmentally owned utilities may have received long-term interfund loans form the government's General Fund or other funds. Also, enterprises may acquire assets under a capital lease arrangement. The portion of interfund loans, required lease payments, or bond or other debt issues to be paid within one year form balance sheet date should be reported as a current liability; the remainder is properly reported in the Long-term Liabilities section of the Utility Statement of Net Assets. (Alternatively, a Balance Sheet may be presented.) Long-term bonds payable should be reported net of unamortized discount or premium, as shown in Illustration 7-5, or else unamortized discount or premium can be reported as an offset against bonds payable at par on the Statement of Net Assets.

Net Assets

As discussed in earlier chapters for the government-wide Statement of Net Assets, GASB Statement No. 34 requires that net assets be reported in three categories: invested in capital assets, net of related debt; restricted; and unrestricted. The same three categories apply to the net assets (total assets minus total liabilities) of an enterprise fund, as shown in Illustration 7-5. Restrictions may be placed by law or regulation, or contractually by agreement with creditors or other outside parties. Illustration 7-5 shows a typical restriction – a sinking fund created pursuant to a bond indenture for repayment of revenue bond principal. Unrestricted net assets represent the residual amount of net assets after segregating investment in capital assets, net of related debt, and restricted net assets.

Illustrative Accounting for a Water Utility Fund

The discussion in preceding pages of the balance sheet accounts of a water utility includes by implication the essential characteristics of accounting necessary for both governmentally owned utilities and investor-owned utilities. In this section, accounting for characteristic transactions of a utility fund is illustrated in general journal entry format for the year following the Statement of Net Assets presented in Illustration 7-5.

It is assumed the Town of JIMMA is located in a state that permits enterprise funds to operate without formal legal approval of their budgets. Utility or other enterprise funds, management must prepare operating budgets and capital expenditure budgets as management tools. For the illustrative case, it is assumed the budgets are submitted to the Town administrators, to the Town legislative body, and to the public, for information, not for legal action. Accordingly, the budget is not formally recorded in enterprise fund accounts. Similarly, utility management must be informed periodically of the status of outstanding construction contracts and purchase orders, but encumbrances need not be recorded in the accounts in order to accomplish this.

The nature of the Accrued Utilities Revenues account was explained previously in the section on Current and Accrued Assets. In the year following the one for which the statement of net assets is shown, it is not feasible when customers' bills are prepared to determine whether a portion of the bill has been accrued and, if so, how much. The simplest procedure, therefore, is to reverse the accrual entry as of the start of the new fiscal year. Assuming the entire December 31, 2001, Town of JIMMA Water Utility Fund revenues accrual has been credited to sales of Water, the following entry is appropriate as of January 1, 2002:

		Debits	Credits
1.	Sales of Water	14,800	
	Accrued Utility Revenues.....		14,800

When utility customers are billed during the year, appropriate revenue accounts are credited. Assuming during 2002 the total bills to non-governmental customers amounted to $696,000, bills to the Town of JIMMA General Fund amounted to $30,000, and all revenue was from sales of water, the following entry summarizes the events:

		Debits	Credits
2.	Customer Accounts Receivable	696,000	
	Due from General Fund	30,000	
	Sales of Water		726,000

If collection from non-governmental customers totaled $680,000 for water billings, Entry 3 is needed;

		Debits	Credits
3.	Cash	680,000	
	Customer Accounts Receivable		680,000

Material and supplies in the amount of $138,000 were purchased during the year by the Water Utility Fund. The liability is recorded as:

		Debits	Credits
4.	Materials and Supplies	138,000	
	Account Payable		138,000

Material and Supplies chargeable to the accounts itemized in the entry below were issued during the year.

		Debits	Credits
5.	Source of Supply Expenses	18,000	
	Pumping Expenses	21,000	
	Water Treatment Expenses	24,000	
	Transmission and Distribution Expenses	13,000	
	Construction Work in Progress	66,000	
	Material and Supplies		142,000

Payrolls for the year were chargeable to the accounts shown in the entry below. Tax Collections Payable is the account provided in the NARUC and FERC systems to report "the amount of taxes collected by the utility through payroll deductions or otherwise pending transmittal of such taxes to the proper taxing authority." Taxes Accrued is the account provided in the NARUC and FERC systems to report the liability for taxes that are the expense of the utility, such as report the liability for taxes that are the expense of the utility, such as the employer's share of social security taxes. In the entry below, it is assumed that the employer's share of social security taxes is charged to the same accounts that the employees' gross earnings are; it is also assumed that checks have been issued for employees' net earnings.

		Debits	Credits
6.	Source of Supply Expenses	8,200	
	Pumping Expenses	15,700	
	Water Treatment Expenses	17,500	
	Transmission and Distribution Expenses	76,250	
	Customer Accounts Expenses	96,550	
	Sales Expenses	17,250	
	Administrative and General Expenses	83,150	
	Construction Work in Progress	30,400	
	Tax Accrued		13,800
	Tax Collections Payable		51,750
	Cash		279,450

Bond interest in the amount of $105,000 was paid; the bonds were issued to finance the acquisition of utility plant assets. Amortization of debt discount and expense amounted to $530.

		Debits	Credits
7.	Interest Long-Term Debt	105,000	
	Amortization of Debt Discount and Expense	530	
	Cash		105,000
	Unamortized Debt Discount and Expense		530

Bond interest in the amount of $12,900 was properly capitalized as part of construction work in progress during the year. (The Town of JIMMA does not impute interest on its own resources during construction.)

		Debits	Credits
8.	Construction Work in Progress	12,900	
	Allowance for Funds Used During Construction		12,900

Construction projects on which costs totaled $220,000 were completed and the assets placed in service:

		Debits	Credits
9.	Utility Plant in Service	220,000	
	Construction Work in Progress		220,000

Collection efforts were discontinued on bills totaling $3,410. The customers owing the bills had paid deposits to the water utility totaling $2,140; the deposits were applied to the bills, and the unpaid remainder was charged to Accumulated Provision for Uncollectible Accounts (Entry 10a). A restricted asset (cash) is reduced by $2,140, the amount of the decrease in Customer Deposits (Entry 10b).

		Debits	Credits
10a.	Customer Deposits	2,140	
	Accumulated Provision for Uncollectible Accounts	1,270	
	Customer Accounts Receivable		3,410
10b.	Cash	2,140	
	Cash–Customer Deposits		2,140

Customers' deposits amounting to $1,320 were refunded by check to customers discontinuing service (see Entry 11a). Deposits totaling $2,525 were received from new customers (see Entry 11b).

		Debits	Credits
11a.	Customer Deposits	1,320	
	Cash—Customer Deposits		1,320
11b.	Cash—Customer Deposits	2,525	
	Customer Deposits		2,525

Customers' advances for construction in the amount of $14,000 were applied to their water bills; in accord with the agreement with the customers and NARUC recommendations, the remainders of the advances were transferred to Capital Contribution from Customers.

		Debits	Credits
12.	Customer Advances for Construction	21,000	
	Customer Accounts Receivable		14,000
	Capital Contributions from Customers		7,000

Payments of Accounts Payable for materials and supplies used in operations totaled $67,200, and payment of Accounts Payable for materials used in construction totaled $66,000. Payments of Taxes Accrued amounted to $13,500, and payments of Tax Collections Payable amounted to $50,000.

		Debits	Credits
13.	Accounts Payable	133,200	
	Taxes Accrued	13,500	
	Tax Collection Payable	50,000	
	Cash		196,700

The Water Utility Fund agreed to pay $25,000 to the Town General Fund as a contribution in lieu of property taxes. The entry in the General Fund is illustrated in Chapter 4 (See Chapter 4, illustrative Entry 22a). The following entry records the event in the accounts of the Water Utility Fund:

		Debits	Credits
14.	Contribution in Lieu of Taxes	25,000	
	Due to General Fund		25,000

During the year interest in the amount of $44,500 was received in Cash on restricted investments. The amount of $1,375 is allocable to investments of customer deposit assets and is unrestricted as to use; the remaining $43,125 adds to the amount restricted for revenue bond repayment.

		Debits	Credits
15a.	Cash	1,375	
	Cash–Bond Repayment	43,125	
	Interest and Dividend Income		44,500
15b.	Net Assets—Unrestricted	43,125	
	Net Assets—Restricted for Bond Repayment		43,125

At year-end, entries to record depreciation expense, the provision for uncollectible accounts, and unbilled customers accounts receivable should be made as illustrated by Entry 16. In accord with regulatory terminology, Customer Accounts Expense, instead of Bad Debts Expense, is debited for the amount added to Accumulated Provision for Uncollectible Accounts. Amounts are assumed.

		Debits	Credits
16.	Depreciation Expense	102,750	
	Customer Accounts Expenses	3,980	
	Accrued Utility Revenues	15,920	
	Accumulated Provision for Depreciation of Utility Plant		102,750
	Accumulated Provision for Uncollectible Accounts		3,980
	Sales of Water		15,920

In accord with the revenue bond indenture, $100,000 unrestricted cash was invested in U.S. Government Securities for eventual retirement of revenue bonds. Net assets are restricted in an amount equal to the increase in restricted assets. In addition, investments from restricted cash for bond repayment amounted to $40,000.

		Debits	Credits
17a.	Investment–Bond Repayment	140,000	
	Cash		100,000
	Cash—Bond Repayment		40,000
17b.	Net Assets—Unrestricted	100,000	
	Net Assets—Restricted for Bond Repayment		100,000

Nominal accounts for the year were closed:

In addition, Net Assets - Invested in Capital Assets, Net of Related Debt, would be increased for depreciation and amortization of debt discount and increased or decreased, as appropriate, for the net change in utility plant during the year. Decreases and recorded as a debit to Net Assets – Invested in Capital Assets, Net of Related Debt, and as a credit to Net Assets – Unrestricted. The reverse entry would be required for increases in capital asset balances.

		Debits	Credits
18.	Sales of Water	727,120	

Capital Contribution from Customers	7,000	
Allowance for Funds Used During Construction	12,900	
Interest and Dividend Revenue	44,500	
Source of Supply Expenses		26,200
Pumping Expenses		36,700
Water Treatment Expenses		41,500
Transmission and Distribution Expenses		89,250
Customer Account Expenses		100,530
Sales Expense		17,250
Administrative and General Expenses		83,150
Interest on Long-Term Debt		105,000
Amortization of Debt Discount and Expense		530
Contribution in Lieu of Taxes		25,000
Depreciation Expense		102,750
Net Assets–Unrestricted		163,660

Required Financial Statement: Illustration

Statement of Net Assets

The Statement of Net Assets for a water utility, and definitions of certain balance sheet categories and items peculiar to regulated utilities, are explained at length in the sections of this chapter preceding the illustrative entries. The Statement of Net Assets of the Town of JIMMA Water Utility Fund as of December 31, 2002, is shown as Illustration 7-6. Note the amount due to the General Fund is offset against the amount due from that fund, and only the net amount of the receivable, $5,000, is shown as an asset.

Illustration 7—6

TOWN OF JIMMA
WATER UTILITIES FUND
STATEMENT OF NET ASSETS
AS OF DECEMBER 31, 2002

ASSETS :			
Current and Accrued Assets:			
Cash		$128,3675	
Customer accounts receivable	$67,590		
Less: Accumulated provision for uncollectible	5,610	61,980	
Accrued utilities revenues		15,920	
Due From General Fund		5,000	
Materials and supplies		24,700	
Total Current and Accrued Assets			$235,965
Restricted Assets:			
Cash		8,790	
Investments		696,000	704,790
Utility Plant:			
Utility plant in service		3,511,825	
Less: Accumulated depreciation		543,075	
Utility Plant – Net		2,968,750	
Construction work in progress		14,300	
Net Utility Plant			2,983,050
Total Assets			3,923,805
LIABILITIES			
Current Liabilities:			
Accounts payable		38,000	
Tax Accrued		300	
Customer advances for construction		1,750	
Total Current Liabilities			40,050
Liabilities Payable from Restricted Assets:			
Customer deposits			22,765
Long-Term Liabilities:			
Revenue bonds payable (net of unamortized discount of $4,770)			1,745,230
Total Liabilities			1,808,045
NET ASSETS			
Invested in capital asses, net of related debt			1,237,820
Restricted for payment of debt service			682,025
Unrestricted			195,915
Total Net Assets			$2,115,760

Operating Statement

The results of the operations of the town of JIMMA's Water Utility Fund for the year ended December 31, 2002, are shown in Illustration 7-7, the statement of Revenues, Expenses, and Changed in Net Assets. The classifications used in the statement are consistent with NARUC and FERC recommendations.

Illustration 7-7

TOWN OF JIMMA
WATER UTILITIES FUND
STATEMENT OF REVENUES, EXPENSES
AND CHANGES IN NET ASSETS
FOR THE YEAR ENDED DECEMBER 31, 2002

Utility Operating Revenue:		
Sales of Water		$727,120
Operating Expenses:		
Sources of Supply Expenses	$26,200	
Pumping Expenses	36,700	
Water Treatment Expenses	41,500	
Transmission and Distribution Expenses	89,250	
Customer Accounts Expenses	100,530	
Sales expenses	17,250	
Administrative and General Expenses	83,150	
Depreciation Expense	102,750	
Contribution in Lieu of Taxes	25,000	
Total Operating Expenses		522,330
Utility Operating Income		204,790
Other Income and Deductions:		
Interest and Dividend Revenue	(44,500)	
Interest on Long-term Debt	105,000	
Amortization of Debt Discount and Expense	530	
Allowance for Funds Used During Construction	(12,900)	
Total Other Income and Deductions		48,130
Income Before Contributions		156,660
Capital contributions from customers		7,000
Change in Net Assets		163,660
Total Net Assets, January 1, 2002		1,952,100
Total Net Assets, December 31, 2002		$2,115,760

Statement of Cash Flows

GASB standards require that a statement of Cash Flows be prepared for all proprietary funds as a part of a full set of annual financial statements. As discussed at length earlier in this chapter, GASB standards for preparation of a cash flow statement differ from FASB standards; the main difference being that GASB standards specify four major categories of cash flows rather than three. The statement of Cash Flows for the Town of JIMMA for the year ended December 31, 2002 (Illustration 7-8), utilizes only three of the four categories of cash flows since the town had no cash flows form non-capital financing activities. Cash flows from operating activities (Illustration 7-8) were provided by receipts form customers (Entry 3) and the net increase in refundable customer deposits (Entries I1a and I1b). Note that the application of customer deposits to pay overdue bills (Entries 10a and 10b) has no effect on total cash and cash equivalents. Chas from operating activates was used to pay employees (Entries 6 and 13). As suggested in the GASB implementation Guide on reporting cash flows,9 all employee-related items (in this case Taxes Accrued and Tax Collections Payable) have been added to the amount actually paid to employees. Payroll taxes and fringe benefits may be included in as separate line "cash payments for taxes, duties, fines, and other fees or penalties," if significant in amount. "Cash paid to employees for services" in the amount of $312,550 is calculated as the net cash paid directly to employees, $63,500 paid for Taxes Accrued and Ax Collections Payable (Entry 13). Although suppliers were paid $133,200 in total, only $67,200 of this amount applied to operating activates.

Cash flows form capital and related activates in Illustration 7-8 show two used of The first item, acquisition and construction of capital assets, is calculated as the sum of $30,400 (Entry) and $66,000 (Entry 13) The other item, interest paid on long-term bonds, reflects bond interest in the amount $105,00 paid in cash (Entry7). Cash flows investing activities show cash provided by interest and dividend income (Entry 15a) and cash used by purchase of investment (entry17a). As shown in Illustration 7-8, two reconciliations are required. The first recon collation is necessary because the Town of JIMMA's Statement of Cash Flows reports Changes in total cash and cash equivalents, whereas the Balance Sheet shows two components of cash and cash equivalents: that included in Current and Accrued Assets and that included in restricted Assets, respectively. GASB standards also require a reconciliation of operating income to net cash provided by operating activities.

Illustration 7-8

TOWN OF JIMMA
WATER UTILITY FUND
STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED DECEMBER 31, 2002

Cash flows from operating activities:		
Cash received from customers	$680,000	
Cash provided from customer deposits	1,205	
Cash paid to employees for services	(312,550)	
Cash paid to suppliers	(67,200)	
Net cash provided by operating activities		$301,455
Cash flows from capital and related financing activities:		
Acquisition and construction of capital assets		(96,400)
Interest paid on long-term bonds		(105,000)
Net Cash used for capital and related financing activities		(201,400)
Cash flows from investing activities:		
Interest and dividend income		44,500
Purchase of Restricted Investment		(140,000)
Net cash provided by investing activities:		(95,500)
Net Increase in Cash and Cash Equivalents		4,555
Cash and Cash Equivalents, 1/1/2003		132,600
Cash and Cash Equivalents, 12/31/2003		$137,155

Reconciliation of Cash and Cash Equivalents to the Balance Sheet

	End of Year	Beg. of Year
Cash and Cash Equivalents in current and accrued assets	128,365	126,000
Restricted cash and cash equivalents	8,790	6,600
Total cash and cash Equivalents	137,155	132,600

Reconciliation of Utility Operating Income to Net Cash Provided by Operating Activities:

Utility Operating income		$204,790
Adjustments:		
Depreciation expense	$102,750	
Increase in accounts Payable	4,800	
Increase in accrued liabilities	2,050	
Decrease in customer deposits	(935)	
Decrease in inventories	4,000	
Increase in receivables from other funds	(5,000)	
Increase in accrued receivables	(1,120)	
Decrease in customer accounts receivable	4,120	
Customer advances applied to customer receivables	(14,000)	
Total Adjustment		96,665
Net Cash Provided by Operating Activities		**$301,455**

Events in Following Year:

The Establishment of a Supplies Fund by the Town of Jimma as of January 1, 2003 is illustrated. The Water Utility Fund advanced $130,000 to Supplies Fund as a long-term loan. The entry by the Supplies Fund is illustrated in Entry 2 in the "Illustrative Case: Supplies Fund"; the corresponding entry in the Water Utility Fund would be:

	Debits	Credits
Interfold Loans to supplies.....	130,000	
Cash.....		130,000

Toward the end of 2003, the Supplies Fund paid its first installment of $6,500 to the Water Utility Fund as a partial repayment of the long-term advance. Entry 9 of the illustrative entries for the supply Fund shown earlier in the chapter illustrates the effect on the accounts of the supplies Fund. The effect on the accounts of the Water Utility Fund is recorded by the following entry:

	Debits	Credits
Cash.....	6.500	
Intend Loan to Supplies Fund—Concurrent.....		6.500

Regulatory Accounting Principles (RAP)

Investor-owned utilities, and governmentally owned utilities in some states, are required to report in a prescribed manner to state regulatory commissions. Electric and certain other utilities subject to the Federal Power Act must also like reports with the FERC. As mentioned at several points in this chapter, both NARUC and with the FERC prescribe charts of accounts and uniform financial statement formats for reporting to regulatory agencies. Even though the town of JIMMA follows GAAP rather than **Regulatory Accounting Principles (RAP)** in preparing its financial statements, the Town uses the cart of accounts and some of the financial statement shown earlier in this chapter are typical of those for wither funds included in comprehensive annual financial reports.

For utilities that are required to report to a state rate regulator commission or the FERC, accounting and reporting procedures under RAP are quite different form GAAP. Because plant assets and long-term debt are customarily and dominant share of the total assets and total debt of utilities, and current assets and current liabilities are relatively insignificant in amount, the regulatory balance sheet format displays plant assets before current assets and long-term debt before current liabilities. In Illustration 7-5, for example, Net Utility Plant amounts to almost 79 percent of total assets, and long-term debt is almost 96 percent of total debt.

Under regulatory reporting Utility Plant in Service is stated at original cost. Original cost is a regulatory concept that differs from **historical cost**, a concept commonly used in accounting for assets of non-regulated business. In essence, historical cost is the amount paid for an asset by its present owner. In contrast, **original cost** is the cost to the owner who first devoted the property to public service. When a regulated utility purchases plant assets from another utility, it must record in its accounts the amounts showing the accounts of the seller for the Utility Plant purchased and for the related accumulated depreciation. Any premium paid by the present owner over and above such cost less depreciation in the general nature of payments for goodwill by non-utility enterprises. But utilities enjoy monopoly privilege and are subject to corresponding restrictions. One of the restrictions is that earnings shall not exceed a fair rate of return. Since goodwill is the capitalized value of excess earnings, utilities can have no goodwill (in the accounting sense). Premium on plant purchased is therefore accounted for as **Utility Plant Acquisition Adjustments**. The amount of acquisition adjustment capitalized is amortized over a period of time determined by the appropriate regulatory body; accumulated amortization is disclosed in the Accumulated Provision for Amortization of Utility Plant Acquisition Adjustments account.

Other asset sections of balance sheets prepared in the regulatory format are Other Property and Investments and Deferred Debits. One item usually reported in the former section is Special Funds, which is similar to the Restricted Assets section of the GAAP-format balance sheets shown in

illustration 7-5 and 7-6. Thus, as mentioned previously, Other Property and Investments is broader in scope than Restricted Assets and may contain items other than restricted assets. One item typically reported under the Deferred Debits caption is Unamortized Debt Discount and Expense, which under GAAP is reported as an offset to the related long-term debt.

Accounting for Non-Utility Enterprise

Early in this chapter it was stressed that each governmentally owned enterprise should follow the accounting and financial reporting standards developed fro investor-owned enterprises in the same industry. Generally, the standards developed by the Financial Accounting Standards Board, and its predecessors, have been accepted by the GASB as applying to Internal Service Funds Enterprise Funds. Consequently, many sections earlier in this chapter, which discuss generally accepted accounting principles applicable to Internal Service Funds (such as "Assets Acquired under Lease Agreements"), apply equally to enterprise funds accounting for activities other than utilities.

Accounting for Municipal Solid Waste Landfills

Accounting to Environmental Protection Agency **(EPA)** estimates, there are approximately 6,000 municipal solid waste landfills **(MSWLFs)** in the United States, of which about 80 percent are owned by state or local general purpose or special propose governments. An EPA Rule, "Solid Waste Disposals Facility Criteria" (40 Code of Federal Regulations, parts 257 and 258), establishes certain closure requirements for MSWLFs and imposes stringent criteria for location, design, and operation of landfills, groundwater monitoring and corrective action, post-closure care, and financial assurance. State governments are assigned primary responsibility for implementing and enforcing the EPA rule, and may increase or reduce its provisions based on site conditions existing within their states.

MSWLF owners and operators may incur a variety of costs, both during the period of operation and after closure. These costs include the cost of equipment and facilities (including final covering of the MSWLF upon closure) and cost of services for such items as post-closure maintenance and monitoring for a period of 30 years after closure. The EPA requires owners and operators to estimate in detail the current dollar cost of hiring a third party to close the largest area of an MSWLF expected to require a final cover and to care for the MSWLF over the 30-year pos-closure period. Each year the closure and post-closure cost estimates must be adjusted for inflation and revised as necessary to reflect changes in plant or conditions. Owners and operators of MSWLF must provide assurances that adequate financial resources will be available to cover the estimated costs of closure, post-closure care, and remediation or containment of environmental hazards when the landfill has been filled to capacity. Several forms of financial assurance are acceptable, including third-party trusts, surety bonds, letters of credit, insurance, or state-sponsored plans.

GASB standards provide guidance both for measuring and reporting estimated total closure and postclosure costs. Although the detailed cost estimation procedures are beyond the scope of this chapter, reporting requirements. For MSWLFs that use proprietary fund accounting are described briefly. An expense and a liability should be recognized each period for a portion of the estimated total current cost of MSWLF closure and postclosure care. The portion of total cost to be recognized is based on the units-of-production method so that estimated total current cost is assigned to periods on the basis of landfill usage rather than the passage of time. Recognition begins in the period in which the MSWLF first accepts solid waste and continues each period until closure. Estimated total closure and postclosure costs should be reevaluated each year during operation of the landfill and the cumulative effect of changes in the estimated costs, if any, should be reported in the period of the change. Costs of equipment, facilities, services, or final cover acquired during the period of the change. Costs of equipment, facilities, services, or final cover acquired during the period are reported as a reduction of the accrued liability and not as capital assets. Equipment and facilities installed prior to commencement of operation of the landfill should be fully depreciated by the closure date.
Assets held by third-party trustees or in surety standby trusts to meet financial assurance requirements should be reported as "amounts held by trustee" in the restricted assets section of the balance sheet and

as net assets restricted for closure and postclosure costs. Earnings on such investments should be reported as revenue.

GASB standards also provide guidance for reporting of MSWLFS in governmental fund types or by other entities such as colleges and universities. Accounting of MSWLF in the General fund, for example, requires that an expenditure and fund liability be reported for the current closure and post closure costs to be extent that an accrued liability would be settled with available fund resources; any remaining liability would be reported in the governmental activities category at the government wide level, as discussed in Chapter 6. Regardless of the fund type or entity reporting the MSWLF activities, GASB standards require disclosures.

Chapter 8
Accounting for Fiduciary Activities —Agency and Trust Funds

Topics to Be Discussed:

- Fiduciary Funds
- Agency Funds
- Tax Agency Funds
- Trust Funds
- Private–Purpose Trust Funds
- Pension Accounting
- Required Disclosures for Other Post-employment Benefits (OPEB)

Learning Objectives:

After studying this chapter, you should be able to:

- Explain how fiduciary funds are used to report on the fiduciary activities of a government.
- Distinguish among agency funds and trust funds (private-purpose, investment, and pension).
- Describe the uses and characteristics of agency funds.
- Explain the creation, operation, accounting, and financial reporting for a cash and investment pool (including an investment trust fund); a private-purpose trust fund; and a pension trust fund.
- Describe accounting for Other Post-Employment Benefits.

8.1) Fiduciary Funds

Fiduciary funds, under the GASB Statement No. 34 reporting mode, are used to account for only those activities in which a governmental unit holds assets as an agent or trustee for individuals, organizations, or other governmental units. These private-purpose fiduciary activities are accounted fro in agency funds, investment trust funds, private-purpose trust funds, and pension trust funds. Resources that are held in trust for the benefit of the government's own programs or its citizenry should be accounted for in a governmental fund rather than a fiduciary fund. Such public-purpose trusts should be accounted for as special revenue funds if the resources are expendable for the trust purpose. A permanent fund, as illustrated in Chapter 4, should be used to account for trusts in which the trust in which the trust principal is permanently restricted, but earnings may be used for the specified public purpose.

In law, there is a clear distinction between an agency relationship and a trust relationship. In accounting practice, the legalistic distinction between trust funds and agency funds are not of major significance. The important and perhaps the sole consideration from an accounting standpoint is what can and what cannot be done with the fund's assets in accordance with laws and other pertinent regulations? The name of a particular fund is not a reliable criterion for determining the correct accounting basis for trust and agency funds. Merely calling a fund by one name or another has no influence on the transactions in which it may engage. Trust funds differ from agency funds principally in degree: trust funds often exist over a longer period of time than an agency fund; represent and develop vested interest of a beneficiary to a greater extent; and involve more complex administration and financial accounting and reporting. Agency funds are used only if the governmental unit holds resources in a purely custodial capacity for others. As noted above, specific accounting procedures and limitations depend on the enactment that brought about creation of a particular trust or agency fund, plus all other regulations under which it operates. Regulations include pertinent statutes, ordinances, wills, trust indentures, and other instruments of endowment, resolutions of the governing body, statements of purposes of the fund, kinds and amounts of assets held, and others. This aggregate of

factors, or such as are applicable to given fund, determines the transactions in which it may and should engage.

This chapter illustrates accounting and financial reporting requirements for fiduciary funds. Because fiduciary activities benefit only other individuals, organizations, and governments, rather than the reporting government, GASB Statement No. 34 excludes the reporting of fiduciary activities in the government-wide financial statements. Thus, fiduciary activities are reported only in the fiduciary fund financial statements.

8.2) Agency Funds

GASB standards identify *agency funds* as one of the four types of fiduciary funds. **Agency funds** are used to account for assets held by a governmental unit acting as agent for one or more other governmental units, or for individuals or private organizations. Similarly, if a fund of a governmental unit regularly receives assets that are to be transmitted to other funds of that unit, an agency relationship exists. Assets accounted for in an agency fund belong to the party or parties for which the governmental unit acts as agent. Therefore, *agency fund assets are offset by liabilities equal in amount; no fund equity exists.* GASB Statement No. 34 requires agency fund assets and liabilities to be recognized on the accrual basis. Revenues, expenditures, and expenses are not recognized in the accounts of agency funds, however.

Unless use of an agency fund is mandated by law, by GASB standards, or by decision of the governing board of a governmental unit, an agency relationship may be accounted for within governmental and/or proprietary funds. For example, local governmental units must act as agent of the federal and state governments in the collection of employees' withholding taxes, retirement contributions, and social security taxes. In the absence of contrary legal requirements or administrative decisions, it is perfectly acceptable to account for the withholdings and the remittance to federal and state governments, within the funds that account for the gross pay of the employees, as shown by the illustrative entries in Chapter 4. In general, if an agency relationship is ordinarily discharged on a rather current basis, and the amounts of assets held as agent tend to be small in relation to fund assets, there is no need to create an agency fund unless required by law or administrative decision.

Agency Fund for Special Assessment Debt Service

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

To illustrate agency fund accounting for special assessment debt service activities, assume the same information used in Chapter 6 for the Town of X except that the governmental unit is not obligated in any manner for the special assessment debt.

The information is: Assume that special assessment bonds, secondarily backed by the general taxing authority of the Town of X, were issued to complete a street-widening project. Upon completion of the project the Town levied assessments amounting to $480,000, payable in 10 equal installments with 5 percent interest on deferred installments, on owners of properties fronting on the improved streets. As shown in Entry, 1 all receivables are recorded at the time of the levy, but Revenues is credited only for the amount expected to be collected within one year from the date of the levy; Deferred Revenues is credited for the amount of deferred installments. Because the entries at the government-wide level would be similar, except that interest Expense would be reported rather than Expenditures, those entries are omitted for the sake of brevity. Required budgetary entries, as shown earlier in this chapter for serial bond and term bond debt service funds, are omitted.

When the assessments in the amount of $480,000, payable in 10 equal installments, were levied on benefited property owners, the following journal entry was made in the agency fund.

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

All current assessments receivable were collected (See Entry 2) along with $24,000 interest (5 percent on the previous unpaid receivable balance). As indicated in Chapter 6, any amounts not collected by the due date should be reclassified as Assessments Receivable—Delinquent.

2.	Cash	72,000	
	Assessments Receivable–Current		48,000
	Due to Special Assessment Bondholders–Interest		24,000

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

3.	Due to Special Assessments Bondholders—Principal	48,000	
	Due to Special Assessments Bondholders—Interest	24,000	
	Cash		72,000

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

4.	Assessments Receivable—Current	48,000	
	Assessments Receivable—Deferred		48,000

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

8.2.1) Tax Agency Funds

An agency relationship that does, logically, result in the creation of an agency fund is the collection of taxes, or other revenues, by one governmental unit for several of the funds it operates and for other governmental units. State governments commonly collect sales taxes, gasoline taxes, and many other taxes that are apportioned to state agencies and to local governmental units within the state. At the local government level, it is common for an elected county official to serve as collector for all property taxes owed by persons or corporations owning property within the country. Taxes levied by all funds and units within the country are certified to the County Collector for collection. The County Collector is required by law to make periodic distributions of tax collections for each year to each fund or unit in the proportion the levy for that fund or unit bears to the total levy for the year. In many jurisdictions, the law provides that units may request advances or “draws” from the tax agency fund prior to regular distributions; advances are usually limited by law to a specified percentage, often 90 percent, of collections for the period from the last distribution until the date of the advance.

Tax agency fund accounting would be quite simple if all taxes levied for a given year were collected in that year. It is almost always true, however, that collections during any year relate to taxes levied in several prior years as well as taxes levied for the current year, and sometimes include advance collections of taxes for the following year. In many jurisdictions, not only does total tax rate very from year to year but the portion that the rate of each unit (and each fund) bears to the total rate also varies from year to year. Additionally, interest and penalties on delinquent taxes must be collected at statutory rates or amounts at the time delinquent taxes are collected; interest and penalties collected must be distributed to participating funds and units in the same manner that tax collections are distributed.

Illustration of Composition of Total Tax Rates

Assume that the Country Collector of Campbell Country is responsible for collecting the taxes due in 2002 for the funds and units located within the Country. Ordinarily, the taxes levied for each fund and unit within the Country are shown in column form in a newspaper advertisement as legal notice to taxpayers. In order to keep the illustrations in this text, legible and comprehensible, Illustration 8-1 shows two columns of such a legal advertisement. Real property tax statements are prepared for each parcel of property located within the jurisdiction for which a tax agency fund is operated. Whether each statement discloses the amount of tax that will be distributed to all of the entities that levy taxes on that parcel, or whether the statement shows only the total tax payable to the Country Collector, the Collector's Office must be able to compute and distributed all taxes collected to the appropriate units and funds.

Illustration 8-1

COMPOSITION OF TAXES TO BE COLLECTED BY COUNT COLLECTOR OF CAMPBELL COUNTRY FOR CERTAIN UNITS WITHIN THE COUNTRY FOR THE YEAR 2002

	Washington Township	Town of Washington
Total State Rate	$0.01	$0.01
County Funds:		
General	1.08	1.08
Capital Projects	0.09	0.09
Debt Service	0.20	0.20
Welfare	0.11	0.11
Total Country Rate	1.48	1.48
Library Fund	0.25	0.25
Township Funds:		
General	0.07	0.07
Fire Protection	0.23	—
Total Township	0.30	0.07
School Funds:		
General	4.50	4.50
Capital Projects	0.18	0.18
Debt Service	0.38	0.38
Total School Rate	5.06	5.06
City Funds:		
General		2.53
Street		0.33
Pension		0.25
Debt Service		0.08
Total Town Rate.		3.19
Total Tax Rates per $100 Assessed Valuation	$7.10	$10.06

For example, Illustration 8-1 shows that a parcel of property located in Washington Township outside the Town of Washington would be taxed at the rate of $7.10 per $100 of assessed valuation; whereas if the parcel were inside the Town limits, the tax rate would be $10.06. Therefore, if a parcel were inside in Washington Township outside the Town had an assessed valuation of $10,000, the total real property tax payable in 2002 would be $710, but a parcel with the same assessed valuation located within the Town would be taxed at $1,006. The total of each of these tax statements is comprised of the taxes levied for each unit, as shown in Illustration 8-1. In turn, the taxes levied for each unit are comprised of the taxes levied for funds of the unit, as also shown in Illustration 8-1. The relationship between direct and overlapping debt is discussed in Chapter 6. Note that Illustration 8-1 shows that a

person or organization owning property within the Town of Washington is required to pay 66 cents of the total rate for debt service (20 cents to Campbell Country, 38 cents to the school district, and 8 cents to the Town of Washington). Illustration 8-2 summarizes the composition of each tax statement by governmental unit.

In those states in which taxes are levied on personal property, the funds and units that levy the personal property taxes are generally assumed to be the ones that levy taxes on the residence of the owner, unless there is convincing evidence that the situs of the personal property is at the another location. Inasmuch as the tax rate levied for each unit and each fund often varies from year to year, it is necessary that all tax collections be identified with the year for which the taxes were levied as well as with the particular parcels for which taxes were collected.

Operation of the Collector's Office often requires the use of substantial administrative, clerical, and computer time and provision of extensive building and computer facilities. Accordingly, it is common for the Collector to be authorized to withhold a certain percentage from the collections for each unit, and to remit to the Country General Fund (or other fund bearing the expenditures for operating the Tax Agency Fund) the total amount withheld from the collections for other funds.

Illustration 8-2

	Parcel Located	
	Outside Town	**In Town**
States	$1.00	$1.00
County Funds	148.00	148.00
Library	25.00	25.00
Township	30.00	7.00
School	506.00	506.00
Town	—	319.00
Total	$710.00	$1,006.00

Accounting Tax Agency Funds

Taxes levied each year should be recorded in the accounts of each fund of each governmental unit in the manner illustrated in preceding chapters. Although an allowance for estimated uncollectible current taxes would be established in each fund, the gross amount of the tax levy for all funds should be recorded in the Tax Agency Fund as a receivable. Note the receivable is designated as belonging to other funds and units, and the receivable is offset in total by a liability. Assuming total real property taxes certified for collection during 2002 amounted to $10,516,400, the Tax Agency Fund entry would be:

		Debits	Credits
1.	Taxes Receivable for Other Funds and Units—Current	10,516,400	
	Due to Other Funds and Units		10,516,400

It would be necessary, of course, for the Country Collector to keep records of the total amount of 2002 taxes to be collected for each of the funds and units that participate in the Tax Agency Fund in order to distribute tax collections properly. Assume that the 2002 taxes were levied for the following units (in order to reduce the detail in this example, a number of the units are combined):

State	$10,400
Campbell Country	1,480,000
Washington School Corporation	5,060,000
Town of Washington	2,400,000
Other units (should be itemized)	1,566,000
Total	$10,516,400

If collections of 2002 taxes during a certain portion of the year amounted to $5,258,200, the Tax Agency Fund entry would be:

		Debits	Credits
2.	Cash	5,258,200	
	Taxes Receivable for Other Funds and Units–Current		5,258,200

The tax collections must in an actual case be identified with the parcel of property against which the taxes were levied, because the location of each parcel determines the governmental units and funds that should receive the tax collections. Assuming for the sake of simplicity that the collections for the period represent collection of 50 percent of the taxes levied against each parcel in Campbell Country, and that the Country General Fund is given 1 percent of all collections for units other than the County as reimbursement for the cost of operating the Tax Agency Fund, the distribution of the $5,258,200 collections would be:

	Taxes Collected (50% of Levy)	Collection Fee (Charged) Received	Cash to Be Distributed
State	$$5,200	$(52)	$5,148
Campbell County	740,000	45,182	785,182
Washington School Corporation	2,530,000	(25,300)	2,504,700
Town of Washington	1,200,000	(12,000)	1,188,000
Other units (should be itemized)	783,000	(7,830)	775,170
Total	$$5,258,200	$ –0–	$5,258,200

If cash is not distributed as soon as the above computation is made, the entry by the Tax Agency Fund to record the liability would be:

		Debits	Credits
3.	Due to Other Funds and Utilities	5,258,200	
	Due to State		5,148
	Due to Campbell County		785,182
	Due to Washington School Corporation		2,504,700
	Due to Town of Washington		1,188,000
	Due to Other Utilities		775,170

If, as is likely, collections during 2002 include collections of taxes that were levied for 2001, 2000, and preceding years, computations must be made to determine the appropriate destitution of collections for each tax year to each fund and unit that levied taxes against the property for which collections have been received.

When cash is distributed by the Tax Agency Fund, the liability accounts shown in Entry 3 should be debited and Cash credited. If cash is advanced to one or more governmental units or funds prior to a regular periodic distribution, the debits to the liability accounts may preceded the credits. By year-end, all advances should be settled, all distributions computed and recorded, and all cash distributed to the units and funds for which the Tax Agency Fund is being operated. Therefore, if all those events have taken place, the year-end Balance Sheet for the Tax Agency Fund would consist of one asset: Taxes Receivable for Other Funds and Units-Delinquent; and one liability; Due to Other Funds and Units.

Entries Made by Funds and Units Participating in Tax Agency Funds

Each unit that receives a distribution must record the appropriate portion of it is each of the funds it maintains. In each fund it must also record the fact that cash received differs from the amount of taxes collected by the fee paid to the Country General Fund. The fee paid is, of course, recorded as Expenditure. For example, the computation for the entries to be made by the various funds of Washington School Corporation would be (using the rates shown in Illustration 8-1):

	2002 Rate	Collections of 2002 Taxes	Collection Fee Paid	Cash Received
School Funds:				
General	$4.50	$2,250,000	$22,500	$2,227,500
Capital Projects	0.18	90,000	900	89,100
Debt Service	0.38	190,000	1,900	188,100
Total.....	$5.06	$2,530,000	$25,300	$2,504,700

From the computations it can be seen that the entry made in the Washington School Corporation General Fund for the 2002 collections distributed should be:

	Debits	Credits
Cash	2,227,500	
Expenditures	22,500	
Taxes Receivable—Current		2,250,000

Similar entries would be made in the other two funds of the Washington School Corporation and in all the funds of units that paid a tax collection fee to the Country General Fund. Collection by the Country General Fund of taxes collected for it and the fee collected for it is computed as follows:

	2002 Rate	Collections of 2002 Taxes	Collection Fee Paid	Cash Received
County Funds:				
General	$1.08	$540,000	$45,182	$585,182
Capital Projects	0.09	45,000	–0–	45,000
Debt Service.....	0.20	100,000	–0–	100,000
Welfare	.11	55,000	–0–	55,000
Total.....	$5.06	$740,000	$45,182	$785,182

The entry to be made in the General Fund of Campbell Country for the 2002 collection distributed should be:

	Debits	Credits
Cash	585,182	
Taxes Receivable–Current		540,000
Revenues		45,182

8.2.2) "Pass-Through" Agency Funds

Grants, entitlements, or shared revenues from the federal or a state government often pass through a lower level of government (primary recipient) before distribution to a secondary recipient. Accounting for such "pass-though" grants depends on whether the primary recipient government is deemed to have *administrative involvement* or *direct financial involvement* in the grants. According to GASB standards:

> A recipient government has administrative involvement if, for example, it (a) monitors secondary recipients for compliance with program-specific requirement, (b) determines eligibility of secondary recipients or projects, even if using grantor-established criteria, or (c) has the liability to exercise discretion in how the funds are allocated. A recipient government has direct financial involvement if, for example, it finances some direct program costs because of a grantor-imposed matching requirement or is liable for disallowed costs.

More often than not, the criteria for administrative or direct financial involvement are met, in which case the primary recipient government must recognize a revenue for the receipt and an expenditure or expense for the transfer in a governmental fund, private-purpose trust fund, or proprietary fund. If,

however, neither administrative nor financial involvement is deemed to exist, then a "Pass-Through" Agency Fund must be used and no revenue or expenditure/expense is recognized.

To illustrate accounting for a "Pass-Through" Agency Fund, assume that $5 million of federal financial assistance is received by a state government from the deferral government, the full amount of which must be passed to local governments according to predetermined eligibility requirements and in amounts according to a predetermined formula. Since the state government is serving merely as a "cash conduit" in this case, the use of a Pass-Through Agency Fund is deemed appropriate. The entry to record receipt of the $5 million in Pass-Through Agency Fund would be:

	Debits	Credits
Cash	5,000,000	
Due to Other Units		5,000,000

Assuming all monies were disbursed to the secondary recipients during the current fiscal year, the Pass-Through Agency Fund entry would be:

	Debits	Credits
Due to Other Units	5,000,000	
Cash		5,000,000

The receipt of Cash or other assets from a Pass-Through Agency Fund should be accounted for by the recipient in conformity with GASB standards discussed previously: Governmental fund types are to recognize all grants as revenue when the grant proceeds are available for use for the purpose of the fund and eligibility requirements have been met. If grant proceeds are available immediately, the Revenues account is credited; if some eligibility requirement must be met, the Deferred Revenues account should be credited at the time the grant proceeds are recognized as assets, and amounts transferred from Deferred Revenues to Revenues as eligibility requirements are met. Proprietary fund types recognize as non-operating revenues the proceeds of grants for operating purposes, or that may be expended at the discretion of the recipient government; if the terms of the grant restrict the use of the proceeds to the acquisition or construction of capital assets, the proceeds must be recorded as capital contribution (See Chapter 7).

8.2.3) Financial Reporting of Agency Funds

As mentioned earlier in this chapter, fiduciary activities are reported only in the fiduciary fund financial statements; they have no effect on the governmental or business-type activities of the primary government reported in the government-wide financial statements. As shown in Illustration 2-9, agency fund financial information is reported in a separate column of the Statement of Fiduciary Net Assets. Agency funds are not included in the Statement of Changes in Fiduciary Net Assets (see Illustration 2-10) because they have no net assets (assets minus liabilities equals zero net assets) and therefore have no *changes* in net assets. GASB standards do not require disclosure of the assets and liabilities of individual agency funds, but a government may optionally include in its Comprehensive Annual Financial Report a combining statement of net assets displaying the assets and liabilities of each agency fund in separate columns.

8.3) Trust Funds

In addition to agency funds, just discussed, the Fiduciary Fund classification includes Investment Trust Funds, Private-Purpose Trust Funds, and Pension Trust Funds.

Historically, trust funds have been created to account for assets received by the government in a trust agreement in which the assets are to be invested to produce income to be used for specified purposes (generally cultural or educational). The majority of such trusts benefit the government's own programs or its citizenry. As discussed and illustrated in Chapter 4, under GASB Statement No. 34, trusts that benefit the government's own programs or citizens at large are now accounted for as either special revenue funds or **Permanent Funds**, depending on whether the principal of the gift is expendable for

the specified purpose or permanently restricted for investment, with only the earnings therefrom expendable for the specified purposes. As discussed in Chapter 4, both special revenue funds and permanent funds are governmental funds types. Under the provisions of Statement No. 34, only trusts that benefit other, such as individuals, organizations, or other governments, are accounted for in fiduciary funds.

The following section illustrated the accounting for an Investment Pool, in which some participants are other (external) governments and some are funds of the sponsoring government. **External Investment Pools** are centrally managed investment portfolios (pools) that manage the investments of other governments and perhaps not-for-profit organizations outside the reporting entity of the government that administers the pool (the sponsoring government). And **investment trust fund** is used to account for the assets, liabilities, net assets, and changes in net assets corresponding to the equity of the *external* participants. Typically, as in the following example, the sponsoring government also participates in the pool; however, its equity is considered *internal* and is not reported in the financial statements of the investment trust fund. Instead, the net assets and changes therein relating to the internal portion of the pool are presented in the financial statements of each participating fund, and in the governmental activities and business-type activities of the sponsoring government's government-wide financial statements. As mentioned earlier in this chapter, the financial information for investment trust funds is reported only in the fiduciary fund financial statements and is not reported in the government-wide financial statements.

8.3.1) Investment Pools – Investment Trust Fund Accounting

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

If an investment pool has *external* participants, GASB standards require that an *investment trust fund* be established to account for the external investment pool. Investment trust funds are accounted for using an economic resources measurement focus and the full accrual basis of accounting.

Creation of an Investment Pool

Earnings on pooled investments and changes in fair value of investments are allocated to the participants having an equity in the pool in proportion to their relative contributions to the pool. To ensure an equitable division of earnings and changes in fair value, it is necessary to revalue all investments in the pool, and all investments being brought into the pool or removed from the pool, to their **Fair Value** as of the time that investments of a fund are being brought into or removed from the pool. Each fund of the sponsoring government and external participant that contributes investments to the pool should debit Equity in Pooled Investments, or some similar account, for the fair value of the investments, credit the Investments account for the carrying value (cost or fair value at the time the investments were previously marked to fair value), and credit or debit Revenues—Change in Fair Value of Investments, depending on whether the current fair value is higher or lower than carrying value, respectively. Note that a net debit balance in the Revenues – Change in Fair Value of Investments account would be reported as a contra-revenue item in the operating statement of the appropriate fund, as a component of investment income, and not as an expenditure or expense.

Illustration 8-3	Assets Transferred to Create Drew Country Investment Pool			
	Fair Value at 12-31-01	Fair Value at 1-10-02	Change in Fair Value	Accrued Interest
Drew Country Debt Service Fund:				
Cash	$1,000,000	$1,000,000	$–0–	$–0–
U.S Agency Obligations	13,373,000	13,425,000	52,000	425,000
Town of Calving Debt Service Fund:				
U.S. Treasury Bills	9,568,000	9,545,000	(23,000)	192,000
U.S. Agency Obligations	158,700	160,000	1,300	3,000
Calvin Independent School District Capital Projects Fund:				
U.S. Agency Obligations	2,789,000	2,800,000	11,000	76,900
Repurchasing Agreements	2,060,000	2,060,000	–0–	13,100
Totals	$28,948,700	$28,990,000	$41,300	$710,000

Illustration of the Creation of an Investment Fund

On January 10, 2002, Drew Country decided to create a new investment pool, to be accounted for as an *investment trust fund*. Operating expenses of the pool, primarily for personnel time, office supplies, computer, telephone, and postage, are considered nominal and therefore will not be charged to the pool. The initial participants in the pool are the Country's own Deb Service Fund and two external participants, the Town of Calvin's Debt Service Fund and the Calvin Independent School District's Capital Projects Fund. As discussed previously, the equity pertaining to the Drew Country Debt Service Fund represents an *internal* investment pool, so its proportionate share of the Investment Pool's assets are allocated back to the Debt Service Fund for financial reporting purposes and are not reported as part of the Investment Trust Fund. The proportionate share of assets allocated to *external* participants, however, is properly reported in the financial statements of the Investment Trust Fund.

Illustration 8-3 shows the specific cash and investments that were transferred on January 10, 2002, to create the Drew Country Investment Pool. At the time the Drew Country Investment Pool is created, journal entries are required in the accounts of the Drew Country Debt Service Fund and Town of Calvin Debt Service Fund, the Calvin Independent School District Capital Projects Fund, and the Investment Trust Fund to record creation of the fund. The journal entries in the Drew Country Debt Service Fund and Drew Country Investment Trust Fund (the Investment Pool) to create the investment pool are shown in Entries 1a and 1b below. Entries in the fund of the external participants would be similar to that for the Drew Country Debt Service Fund and therefore are omitted here for the sake of brevity.

		Debits	Credits
Drew County Debt Service Fund:			
1a.	Equity in Pooled Investments	14,850,000	
	Cash		1,000,000
	Investments—U.S. Agency Obligations		13,373,000
	Revenues—Change in Fair Value of Investments		52,000
	Revenues—Investment Earnings		425,000
Drew Country Investment Pool:			
1b.	Cash	1,000,000	
	Investments —U.S. Treasury Bills	9,545,000	
	Investments—U.S. Agency Obligations	16,385,000	
	Investments—Repurchase Agreements	2,060,000	
	Accrued Interest Receivable	710,000	
	Due to Debt Service Fund		14,850,000
	Additions–Deposits in Pooled Investments–Town of Calvin		9,900,000
	Additions–Deposits in Pooled Investments–Calvin		

Independent School District	4,950,000

A trial balance prepared for the Drew Country Investment Pool immediately after Entry 1b has been posted to the Pool's general ledger is presented in Illustration 8-4.

Illustration 8-4

DREW COUNTRY
INVESTMENT POOL
TRAIL BALANCE
AS OF JANUARY 10, 2002

Account Title	**Debits**	**Credits**
Cash.....	$1,000,000	
Investment—U.S. Treasury Bills	9,545,000	
Investment—U.S. Agency Obligations	16,385,000	
Investment—Repurchase Agreements.....	2,060,000	
Accrued Interest Receivable	710,000	
Due to Debt Service Fund.....		$14,850,000
Additions–Deposits in Pooled Investment–Town of Calvin....		9,900,000
Additions – Deposits in Pooled Investment – Calvin Independent School District.....		4,950,000
Totals.....	$29,700,000	$29,700,000

On February 1, 2002, Drew Country sold tax-supported bonds in the amount of $15,000,000 on finance the construction of roads and bridges. The proceeds of the bonds are added to the pool for investment until such time as they are needed for Capital Projects Fund disbursements. As of February 1, 2002, the U.S. Treasury bills in the pool have a current fair value of $9,535,000 ($10,000 less than the carrying value reported in the trial balance sheet shown in Illustration 8-4), and the U.S. Agency Obligations in the pool have a fair values of $15,695,000 ($310,000 more than the carrying value reported in the trial balance); the fair value of the repurchase agreement is the same as reported in the trial balance. The balance of the Cash account was still $1,000,000 as of February 1, 2002. Therefore, total assets of the pool, revalued to fair value as of February 1, 2002, amount to $30,000,000 (a net increase of $300,000 over the carrying values previously reported).

In the Investment Pool accounts, the $300,000 increase in carrying value of assets should be credited to a liability accounts for the share of the internal participant (Drew Country's Debt Service Fund) and to "Additions" accounts (addition to net assets, similar to revenue) for the shares of the external participants, based on their equitable proportions in the pool just prior to the asset participants, based on their equitable proportions in the pool just prior to the asset revaluation. The liability to the Debt Service Fund, therefore, is increased by $150,000 (300,000 X 14,850/29,700); Additions–Change in Fair Value–Town of Calvin is credited for $100,000 (300,000 X 9,900/29,700); and Additions–Change in Fair Value–Calvin Independent School District is credited for $50,000 (300,000 X 4,950/29,700). Note that the equity of each participant in the pool remains proportionately the same (i.e., the amount due to the Town of Calvin is $10,000,000 after revaluing the investments to current fair value; total liabilities and net assets (if the Additions accounts were closed) of the pool are $30,000,000; 10,000/30,000 = 9,900/29,700, etc.). The journal entry in the Investment Pool summarizing the revaluation of investments and the Capital Projects entry into the Investment Pool is given as:

Drew County Investment Pool:	Debits	Credits
2. Cash	15,000,000	
Investments—U.S. Agency Obligations	310,000	
Investments—U.S. Treasury Bills		10,000
Due to Debt Service Fund		150,000
Due to Capital Project Fund		15,000,000
Additions–Change in Fair Value of Investments–Town of Calvin		100,000
Additions–Change in Fair Value of Investments–Calvin Independent School District		50,000

After revaluation of investments in the pool and receipt of $15,000,000 cash from proceeds of bonds sold to finance road and bridge construction, the Trial Balance of the Investment Pool becomes as shown in Illustration 8-5.

Illustration 8–5

DREW COUNTRY
INVESTMENT POOL
TRAIL BALANCE
AS OF FEBRUARY 1, 2002

Account Title	**Debits**	**Credits**
Cash	$16,000,000	
Investment—U.S. Treasury Bills	9,535,000	
Investment—U.S. Agency Obligations	16,695,000	
Investment—Repurchase Agreements	2,060,000	
Accrued Interest Receivable	710,000	
Due to Debt Service Fund		$15,000,000
Due to Capital Projects Fund		15,000,000
Additions–Deposits in Pooled Investment–Town of Calvin		9,900,000
Additions – Deposits in Pooled Investment – Calvin Independent School District		4,950,000
Additions – Change in Fair Value of Investment – Town of Calvin		100,000
Additions – Change in Fair Value of Investment – Town of Calvin		50,000
Totals	$45,000,000	$45,000,000

Operation of a Cash and Investment Pool

Although the capital projects fund invested $15,000,000 cash in the pool, upon admission to the pool that Fund no longer has a specific claim on the cash of the pool; rather, it (and each Fund or unit that is a member of the pool) has a proportionate interest in each of the assets of the pool, and will share in earnings, gains, and losses of the pool in that proportion. Ordinarily, it is inconvenient and unnecessary to apportion to liability and additions to net asset accounts for each receipt of dividends or interest and each revaluation of the portfolio to fair value (some pools revalue to fair value daily). It is simpler to accumulate the earnings in an Undistributed Earnings on Pooled Investments account and the unrealized and realized gains and losses in a Reserve for Change in Fair Value of Pooled Investments account (both of these accounts are clearing accounts), and to make periodic distributions from these accounts to the specific liability and additions to net asset accounts for pool participants.

The frequency of distribution depends on whether all cash of all funds is pooled along with investments, or whether each fund retains an operating cash account. In the former case, the pool would have frequent receipts attributable to collections of revenues and receivables of the funds, and would have daily disbursements on behalf of the funds; in this case, the interest of each fund in the

pool would have to be recomputed each day. If, however, a working cash balance is retained in each active fund, the receipts and disbursements of pool cash would be much less frequent, and the distribution of gains and losses, and earnings, and recomputed of the interest of each fund in the pool could be correspondingly less frequent.

As an example of accounting for earnings on investments of a pool, assumed the pool shown in Illustration 8-5 collects interest of $1,610,000, including $710,000 accrued as of March 31, 2002. An appropriate entry would be:

		Debits	Credits
3.	Cash	1,610,000	
	Accrued Interest Receivable		710,000
	Undistributed Earnings on Pooled Investments		900,000

By the time the earnings are to be distributed, the fair value of all investments may have changed. Even if this is true, the proportionate interest of each fund will not have changed because each participant continues to bear gains and losses in the same proportion until a participant continues to bear gains and losses in the same proportion until a participant changes all participants' proportionate interest in the pool by contributing additional assets to the pool or taking assets out of the pool. therefore, in this example, when earnings are distributed the shares apportioned to the funds are: Drew Country Debt Service Fund, 15/45 or 3/9; Drew Country Capital Projects Fund, 15/45 or 3/9; Town of Calvin, 10/45 or 2/9; and Calvin Independent School District, 5/45 or 1/9. The entry in the Investment Pools to distribute $900,000 of earnings is:

Drew Country Investment Pool:		Debits	Credits
4a.	Undistributed Earnings on Pooled Investments	900,000	
	Due to Debt Service Fund		300,000
	Due to Capital Projects Fund		300,000
	Additions – Investment Earnings – Town of Calvin		200,000
	Additions–Investment Earnings–Calvin Independent School District		100,000

After the distribution, each participant has the same proportionate interest in the assets of the pool as it had before the distribution.

As noted previously, internal management of the pool is enhanced if each participant that is a member of the pool maintains an asset account with a title such as Equity in Pooled Investments. The balance of this account in each member's fund should be the reciprocal of the pool's account that reports the pool's liability or net asset balance to that participant (deeding on whether the participant is an internal member or external member). Thus, in the Drew Country example, the Drew Country Debt Service Fund's Equity in Pooled Investments had a debit balance of $15,000,000 as of March 31, 2002, before the earnings distributed. Upon notification of the earnings distribution on the pooled investments, the Debt Service Fund would make the following entry:

Drew County Investment Pool:		Debits	Credits
4b.	Equity in Pooled Investments	300,000	
	Revenues–Investment Earnings		300,000

Interest and dividends earned on pooled investments would, of course, increase the equity of the members of the pool, as would realized gains on the sales of investments (excess of fair value on date of sale over carrying price) and unrealized gains resulting from periodic revaluation of the pooled investment portfolio to fair value in times of rising market values of securities held in the portfolio to fair value in items of rising market values of securities held in the portfolio. Realized losses on securities sold (deficit of fair value at prior revaluation date compared with fair value at the dale date), and unrealized loses resulting from periodic revaluation of the portfolio in times of falling market values, both decrease the equity of funds that are members of the pool. in the Drew Country

Investment Pool example, each member fund maintains an operating cash account. Consequently, the pool does not need to distributed gains and losses daily, so it accumulates *realized and unrealized gains and losses in a Reserve for Change in Fair Value of Pooled Investments* account. This procedure allows a netting of gains and losses in each account, so that only the net realized and unrealized gain (or loss) need be distributed to pool participants, thus saving some clerical or computer time.

GASB standards require that realized and unrealized gains and losses be reported as a single amount, "Change in Fair Value of Investments," as a component of investment income, rather than being reported as separate amounts in the financial statement. However, realized and unrealized gains and losses can be disclosed in the notes to the financial statements, if desired. If a governmental unit intends to disclose realized an unrealized gains or losses, or needs such information for internal management purposes, it may be useful to maintain a separate *Allowance for Changes in Fair Value of Pooled Investments* (a contra-asset account) to record all changes in fair value rather than increasing and decreasing the balance of the investment accounts. This technique permits the investment accounts to be carried at cost.

Assume that during fiscal year 2002 the realized gains on sales of pooled investments of the Drew Country Cash and Investments Pool, all credited to the Reserve for Change in Fair Value of Pooled Investments, amounted to $235,000 (measured as excess of fair value at the sale dates over prior fair value). During the year, realized losses, all debited to the Reserve account, totaled $50,000 (measured as the deficit of fair value at the sale dates under prior fair value). Thus, there was a net credit of $185,000 for realized gains and losses for the period. Similarly, assume the net effect of making the portfolio to fair value is an unrealized gain or $265,000, which is credited to the Reserve account. The net effect of recognizing these gains and losses in the account of the Investment Pool, pending distribution, is summarized in Entry 5.

Drew County Investment Pool:	Debits	Credits
5. Investments (specific investments should be debited or credited here)	450,000	
Reserve for Change in Fair Value of Investment		450,000

Assuming no participants have joined the pool or withdrawn from the pool, and the four participants that have continued to be members of the pool have not transferred additional assets to the pool, nor withdrawn any, the realized and unrealized net gains of $450,000 should be distributed to the member funds in the proportions used for the distribution of earnings (3/9, 3/9, 2/9, and 1/9). The distribution is shown in the following entry:

Drew County Investment Pool:	Debits	Credits
6. Reserve for Change in Fair Value of Investments	450,000	
Due to Debt Service Fund.....		150,000
Due to Capital Projects Fund		150,000
Additions–Change in Fair Value of Investment–Town of Calvin		100,000
Additions–Change in Fair Value of Investments–Calvin Independent School District.....		50,000

At December 31, 2002, interest earnings of $720,000 had accrued and were recorded, as shown in Entry 7 below

Drew County Investment Pool:	Debits	Credits
7. Accrued Interest Receivable.....	720,000	
Undistributed Earnings on Pooled Investments		720,000

Assuming that the accrued interest was immediately distributed to pool participants in the same proportion listed for Entry 6, the following entry would be made to record the distribution:

Drew County Investment Pool:	Debits	Credits
8. Undistributed Earnings on Pooled Investments	720,000	
Due to Debt Service Fund		240,000
Due to Capital Projects Fund		240,000
Additions – Investment Earnings – Town of Calvin		160,000
Additions–Investment Earnings–Calvin Independent School District		80,000

Both entries 6 and 8 would, of course, lead to entries to recognize an increase in each participant's Equity in Pooled Investments and Revenues. Those entries would be similar to Entry 4b and thus are not shown here.

After all earnings and changes in fair value have been accounted for by the entries illustrated, the equities and proportionate interest of the participants are:

Debt Service Fund	$15,690,000, or 3/9 of total
Capital Projects Fund	15,690,000, or 3/9 of total
Town of Calvin	10,460,000, or 2/9 of total
Calvin in Independent School District	5,230,000, or 1/9 of total
Total	$47,070,000

Withdrawals of Assets from the Pool

If a participant in a pool withdraws part of its equity from a pool, that participant's proportionate interest is decreased and all other participant's proportionate interest is increased. Before a withdrawal is made, there should be an apportionment of earnings, gains, and losses to dare. The same is true in the event of complete withdrawal of one or more participants from the pool.

Continuing with the Drew Country Investment Pool example, assumed the Debt Service Fund needs to withdraw $5,000,000 from the pool to retire matured bonds. Ignoring the fact that in most practical cases it would be necessary to first sell some investments, the entry in the Investment Pool agency fund for the withdrawal is given as:

Drew Country Investment Pool:	Debits	Credits
9a. Due to Debt Service Fund	5,000,000	
Cash		5,000,000

The corresponding entry in the Debt Service Fund is:

	Debits	Credits
9b. Cash	5,000,000	
Equity in Pooled Investments		5,000,000

After withdrawal of $5,000,000 by the Debt Service Fund, the proportionate interests in the pool become:

Debt Service Fund	$10,690,000, or 25.4% of total
Capital Projects Fund	15,690,000, or 37.3% of total
Town of Calvin	10,460,000, or 24.9% of total
Calvin in Independent School District	5,230,000, or 12.4% of total
Total	$42,070,000

Closing Entry

To assist in preparing financial statements, the Additions accounts (see Entries 1b, 2, 4a, 6 and 8), which reflect changes in the external participants' proportionate interest due to net new deposits/withdrawals, investment earnings, and changes in fair value, must be closed to the appropriate net asset accounts, as shown in Entry 10 below:

Drew County Investment Pool:	Debits	Credits
10. Additions–Deposits in Pooled Investments–Town of Calvin	9,900.000	
Additions–Deposits in Pooled Investments–Calvin Independent School District	4,950,000	
Additions –Investment Earnings–Town of Calvin	360,000	
Additions–Investment Earnings–Calvin Independent School District	180,000	
Additions – Change in Fair Value of Investments – Town of Calvin	200,000	
Additions–Change in Fair Value of Investments–Calvin Independent School District	100,000	
Net Assets Held in Trust for Participants–Town of Calvin		10,460,000
Net Assets Held in Trust for Participants–Calvin Independent School District		5,230,000

8.3.2) Illustrative Financial Statements

Illustrative fiduciary fund statements, prepared for internal management purposes, are presented in Illustrations 8-6 and 8-7. These statements are prepared as of December 31, 2002, Drew Country's fiscal year-end. These statements also provide the information to be reported in a column of the Statement of Fiduciary Fund Net Assets (see Illustration 2-9) and Statement of Changes in Fiduciary Fund net Assets (see Illustration 2-10). It should be noted that only, the $15,690,000 of assets representing the 37.3 percent proportionate interest of the *external* participants (the Town of Calvin and the Calvin Independent School District) is reported in the fiduciary fund (Investment Trust Fund) financial statements. The 62.7 percent proportionate interests of Drew Country's own funds are reported as Equity in Pooled Investments (or as Cash, Investments, and Interest Receivable, if desired) in the Balance Sheet – Governmental Funds.

1. Statement of Net Assets

Illustration 8-6

DREW COUNTY
INVESTMENT POOL
STATEMENT OF NET ASSETS
AS OF DECEMBER 31, 2002

ASSETS		
Cash (Note A)		$4,702,898
Investment (Note A)		10,718,579
Accrued interest receivable (Note A)		268,524
Total Assets		15,690,000
LIABILITIES		
Total Liabilities		–0–
NET ASSETS		
Held in trust for participants–Town of Calvin	$10,460,000	
Calvin Independent School District	5,230,000	
Total Net Assets		$15,690,000

2. Statement of Changes in Net Assets

Illustration 8-7

DREW COUNTY
INVESTMENT POOL
STATEMENT OF CHANGES IN NET ASSETS
FOR THE YEAR ENDED DECEMBER 31, 2002

ADDITIONS	
Deposits of participants	$14,850,000
Investment Earnings	540,000
Increase in fair value of investments	300,000
Total Additions	15,690,000
DEDUCTIONS	
Total Deductions	–0–
Change in Net Assets	15,690,000
Net Assets, January 1, 2002	15,690,000
Net Assets, December 31, 2002	–0–
Net Assets, December 31, 2002	$15,690,000

8.4) Private-Purpose Trust Funds

The fair value of assets placed in trust under a trust agreement is referred to as the principal, or corpus, of the trust. Under the reporting model being superseded by GASB Statement No. 34, if the principal of the trust must be held intact in order to produce income, the trust is called nonexpendable. Nonexpendable trust funds are often called endowment funds. The income from the assets of a nonexpendable trust may be used only for the purposes specified by the trustor; therefore, the income is expendable. If the principal amount can be expended for the specified purpose, the trust is referred to under the model being superseded as an expendable trust fund.

Not all trust funds require the historic distinction between corpus and income; loan funds operated as trust funds are usually nonexpendable both as to principal and income, whereas public employee retirement systems are funds whose principal and income are both expendable for specified purposes.
In addition to the nonexpendable versus expendable classification, trust funds may also be classified as pubic or private. Public trust funds re those whose principal or income, or both, must be used for some public purpose; the beneficiaries of private trust funds are private individuals, organizations, or other governments. Funds established for the purpose of holding performance deposits of licensees under a governmental unit's regulatory activities are example of private trust funds. Funds used to account for escheat property arising from the estate of persons who die intestate without any known heirs is another example of a private trust fund. GASB Statement No. 34 refers to these trusts as public-purpose and private-purpose.

GASB Statement No. 34 significantly changes accounting and financial reporting practices for trusts referred to in the previous reporting model as nonexpendable and expendable trusts. Because, most of trusts are created for public purposes (for example, to maintain parks and cemeteries or to acquire art for public buildings); they are considered governmental rather than fiduciary activities under the new reporting model. Thus, nonexpendable public-purpose trusts are now accounted for as permanent funds and expendable public-purpose trusts are accounted for as special revenue funds. These governmental fund types were discussed and illustrated in Chapter 4.

Private-purpose trust funds are relatively few compared with public-purpose trust funds. Further, private-purpose trust funds follow accounting and financial reporting practices that are quite similar to those illustrated in the previous section on investment trust funds. A private-purpose trust fund whose principal is permanently restricted for investment, with earnings available for a specified private purpose, is accounted for in manner similar to the Town of Columbia Library Endowment Fund

illustrated in Chapter 4 as a Permanent Fund. The principal difference is that financial information for a private-purpose trust is reported in the Statement of Fiduciary Net Assets and Statements of changes in Fiduciary Net Assets, whereas that for a permanent fund is reported in the Balance Sheet – governmental Funds and Statement of Revenues, Expenditures, and Changes in Fund Balances – Governmental Funds. Even though a private-purpose trust reports additions and deductions from net assets (see illustration 8-7 for an example), those items are measured in essentially the same manner as revenues and expenditures of a permanent fund. Because there is little difference in accounting and reporting for private-purpose trusts and permanent funds and investment trust funds, already illustrated, no journal entries or financial statements are provided in this chapter for private-purpose funds.

8.5) Pension Accounting

Assets held by public pension plans for fiscal year 1996-97 amounted to nearly $1.5 trillion. Thus, it is not surprising that the GASB has devoted substantial effort to improving accounting and financial reporting for pension plans. This section provides an overview of the accounting and reporting requirements for pension plans, as well as the governmental employers that sponsor such plans.

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

A **defined benefit plan** provides a specified amount of benefits based on a formula that may include such factors as age, salary, and years of employment. Determining the present value of projected pension benefits involves numerous factors, such as employee mortality, employee turnover, salary progression, and investment earnings. To ensure that plan assets will be adequate to cover future benefits, professional actuaries are engaged to calculate the present value of benefits and the required contributions that must be made by employers and, in some cases, employees. Of course, the basic assumptions underlying actuaries' projections may change over time, giving rise to periodic revisions in the required contributions. Because of the need to rely extensively on actuaries' estimates, it is not surprising that accounting for defined benefit plans is much more complex than for defined contribution plans. The remainder of this section provides a summary overview of the accounting and financial reporting requirements for defined benefit pension plans; a complete discussion of these plans is considerably beyond the scope of this text.

The illustrative transactions for defined benefit pension plan accounting discussed in this section are based on a "single-employer plan," that is, a single plan administered by a single governmental employer. Readers should be aware, however, that many governments sponsor multiple pension plans for different classes of employees (for example, a plan for general employees and one more separate and usually more generous plans for public safety employees). Further , in some states, some or all local government employees participate in a statewide defined benefit pension plan, rather than one

sponsored by the local government itself. Such plans or groups of plans are often referred to as **Public Employee Retirement Systems** (PERS). The GASB standards that apply to a single-employer plan apply as well to multiple-employer plans, although accounting and reporting for multiple-employer plans are more complex.

Under GASB Statement No. 34, pension plans are accounted for in the basic fiduciary fund statements of the sponsoring government. Some plans are administered as legally separate entities and therefore publish "stand-alone" financial statements, as well as reporting their pension fund financial information in the fiduciary funds statements of the sponsoring governments.

Until 1996, governments had considerable latitude regarding the choice of accounting method for pension plans. GASB Statement No. 1, issued in 1984, permitted governments to follow both the pension accounting and reporting standards set forth in NCGA Statement 1, in NCGA Statement 6, or in FASB Statement No. 35, pending the issuance by the GASB of a statement or statements on pension accounting and financial reporting. GASB Statement No. 5, "Disclosure of Pension Information by Public Employee Retirement Systems and State and Local Governmental Employers," issued in late 1986, superseded the disclosure requirements of the three statements just cited. Those disclosures were very extensive, often resulting in more than 10 pages of pension-related disclosures in the Notes to the Financial Statements. After several years of effort, the GASB issued three new standards that collectively provide comprehensive guidance on pension accounting and financial reporting. These standards provide accounting and reporting guidance for defined benefit pension plans (GASB Statement No. 25P, post employment healthcare plans administered by defined benefit pension plans (GASB Statement No. 26), and the sponsor/employer (GASB Statement No. 27). Complete text of these standards can be found in the GASB's *Codification of Governmental Accounting and Financial Reporting Standards*, Section Pe5, Po50, and P20, respectively. Most observers agree that the new standards have helped to achieve more uniform reporting of governmental pension plans. Moreover, required note disclosures have been reduced substantially under the new standards.

Required Financial Reporting for Defined Benefit Pension Plans

GASB standards establish a financial reporting framework for defined benefit pension plans that includes both required financial statements and required schedules of historical trend information. The schedules *required supplementary information* that must follow immediately after the financial statements. Two financial statements and two supplementary schedules of historical trend data are required. These requirements are described as:

a. A *statement of plan net assets* showing plan assets, liabilities, and net assets. Plan asses should be reported at fair value. (See Illustration 8-8 for an example of a PERS that administers three defined benefit pension plans.)
b. A *statement of changes in plan net assets* showing additions to plan net assets, deductions from plan net assets, and net increase (decrease) in plan net assets. (See Illustration 8-9.)
c. A *schedule of funding progress* showing historical trend data about the actuarially determined status of plan funding "from a long-term, ongoing perspective and the progress made in accumulating sufficient assets to pay benefits when due." (See Illustration 8-10.)

Illustration 8-8

COLUMBINE RETIREMENT SYSTEM
STATEMENTS OF PLAN NET ASSETS
AS OF JUNE 30, 19X2, AND 19X1
(IN THOUSANDS)

	State Employees	School Districts	Municipal Employees	19X2 Total	19X1 Total
Assets					
Cash and short-term investments	$66,129	$116,988	$26,014	$210,131	$440,146
Receivables:					
Employer	16,451	18,501	2,958	37,910	45,770
Employer—Long Term	33,495	986	–0–	986	1,088
Interest and Dividends	-0–	48,299	4,951	86,745	81,183
Total receivable	48,946	67,786	7,909	125,641	128,041
Investment at fair value:					
U.S. Government obligations	541,289	780,541	80,001	1,401,831	1,571,404
Municipal bonds	33,585	48,416	4,969	86,970	86,417
Domestic corporate bonds	892,295	1,217,251	191,801	2,301,347	1,961,288
Domestic stocks	1,276,533	1,784,054	183,893	3,244,480	3,230,446
International Stocks	461,350	665,259	68,187	1,194,806	1,187,703
Mortgages	149,100	209,099	24,453	382,652	319,745
Real estate	184,984	266,748	27,350	479,082	420,806
Venture capital	26,795	38,638	3,960	69,393	37,120
Total investments	3,565,931	5,010,016	584,614	9,160,561	8,814,929
Properties, at cost, net of accumulated depreciation of $5,164 and $4,430, respectively	6,351	8,924	1,040	16,315	16,093
Total Assets	3,688,357	5,203,714	620,577	9,512,648	9,399.209
Liabilities					
Refunds payable and other	4,212	1,849	429	6,490	37,211
Net assets held in trust for pension benefits	$3,684,145	$5,201,865	$620,148	$9,506,158	$9,361,998

d. A schedule of employer contributions showing historical trend data about the annual required contributions of the employer (ARC) and employer contribution in relation to ARC. (See Illustration 8-11.)

Illustration 8-9

COLUMBINE RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN PLAN NET ASSETS
FOR THE YEAR ENDED JUNE 30, 19X2, AND 19X1
(IN THOUSANDS)

	State Employees	School Districts	Municipal Employees	19X2 Total	19X1 Total
Additions:					
Contributions:					
Employer	$137,916	$157,783	$19,199	$314,898	$284,568
Employer-long-term	–0–	102	–0–	102	102
Plan member	90,271	117,852	16,828	225,651	216,106
Total contributions	228,887	275,737	36,027	540,651	500,776
Investment Income:					
Net appreciation (depreciation) in fair value of investments	(241,408)	(344,429)	(35,280)	(621,117)	788,913
Interest	157,371	225,446	23,098	405,915	422,644
Dividends	123,953	177,654	18,191	319,798	560,848
Real estate operating income, net	10,733	15,383	1,575	27,691	25,296
	50,649	74,054	7,584	132,287	1,797,701
Less investment expense	54,081	61,872	7,529	123,482	500,674
Net investment income	(3,432)	12,182	55	123,482	1,297,027
Total additions	225,455	287,919	36,082	8,805	1,797,803
Deductions:					
Benefits	170,434	172,787	18,073	361,294	325,881
Refund of contributions	15,760	13,200	3,671	32,621	38,406
Administrative expense	4,984	5,703	684	11,381	12,681
Total deductions	191,168	191,690	22,438	405,296	376,981
Net increase	34,287	96,229	13,644	144,160	1,420,835
Net assets held in trust for pension benefits:					
Beginning of year	3,649,858	5,105,636	606,504	9,361,998	7,941,163
End of year	$3,684,145	$5,201,865	$620,148	$9,506,158	$9,316,998

In addition, the plan is required to provide note to the financial statements and notes to the required schedules. The notes to the financial statements should disclose the following information.

a. Plan descriptions, including
   1. Identification of the type of plan.
   2. Classes of employees covered.
   3. Brief description of benefit provisions.
b. Summary of significant accounting policies
c. Description of contributions and reserves, including:
   1. The authority under which contributions are made.
   2. Funding policies.
   3. Required contribution rates of active plan members.
   4. Brief description of any long-term contracts for contribution.
   5. Balance of the plan's legally required reserves at the reporting date.

Illustration 8-10: Required Supplementary Information

SCHEDULES OF FUNDING PROGRESS
(DOLLAR AMOUNTS THOUSANDS)

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) Entry Age (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)	Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b-a)/c)
SEPP						
12/31/W6	$2,005,238	$2,626,296	$621,058	76.4%	$901,566	68.9%
12/31/W7	2411610	2,092,399	490,789	83.1%	956,525	51.3%
12/31/W8	2709432	3,331,872	622,440	83.3%	1,004,949	61.9%
12/31/W9*	3001314	3,604,297	602,983	83.3%	1,049,138	57.5%
12/31/X0	3366946	3,930,112	563,166	85.7%	1,093,780	51.5%
12/31/X1	3658323	4,284,961	626,638	85.4%	1,156,346	54.2%
SDEPP						
12/31/W6	$2888374	$3,499,572	$611,198	82.5%	$1,205,873	50.7%
12/31/W7	3473718	3,867,483	393,765	89.8%	1,279,383	30.8%
12/31/W8	3902705	4,439,761	537,056	87.9%	1,344,151	40.0%
12/31/W9*	4323137	4,802,700	479,563	90.0%	1,403,255	34.2%
12/31/X0	4849798	5,236,922	387,124	92.6%	1,462,695	26.5%
12/31/X1	5269502	5,709,764	440,262	92.3%	1,546,650	28.5%
MEPP						
12/31/W6	301,305	342,842	41,537	87.9%	163,508	25,4%
12/31/W7	362,366	378,885	16,519	95.6%	173,476	9.5%
12/31/W8	407,117	434,949	27,832	93.65	182,258	15.3%
12/31/W9*	450,975	470,512	19,537	95.8%	190,272	10.3%
12/31/X0	505,714	513,044	7,330	98.6%	198,368	3.7%
12/31/X1	549,696	559,367	9,671	98.3%	209,715	4.6%

The notes to the required schedules should provide:

a. Identification of actuarial methods used and significant actuarial assumptions for the most recent year covered by the required supplementary schedules.
b. Factors as changes in benefit provisions, employees covered by the plan, or actuarial methods or assumptions used that significantly affect the trend reported in the schedules.

Illustration 8-11: Schedules of Employer Contributions (Dollar Amounts in Thousands)
Employee Contributions

Year Ended June 30	SEPP Annual Required Contribution	SEPP Percentage Contributed	SDEPP Annual Required Contribution	SDEPP Percentage Contributed	MEPP Annual Required Contribution	MEPP Percentage Contributed
19W7	$100,729	100%	$115,935	100%	$15,042	100%
19W8	106,030	100	122,682	100	15,959	100
19W9	112,798	100	129,822	100	16,768	100
19X0	118,735	100	137,378	100	17,505	100
19X1	124,276	100	142,347	100	18,049	100
19X2	137,916	100	157,783	100	18,653	100

Statement of Plan Net Assets

Illustration 8-8, reported from the GASB *Codification*, presents the statements of plan net assets for the hypothetical Columbine Retirement System, a public employee retirement system (PERS).

Columbine administers three pension plans: the state employees' plan, the school districts' plan, and the municipal employees' plan. As shown, plan investments should be reported at fair value (last reported sales price) for all investments in securities that trade on active exchanges. Investments in mortgages should be based on the discounted present value of future interest and principal payments to be received. Investments in real estate should be reported at fair value based on independent appraisals. All other investments should be reported at estimated fair value, including institutional price quotes for debt securities for which trade prices are unavailable.

Depreciable assets of a PERS, that is, assets held as property, plant, and equipment for use by the PERS, should be reported at cost less accumulated depreciation. Cash and short-term investments (reported at cost), and receivables typically represent a minor part of the total assets of a PERS. An astute reader will note also the assets of a PERS are not classified as current and noncurrent; the distinction not being important since short-term liabilities typically are immaterial in relation to available plan assets. PERS liabilities, usually short-term (e.g., benefits due but unpaid, refunds for terminated employees, vouchers payable, accrued expenses, and payroll taxes payable), are reported as a deduction from) ERS assets; the difference is captioned "Net assets held in trust for pension benefits."

Statement of Changes in Plan Net Assets

The statement of Changes in Net Plan Assets for the Columbine Retirement System is presented in Illustration 8-9. This statement reports employer and employee contributions and investment income as additions to net assets rather than as revenues. Similarly, benefits paid, refunds of contributions, and administrative expense are reported under the caption deductions from net assets rather than as expenses. The net increase (decrease) in net assets is added to beginning-of-period net assets. Additions and deductions are recognized on the accrual basis.

Schedule of Funding Progress

An example Schedules of Funding Progress is presented in Illustration 8-10. This schedule shows funding progress of the plan in relation to actuarial requirements. A key measure of how well the plan is funded is the *funded ratio*. The funded ratio is the ratio of *actuarial value of assets to actuarial accrued liability* (AAL). Actuarial value of assets is the value of plan assets used by the actuary; the methods of determination for the various assets should be disclosed in the notes. **Actuarial accrued liability** is determine d by using any of several generally accepted actuarial methods (consistency applied, of course) – in this case, the Entry Age method – and is the present value of projected benefits, other than normal costs (benefits earned from current and future employees service). Thus, AAL arises primarily from past under funding and ad hoc change in plan provisions. Both the Schedule of Funding Progress and the other required schedule, the Schedule of Employer Contributions, should present information for the current year and as many prior years for which comparable data can be provided. By the sixth and subsequent year after implementation of GASB Statement No. 25, information should be provided for the current and five prior years (six years in total).

Schedule of Employer Contributions

The key information the reader should note in the *Schedules of Employer Contributions* shown in Illustration 8-11 is the *annual required contribution* (ARC) and what percentage of the ARC the employer has contributed. **Annual required contribution** is an actuarially determined amount that the employer should contribute each year to ensure full actuarial funding of the plan. Calculation of the ARC is discussed later in the section headed "Employer's Pension Accounting."

Alternative Reporting and Disclosure

The two financial statements and two schedules discussed previously, and related note disclosures, are those required in the stand-alone statements of a plan or PERS. The financial information and note disclosures required should also be reported in the employment's governments of fiduciary net assets and statement of changes in fiduciary net assets and related notes.

Illustration 8-12

JOHNSON COUNTY EMPLOYEE RETIREMENT SYSTEM
STATEMENT OF PLAN NET ASSETS
JUNE 30, 2001

Assets	
Cash	$28,569
Accrued interest receivable	2,507,612
Investment (at fair value):	
Bonds	71,603,976
Common stocks	31,957,205
Commercial paper and repurchase agreements	12,570,401
Properties, at cost, net of accumulated depreciation of $17,673	22,644
Total assets	118,690,407
Liabilities	
Account payable and accrued expenses	401,581
Net assets held in trust for pension benefits	$118,288,826

Illustrative Transactions for a Defined Benefit Pension Plan

Assuming the Johnson County Employee Retirement Plan started the fiscal year beginning July 1, 2002, with the Statement of Plan Net Assets presented in Illustration 8-12. During fiscal year 2002, the following transactions occurred that required journal entries as shown.

† Accrued interest receivable as of June 30, 2001 was collected:

		Debits	Credits
1.	Cash	2,507,612	
	Accrued Interest Receivable		2,507,612

† Member contributions in the amount of $8,009,400 and employer contributions in the amount of $14,126,292 were received in cash:

		Debits	Credits
2.	Cash	22,135,692	
	Additions–Member		8,009,400
	Additions–Employer Contribution		14,126,292

† Annuity benefits in the amount of $3,134,448 and disability benefits in the amount of $287,590 were recorded as liabilities:

		Debits	Credits
3.	Deductions–Annuity Benefits	3,134,448	
	Deductions–Disability Benefits	287,590	
	Accounts Payable and Accrued Expenses		3,422,038

† Accounts payable and accrued expenses paid in cash amounted to $3,571,969:

		Debits	Credits
4.	Accounts Payable and Accrued Expenses	3,571,969	
	Cash		3,571,969

† Terminated employees whose benefits were not vested were refunded $2,057,265 in cash.

		Debits	Credits
5.	Deductions–Refunds to Terminated Employees	2,057,256	
	Cash		2,057,256

Investment income received in cash amounted to $9,440,769; $4882.076 interest income was accrued at year-end. In addition, the fair value of investments in bonds decreased during the year by $5,626,382 and the fair value of investments in common stocks increased by $3,472,600.

† In addition to the required management's discussion and analysis (MD&A), basic financial statements (government-wide and fund), and required supplementary information other than the MD&A, the CAFR should contain introductory material, individual fund and combining financial statements, schedules necessary to demonstrate legal compliance, and statistical tables.

		Debits	Credits
6a.	Cash	9,440,769	
	Accrued Interest Receivable	4,822,076	
	Additions–Investment Income		14,262,845
6b.	Investment in Common Stock	3,427,600	
	Deductions–Change in Fair Value of Investments	2,198,782	
	Investment in Bonds		5,626,382

† Commercial paper and repurchase agreements carried at a cost of $1,354,568 matured, and cash in that amount was received.

		Debits	Credits
7.	Cash	1,354,568	
	Commercial Paper and Repurchase Agreements		1,354,568

† Common stocks carried at fair value of $6,293,867 were sold for that amount; $1,536,364 was reinvested in common stocks and the remainder in bonds. An additional amount of $29,229,967 was also invested in bonds:

		Debits	Credits
8a.	Cash	6,293,867	
	Investment in Common Stock		6,293,867
8b.	Investments in Bonds	33,987,470	
	Investments in Common Stocks	1,536,364	
	Cash		33,523,834

† Administrative expenses for the year totaled $568,219 all paid in cash:

		Debits	Credits
9.	Deductions–Administrative Expenses Cash	568,219	
	Cash		568,219

† Equipment costing $11,059, on which depreciation in the amount of $5,000 had accumulated, was sold for $6,059 cash.

		Debits	Credits
10.	Accumulated Depreciation–Equipment	5,000	
	Cash	6,059	
	Equipment		11,059

† Equipment costing $15,000 was purchased:

		Debits	Credits
11.	Equipment	15,000	
	Cash		15,000

† Depreciation expenses for the year amounted to $12,000 (charge to Administrative Expense):

		Debits	Credits
12.	Deductions–Administrative Expenses	12,000	
	Cash		12,000

† Nominal accounts for the year were closed:

		Debits	Credits
13.	Additions–Members Contributions	8,009,400	
	Additions–Employer Contributions	14,126,292	
	Additions–Investment Income	14,262,845	
	Deductions–Annuity Benefits		3,134,448
	Deductions–Disability Benefits		287,590
	Deductions–Refunds to Terminated Employees		2,057,265
	Deductions–Administrative Expenses		580,219
	Deductions – Change in Fair Value of Investments		2,198,782
	Net Assets Held in Trust for Pension Benefits		28,140,233

Entries 1 through 13 result in the financial statements shown as Illustrations 8-13 and 8-14, when applied to the accounts existing at the beginning of the period as shown in Illustration 8-12.

† **Statement of Plan Net Assets**

Illustration 8-13

JOHNSON COUNTY EMPLOYEE RETIREMENT SYSTEM
STATEMENT OF PLAN NET ASSETS
JUNE 30, 2002

Assets	
Cash	$30,849
Accrued interest receivable	4,822,076
Investment (at fair value):	
Bonds	99,965,064
Common stocks	30,627,302
Commercial paper and repurchase agreements	11,215,833
Properties, at cost, net of accumulated depreciation of $17,673	19,585
Total assets	146,680,709
Liabilities	
Account payable and accrued expenses	251,650
Net assets held in trust for pension benefits	$146,429,059

† **STATEMENT OF CHANGES IN PLANT NET ASSETS**

Illustration 8-14

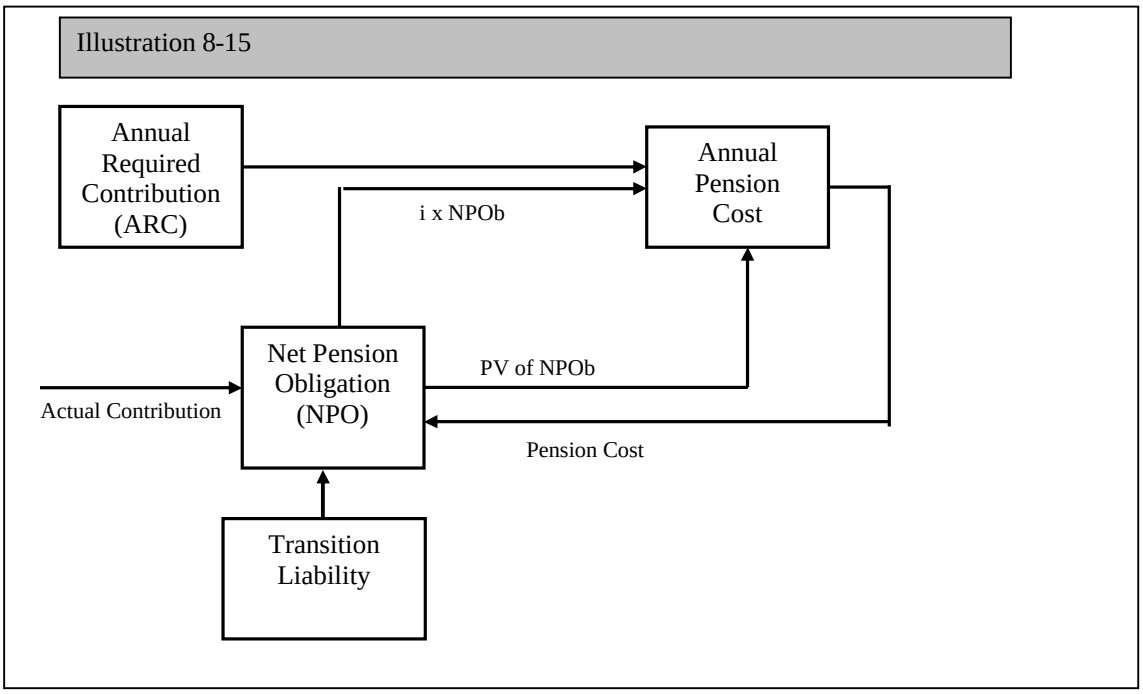
JOHNSON COUNTY EMPLOYEE RETIREMENT SYSTEM
STATEMENT OF CHANGES IN PLANT NET ASSETS
FOR THE FISCAL YEAR ENDED JUNE 30, 2002

Additions	
Contributions:	
Employer	$14,126,292
Plan members	8,009,400
Total contributions	22,135,692
Investment income:	
Net decrease in fair value of investments	(2,198,782)
Interest and Dividends	14,262,845
Total investment income	12,064,063
Total additions	34,199,755
Deductions:	
Annuity Benefits	3,134,448
Disability Benefits	287,590
Refund to terminated employees	2,057,265
Administrative expenses	580,219
Total deductions	6,059,522
Net increase	28,140,233
Net assets, July 1, 2001	118,288,826
Net assets, June 30, 2002	$146,429,059

Employer's Pension Accounting

GASB standards for the employer's accounting for defined benefit pension plans provide guidance for measurement, recognition, and display of the employer's pension information. In addition to general purpose government employers, the standards apply also to governmental public benefit corporations and authorities, utilities, hospitals, and other health care providers, colleges and universities, and, if they are employers, to public employee retirement systems.

Many of the note and statistical disclosures applicable to defined benefit pension plans, discussed in the preceding paragraphs, apply as well to the employer. If the plan (or PERS) is deemed to be part of the government's reporting entity, then many of the employer's required disclosures are redundant of those required of the plan (a pension trust fund). In this case, the employer need not make disclosures that would duplicate those made by the plan. If the plan issues a standard-alone financial report, however, the employer will have to make many of the same disclosures in the CAFR that the plan makes in its stand-alone report. Because of the similarity of the disclosures and supplementary information required of the employer to those enumerated previously for the plan, the reader is referred to GASB Codification, Sec. P.20.117, for specific disclosure requirements applicable to the employer.



Whether a government employer accounts for payroll in a governmental fund or proprietary fund, or both, there are three primary measures to be calculated and reported: (1) annual required contribution (ARC), (2) annual pension cost, (3) net pension obligation (NPO).

Calculation of Annual Pension Cost and Net Pension Obligation

Annual pension cost must be calculated and disclosed in the notes to the employer's financial statements, as shown in Illustration 8-15, the annual required contribution (ARC) is the starting point for understanding the calculation of annual pension cost. A discussion of the detailed procedures for calculating ARC is well beyond the scope of this text; therefore only identification of the components of ARC is discussed here.

ARC is calculated in accordance with certain parameters provided in GASB standards. The parameters require that for financial reporting purposes an actuarial valuation be performed at least biennially and that ARC be based on an actuarial valuation as of a date not more than 24 months prior to the beginning of the current fiscal year. A component of ARC is the **actuarial present value of total projected benefits**, allowing for projected salary increases and additional statutory or contractual agreements such as ad hoc cost-of-living increases and other types of postemployment benefits increases.

The parameters used to calculate ARC also provide broad guidance regarding actuarial and economic assumptions, even though any of six actuarial methods are permitted, subject to the limitation that in most cases the same actuarial method should be used both for funding and financial reporting purposes. Further, both the plan and the employer should be use the same actuarial method.

An employer's ARC should include **normal cost** (i.e., the actuarial present value of benefits allocated to the current year by the actuarial cost method being used) and amortization of any **unfunded actuarial liability** (same as unfunded actuarial accrued liability defined previously in the discussion of the required Schedule of Funding Progress). The provision for amortization can be determined using either level dollar amounts each year or a level percentage of the projected payroll. The amortization period must fall between defined maximum and minimum amortization periods. The maximum amortization period for the 10 years after June 15, 1996, the effective date of GASB Statement No. 25, is 40 years. After the first 10 years the maximum period is 30 years. If there is a

significant decrease in the total unfunded actuarial liability caused by a change in actuarial cost method or a change in asset valuation method, the decrease must be amortized over a period of not less than 10 years.

Once ARC has been calculated, it becomes an input to the calculation of annual pension cost (see Illustration 8-15). If there were no net pension obligation (NPO), the annual pension cost would be the same as ARC, and that would be the amount the employer should contribute during the period to the plan in order to fully fund current-period accrued benefits. If the employer has under contributed in the past, then Arc will contain an amount for the amortization of the unfunded actuarial liability. Moreover, if actual contributions have been less than annual pension cost, NPO will have positive balance. Thus, annual pension cost will be affected by the existence of NPO, in addition to Arc. Before discussing the precise calculation of annual pension cost in the presence of an NPO, it will be useful to first examine the components of NPO.

Net Pension Obligation

Net pension obligation (NPO) has two components: (1) the transaction pension liability (or asset), if any, existing at the data GASB Statement No. 27 was implemented and (2) the cumulative difference from the implementation date of Statement No. 27 to the current balance sheet date between annual pension cost (the amount that should be contributed) and the employer's actual contributions. These inputs to NPO (actual contribution, annual pension cost, and transitional liability) are shown clearly in Illustration 8-15.

Annual Pension Cost

When an employer has an NPO, **annual pension cost** is equal to: (1) the ARC, plus (2) one year's interest on the beginning-of-year NOP, and minus or plus (3) an adjustment for any amounts already included in ARC for past amortization of contribution deficiencies or excess contributions. The adjustment is minus if the beginning balance of NPO is positive (contribution deficiencies) and plus if NPO is negative (excess contributions). As shown in Illustration 8-15, the adjustment to ARC is approximated by deducting an amount equal to the present value of the beginning pension cost and NPO are related and how each is calculated.

Illustration 8-16: Calculation of Annual Pension Cost and Net Pension Obligation	
Annual required contribution (ARC)	$165,485
Interest on net pension obligations (i x NPO).....	5,070
Adjustments to annual required contribution (PV of NPO_b)	(3,692)
Annual pension cost	166,863
Contributions made during the year	(157,982)
Increase in net pension obligation.....	8,881
Net pension obligation, January 1, 2001	67,594
Net pension obligation, December 31, 2001.....	$76,475

Employer Reporting of Pension Expenditure/Expense

Referring to Illustration 8-15 and 8-16, a governmental employer that reports pension expenditures in a governmental fund should recognize the expenditures on the modified accrual basis. Thus, the amount recognized will be the actual amount contributed to the plan during the year. If the amount of pension expenditures for the year is less than annual pension cost, the difference should be added to NPO. If the expenditures amount is greater than annual pension cost, the difference should be deducted from NPO. Any cumulative positive balance of NPO, including a transition liability, should be reported in the Statement of Net Assets at the government-wide level. A negative NPO balance should be used to reduce any other liability to the plan to zero, but should not be reported as an asset. Annual pension cost should be disclosed in the Notes to the Financial Statements. Under or over funding by a proprietary fund employer should be reported in the same manner except the NPO should be reported in the Balance Sheet of the proprietary fund. The amount of pension expense recognized in the proprietors fund should be the same as the annual pension cost. This amount would also be

recognized as program expenses in the government-wide Statement of Activities, both for governmental activities and business-type activities.

8.6) Required Disclosures for Other Postemployment Benefits (OPEB)

Since unfunded other Postemployment benefits (OPEB), such as health care benefits for retirees, may represent a material liability, GASB standards require certain disclosures by governmental employers that provide OPEB. If the OPEB plan is administered by a defined benefit pension plan, the OPEB follows the standards set forth in GASB Statement No. 26 and codified in GASB Codification, Sec. Po 50. Those standards impose financial reporting and disclosure requirements on the OPEB plan that are very similar to those for defined benefit pension plans, and thus do not need to be elaborated on here.

For OPEB plans that are not administered as part of a defined benefit pension plan, GASB standards provide disclosure standards only; financial display issues relating to such OPEB plans are being examined in a separate project by the GASB. The Notes to the Financial Statements should provide, at a minimum, the following disclosures, either separately for each OPEB or in the aggregate for all OPEB provided.

a. Description of the OPEB; employee groups covered; eligibility requirements; and the employer and participant obligations to contribute, quantified in some manner.
b. Description of the statutory, contractual, or other authority under which OPEB provisions and obligations to contribute are established.
c. Description of the accounting and financing or funding policies followed.
d. Expenditure/expense information. If OPEB are financed on a pay-as-you-go basis, the employer should disclose expenditures/expenses recognized during the period by the employer (net of participant contributions) and the number of participants currently eligible to receive benefits. If OPEB are advance funded on an actuarially determined basis, the employer should disclose the number of active plan participants, the employer's actuarially required and actual contributions for the period (net of participant contributions), and the amount of net assets available for the OPEB, and the actuarial accrued liability and unfunded actuarial accrued liability.
e. Description (and dollar effect, if measurable) of any significant matters that affect the comparability of the disclosures with those for the previous period.
f. Any additional information that the employer believes will help users assess the nature and magnitude of the cost of the employer's commitment to provide OPEB.

Employers that advance fund on OPEB through a pension plan have the option of following required employer pension disclosures, discussed previously in this chapter, or the OPEB disclosures just listed.

Text: Earl R. Wilson, Susan C. Kattelus, Leon E. Hay, (2001), *Accounting for Governmental and Nonprofit Entities*, 12th Edition, McGraw–Hill, Inc., United States

References:

John H. Engstrom and Paul A. Copley (2004), *Essentials of Accounting for Governmental and Not-for-Profit Organizations*, 7th Edition, McGraw–Hill, Inc, United States

Robert J. Freeman and Craig D. Shoulders (2003), *Governmental and Nonprofit Accounting: Theory and Practice*, 7th Edition, Prentice Hall Publishing, United States

Granof H. (2007), Government and Non-for-Profit Accounting, 4th Edition, John Wiley & Sons, Inc, United States