**Chapter Two**

**Principles of accounting and financial reporting of governmental entities**

**2.1 Activities of Government**

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

Some readers may be surprised to learn that governments also engage in a variety of **business-type activities.** These activities include, among others, public utilities(e.g., electric, water, gas, and sewer utilities), transportation systems, toll roads, toll bridges, hospitals, parking garages and lots, liquor stores, golf courses, and swimming pools. Many of these activities are intended to be self-supporting by charging users for the services they receive. Operating subsidies from general tax revenues are not uncommon, however, particularly for transportation systems.

A final category of activity in which governments are involved is **fiduciary activities.** Governments often act in a fiduciary capacity, either as an agent or trustee, for parties outside the government. For example, a government may serve as agent for other governments in administering and collecting taxes. Governments may also serve as trustee for investments of other governments in the government’s investment pool, for **escheat properties** that revert to the government when there are no legal claimants or heirs to a deceased individual’s estate, and for assets being held for employee pension plans, among other trustee roles.

**2.2 Summary Statement of Governmental Accounting and Financial Reporting Principles**

Following is a summary statement of accounting and financial reporting principles for state and local governments, as modified by GASB *Statement No. 34.*14 Principles summarized here that have not been discussed in Chapters 1 and 2 will be covered in depth in following chapters.

1. **Accounting and Reporting Capabilities**

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

2. **Fund Accounting Systems**

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

3. **Types of Funds**

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

*a.* **Governmental Funds**

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

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

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

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

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

*b.* **Proprietary Funds**

***(6) Enterprise Funds***—*may* be used to report any activity for which a fee is charged to external users for goods or services. An enterprise fund *must* be used if (a) the activity is being financed with debt that is secured solely from the fees and charges for the activity, (b) laws and regulations require that the costs of providing services, including capital costs such as depreciation or debt service, be recovered from fees and charges, or (c) pricing policies of the activity are intended to recover its costs, including capital costs.

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

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

**(8) *Agency funds.***

**(9) *Pension (and other employee benefit) trust funds.***

**(10) *Investment trust funds.***

**(11) *Private-purpose trust funds.***

4. **Number of Funds**

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

5. **Reporting Capital Assets**

A clear distinction should be made between general capital assets and capital assets of proprietary and fiduciary funds. Capital assets of proprietary funds should be reported in both the government-wide and fund 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.

6. **Valuation of Capital Assets**

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

7. **Depreciation of Capital Assets**

Capital assets should be depreciated over their estimated useful lives unless they are either inexhaustible or are infrastructure assets using the modified approach as set forth in *GASBS 34*, pars. Inexhaustible assets such as land and land improvements should not be depreciated. Depreciation expense should be reported in the government wide statement of activities; the proprietary fund statement of revenues, expenses, and changes in fund net assets; and the statement of changes in fiduciary net assets.

8. **Reporting Long-Term Liabilities**

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

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

*a.* **Government-wide Financial Statements**

The government-wide statement of net assets and statement of activities should be prepared using the economic resources measurement focus and the accrual basis of accounting. Revenues, expenses, gains, losses, assets, and liabilities resulting from exchange and exchange-like transactions should be recognized when the exchange takes place. Revenues, expenses, assets, and liabilities resulting from no exchange transactions should be recognized in accordance with [*Codification*] Section N50, “No exchange Transactions.”

*b.* **Fund Financial Statements**

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

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

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

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

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

10. **Budgeting and Budgetary Control**

*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.* A common terminology and classification should be used consistently through out the budget, accounts, and financial statements.

11. **Budgetary Reporting**

*a.* Budgetary comparison schedules should be presented for the General Fund and each major special revenue fund that has a legally adopted budget as part of the required supplementary information (RSI). Governments may elect to present the budgetary comparisons as part of the basic financial statements.

12. **Transfer, Revenue, Expenditure, and Expense Account Classification**

1. Transfers should be classified separately from revenues and expenditures or expenses in the basic financial statements.
2. Proceeds of general long-term debt issues should be classified separately from revenues and expenditures in the governmental fund financial statements.
3. Governmental fund revenues should be classified by fund and source. Expenditures should be classified by fund, function (or program), organization unit, activity, character, and principal classes of objects.
4. Proprietary fund revenues should be reported by major sources, and expenses should be classified in essentially the same manner as those of similar business organizations, functions, or activities.
5. The statement of activities should present *governmental* activities at least at the level of detail required in the governmental fund statement of revenues, expenditures, and changes in fund balance—at a minimum by *function.* Governments should present *business-type* activities at least by *segment.*

13. **Annual Financial Reports**

1. A comprehensive annual financial report (CAFR) should be prepared and published, covering all activities of the primary government (including its blended component units) and providing an overview of all discretely presented component units of the reporting entity—including introductory section, management’s discussion and analysis (MD&A), basic financial statements, required supplementary information other than MD&A, combining and individual fund statements, schedules, narrative explanations, and statistical section. The reporting entity is the primary government (including its blended component units) and all discretely presented component units per [*Codification*] Section 2100,“Defining the Financial Reporting Entity.”
2. The minimum requirements for general purpose external financial reporting are:

(1) Management’s discussion and analysis.

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

(a) Government-wide financial statements.

(b) Fund financial statements.

(c) Notes to the financial statements.

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

1. As discussed in [*Codification*] Section 2100, the financial reporting entity consists of (1) the primary government, (2) organizations for which the primary government is financially accountable, and (3) other organizations for which the nature and significance of their relationship with the primary government are such that exclusion would cause the reporting entity’s basic financial statements to be misleading or incomplete. The reporting entity’s government-wide financial statements should display information about the reporting government as a whole, distinguishing between the total primary government and its discretely presented component units as well as between the primary government’s governmental and business-type activities. The reporting entity’s fund financial statements should present the primary government’s (including its blended component units, which are, in substance, part of the primary government) major funds individually and no 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.
2. The nucleus of a financial reporting entity usually is a primary government. However, a governmental entity other than a primary government (such as a component unit, joint venture, jointly governed organization, or other stand-alone government)serves as the nucleus for its own reporting entity when it issues separate financial statements. For all of these entities, the provisions of [*Codification*] Section 2100should are applied in layers “from the bottom up.” At each layer, the definition and display provisions should be applied before the layer is included in the financial statements of the next level of the reporting government.