

ARBA MINCH UNIVERSITY

COLLEGE OF BUSINESS AND ECONOMICS

DEPARTMENT OF ACCOUNTING AND FINANCE



Accounting for Governmental and Not for Profit Accounting
ACFN 3122

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**ARBA MINCH UNIVERSITY
COLLEGE OF BUSINESS AND ECONOMICS
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Course Title: Accounting for Governmental and Not for
Profit Accounting

Course Code: ACFN 3122

**Prepared by: Kedir Musa (MSc.) and
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CHAPTER ONE

OVERVIEW OF GOVERNMENTAL AND NOT FOR PROFIT ORGANIZATIONS

Learning objectives

At the end of this chapter, you should be able to:

- ✓ Identify the authoritative bodies responsible for setting financial reporting standard for state and local governments, the federal government, and not-for-profit organizations.
- ✓ Contrast and compare the objectives of financial reporting for state and local governments, the federal government, and not-for-profit organizations.
- ✓ Describe the elements of financial reporting of Not For Profit organizations
- ✓ Identify and explain the characteristics that distinguish governmental and not-for-profit entities from for-profit entities.
- ✓ Explain how management's discussion and analysis (MD&A), basic financial statements, and required supplementary information of state and local governments 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 state and local governments.

1.1. Introduction

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

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

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

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

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

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

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

QUICK CHECK

1. Distinguish between general purpose governments and special purpose governments.

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

Governmental and not-for-profit organizations differ in important ways from business organizations. Moreover, as mentioned at the beginning of this chapter, accounting and financial reporting for governmental and not-for-profit organizations are markedly different from accounting and financial reporting for businesses. An understanding of how these organizations differ from business organizations is essential to understanding the unique accounting and financial reporting principles that have evolved for governmental and not-for-profit organizations.

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

- a. Receipts of significant amounts of resources from resource providers who do not expect to receive either repayment or economic benefits proportionate to the resources provided.
- b. Operating purposes that are other than to provide goods or services at a profit or profit equivalent.
- c. Absence of defined ownership interests that can be sold, transferred, or redeemed, or that convey entitlement to a share of a residual distribution of resources in the event of liquidation of the organization.

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

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

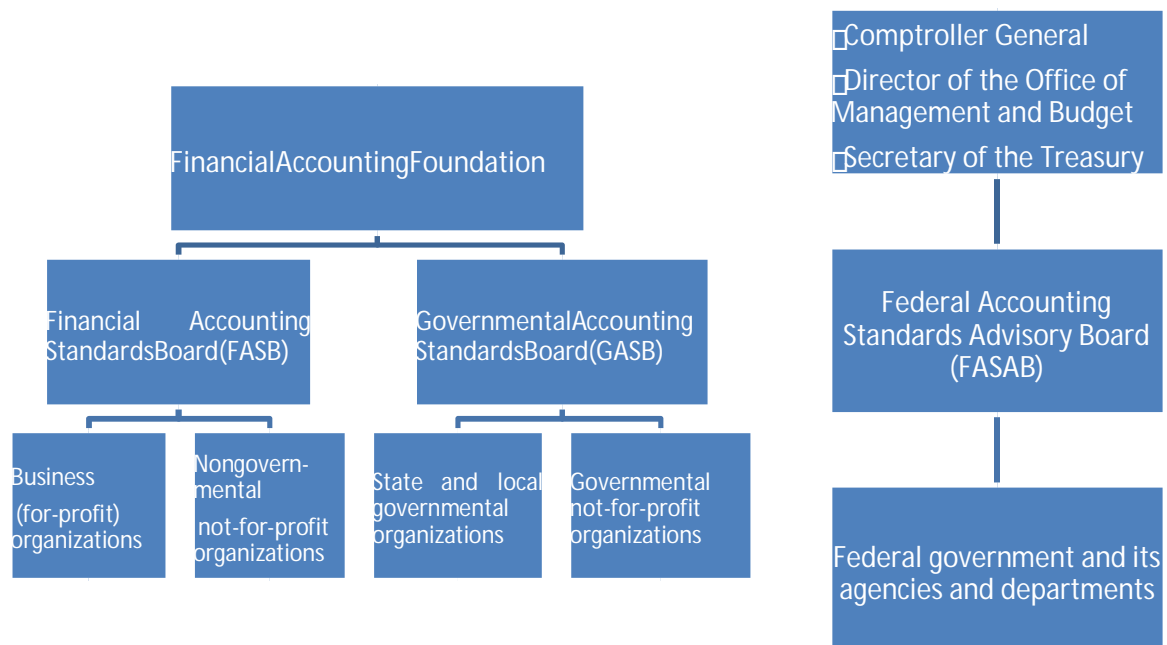
QUICK CHECK

1. List the characteristics that distinguish governmental and not-for-profit entities from business organizations.

1.4. Sources of Financial Reporting Standards

Illustration 1-1 shows the primary sources of accounting and financial reporting standards for business and not-for-profit organizations, state and local governments, and the federal government. Specifically, the FASB sets standards for for-profit business organizations and nongovernmental not-for-profit organizations; the GASB sets standards for state and local governments, including governmental not-for-profit organizations; and the Federal Accounting Standards Advisory Board (FASAB) sets standards for the federal government and its agencies and departments.

Illustration 1-1: Primary Sources of Accounting and Financial Reporting Standards for Businesses, Governments, and Not-for-Profit Organizations.



Authority to establish accounting and reporting standards for not-for-profit organizations is split between the FASB and the GASB because a sizable number of not-for-profit organizations (particularly colleges and universities, and hospitals) are governmentally owned, but most are independent of governmental units. Accordingly, the GASB has the responsibility for establishing accounting and financial reporting standards for not-for-profit organizations that are considered to be governmental in character. The FASB has the responsibility for establishing accounting and financial reporting standards for nongovernmental not-for-profit organizations.

The GASB and the FASB are parallel bodies under the oversight of the Financial Accounting Foundation. The Financial Accounting Foundation appoints the members and supports the operating expenses of the two boards by obtaining contributions from business corporations; professional organizations of accountants, financial analysts, and other groups concerned with financial reporting; CPA firms; debt-rating agencies; and state and local governments (in the case of the GASB). Because of the breadth of support and the lack of ties to any single organization or governmental unit, the GASB and the

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

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

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

This definition, though helpful, provides insufficient guidance because it fails to explain the meaning of ‘Shaving governmental character.’ In order to provide additional guidance for auditors on this issue, two audit and accounting guides of the AICPA, with the tacit approval of both the FASB and the GASB, state:

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

- a. Popular election of officers or appointment (or approval) of a controlling majority of the members of the organization’s governing body by officials of one or more state or local governments.
- b. the potential for unilateral dissolution by a government with the net assets reverting to a government. or
- c. the power to enact *and* enforce a tax levy.

Furthermore, organizations are presumed to be governmental if they have the ability to issue directly (rather than through a state or municipal authority) debt that pays interest exempt from federal taxation. However, organizations possessing only that ability (to issue tax-exempt debt) and none of the other governmental characteristics may rebut the presumption that they are governmental if their determination is supported by compelling, relevant evidence. Colleges and universities, hospitals, museums, and social service agencies are examples of organizations that may be either governmental or nongovernmental.

QUICK CHECK

1. Discuss the primary sources of accounting and financial reporting standards for businesses, governments, and not-for-profit organizations.

1.5. Objectives of Financial Reporting

In its *Concepts Statement No. 1*, “Objectives of Financial Reporting,” the Governmental Accounting Standards Board stated that “**Accountability** is the cornerstone of all financial reporting in government...Accountability requires governments to answer to the citizenry - to

justify the raising of public resources and the purposes for which they are used. The board elaborated:

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

Illustration 1-2 shows several ways that state and local governmental financial reporting is used in making economic, social, and political decisions and assessing accountability. Closely related to the concept of accountability as the cornerstone of governmental financial reporting is the concept the GASB refers to as **interperiod** equity. The concept and its importance are explained as follows:

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

Accountability is also the foundation for the financial reporting objectives the Federal Accounting Standards Advisory Board (FASAB) has developed for the federal government. The FASAB’s *Statement of Accounting and Reporting Concepts Statement No. 1* identifies four objectives of federal financial reporting (see Illustration 1-2) focused on evaluating budgetary integrity, operating performance, stewardship, and adequacy of systems and controls.

Illustration 1-2 Comparison of Financial Reporting Objectives - State and Local Governments, Federal Government, and Not-for-Profit Organizations

State and Local Governments	Federal Government	Not-for-Profit Organizations
-----------------------------	--------------------	------------------------------

<p>Financial reporting is used in making economic, social, and political decisions and in assessing accountability primarily by:</p> <ul style="list-style-type: none"> • Comparing actual financial results with the legally adopted budget • Assessing financial condition and results of operations • Assisting in determining compliance with financerelated laws, rules, and regulations • Assisting in evaluating efficiency and effectiveness 	<p>Financial reporting should help to achieve accountability and is intended to assist report users in evaluating:</p> <ul style="list-style-type: none"> • Budgetary integrity • Operating performance • Stewardship • Adequacy of systems and controls 	<p>Financial reporting should provide information useful in:</p> <ul style="list-style-type: none"> • 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
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Unlike the FASB and the GASB, which focus their standards on external financial reporting, the FASAB and its sponsors in the federal government are concerned with both internal and external financial reporting. Accordingly, the FASAB has identified four major groups of users of federal financial reports: citizens, Congress, executives, and program managers. Given the broad role the FASAB has been assigned, its standards focus on cost accounting and service efforts and accomplishment measures, as well as on financial accounting and reporting. Financial reports of not-for-profit organizations - voluntary health and welfare organizations, private colleges and universities, private health care institutions, religious organizations, and others—have similar uses. However, as Illustration 1-2 reveals, the reporting objectives for not-for-profit organizations emphasize decision usefulness over financial accountability needs, presumably reflecting the fact that the financial operations of not-for-profit organizations are generally not subject to as detailed legal restrictions as those of governments.

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

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

QUICK CHECK

1. Compare and contrast the financial reporting objectives of -state and local governments, federal government, and not-for-profit organizations

1.6. Financial Reporting of State and Local Governments

Like the FASB, the GASB has issued concepts statements that communicate the framework within which the Board strives to establish consistent financial reporting standards for entities within their jurisdiction. The GASB, as well as the FASB, is concerned with establishing standards for financial reporting to external users - those who lack the authority to prescribe the information they want and who must rely on the information management communicates to them. The Board does not intend to set standards for reporting to managers and administrators or others deemed to have the ability to enforce their demands for information.

Illustration 1-3 displays the minimum requirements for general purpose external financial reporting under the governmental financial reporting model specified by GASB *Statement No. 34*. Central to the new model is the management's **discussion and analysis (MD&A)**. The MD&A is **Required Supplementary Information (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 of the prior year.

As shown in Illustration 1-3, *GASBS 34* prescribes two categories of **basic financial statements**, government-wide and fund. **Government-wide financial statements** are intended to provide a highly aggregated overview of a government's net assets and results of financial activities. The government-wide financial statements report on the government as a whole and assist in assessing **operational accountability** - whether the government has used its resources efficiently and effectively in meeting operating objectives. The GASB concluded that reporting on operational accountability is best achieved by using essentially the same basis of accounting and measurement focus used by business organizations: the accrual basis and flow of economic resources measurement focus.

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

As shown in Illustration 1-3, the notes to the financial statements are considered integral to the statements. In addition, governments are required to disclose certain RSI (other than MD&A).

schedules. To determine and demonstrate compliance with laws, regulations, and agreements, governmental units use **fund accounting**. The technical definition of *fund* and the characteristics of each fund type and category as provided in GASB standards will be explained later.

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

a. **Government-wide financial statements**

1. Statement of net assets
2. Statement of activities

b. **Fund financial statements**

1. Balance Sheet – Governmental Funds
2. Statement of Revenues, Expenditures, and Changes in Fund Balances – Governmental Funds
3. Statement of Net Assets – Proprietary Funds
4. Statement of Revenues, Expenses, and Changes in Fund Net Assets – Proprietary Funds
5. Statement of Cash Flows – Proprietary Funds
6. Statement of Fiduciary Net Assets
7. Statement of Changes in Fiduciary Net Assets

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

QUICK CHECK

1. Discuss minimum requirements for general purpose external financial reporting.

Chapter Summary

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

States, counties, municipalities and townships are **general purpose governments** - governments that provide many categories of services to their residents. Independent school districts, public colleges and universities, and special districts are **special purpose governments** - governments that provide only a single function or a limited number of functions.

FASB sets standards for for-profit business organizations and nongovernmental not-for-profit organizations; the GASB sets standards for state and local governments, including governmental not-for-profit organizations; and the Federal Accounting Standards Advisory Board (FASAB) sets standards for the federal government and its agencies and departments.

There are two categories of **basic financial statements**, government-wide and fund.

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

Fund financial statements, the other category of basic financial statements, assist in assessing **fiscal accountability** - whether the government has raised and spent financial resources in accordance with budget plans and in compliance with pertinent laws and regulations. Certain funds, referred to as *governmental funds*, focus on the short-term flow of current financial resources rather than on the flow of economic resources. Other funds, referred to as *proprietary* and *fiduciary funds*, account for the business-type and certain fiduciary activities of the government.

SELF-ASSESSMENTS QUESTIONS

Part I: Multiple choice Questions

Choose the correct answer among the given alternatives.

1. The organization that establishes accounting and financial reporting standards for the federal government is the
 - a. Governmental Accounting Standards Board (GASB).
 - b. Federal Accounting Standards Advisory Board (FASAB).
 - c. Financial Accounting Standards Board (FASB).
 - d. Cost Accounting Standards Board (CASB).
2. The Governmental Accounting Standards Board (GASB) has the authority to set accounting and financial reporting standards for all of the following *except*:
 - a. Governmental not-for-profit organizations.
 - b. State and local governments.
 - c. Public colleges and universities
 - d. The federal government and its agencies and departments.
3. Which of the following concepts is the cornerstone of governmental financial reporting?
 - a. Relevance.
 - b. Interperiod equity
 - c. Accountability.
 - d. Liquidity.
4. Federal accounting and reporting standards issued by the FASAB:
 - a. First require ratification by the GASB before being released.
 - b. Are considered authoritative guidance for the federal government and its agencies and departments under Rule 203 of the AICPA Code of Professional Conduct, as well as under the GAAP hierarchy promulgated by the FASAB.
 - c. Should not be construed as generally accepted accounting principles.
 - d. Both A and B are correct.
5. The concept of *interperiod equity* relates to whether:

- a. Current period revenues are sufficient to pay for current period services.
 - b. Current assets are larger than current liabilities.
 - c. The organization enforces a policy of tax equity.
 - d. All of the above.
6. Which authoritative standards-setting body focuses its standards on *both* internal and external financial reporting?

	<u>FASB</u>	<u>GASB</u>	<u>FASAB</u>
A)	N	N	N
B)	N	Y	Y
C)	Y	Y	Y
D)	N	N	Y

7. As compared with business organizations, which of the following are distinguishing characteristics of governments and not-for-profit organizations?
- a. Lower importance of cost accounting systems.
 - b. Resource providers expect benefits proportional to the resources provided.
 - c. Absence of profit motive.
 - d. All of the above.
8. Financial reporting by state and local governments should be useful in making economic, social, and political decisions, and in assessing accountability by:
- a. Assisting in determining compliance with finance-related laws, rules, and regulations.
 - b. Assisting financial report users in evaluating government profitability
 - c. Improving government managers' capacity to deliver services to the public.
 - d. All of the above.
9. Which of the following is included in the minimum requirements for general purpose external financial reporting specified by GASB standards?
- a. Management discussion and analysis (MD&A).
 - b. Government-wide financial statements.
 - c. Fund financial statements.
 - d. All of the above.
10. Fiscal accountability can best be assessed by which required basic financial statements?
- a. Government-wide.

- b. Governmental fund.
- c. Both A and B are correct.
- d. None of the above.

Part II: Discussion questions

Give clear and brief answers for the following questions by yourself by referring material

1. Explain how *general purpose governments* differ from *special purpose governments* and give a few examples of each type of government.
2. “Governmental and not-for-profit organizations do not differ significantly from for-profit organizations and therefore should follow for-profit accounting and reporting standards.” Do you agree or disagree with this statement? Why or why not?
3. Which standard-setting bodies have responsibility for establishing accounting and reporting standards for (1) state and local governments, (2) business organizations, (3) not-for-profit organizations, and (4) the federal government and its agencies and departments?
4. Distinguish between *accountability* and *interperiod equity*.
5. What are the three sections of a comprehensive annual financial report (CAFR)? What information is contained in each section? How do the minimum requirements for general purpose external financial reporting relate in scope to the CAFR?

CHAPTER TWO

Principles of accounting and financial reporting of governmental entities.

Learning objectives

At the end of this chapter, learners 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
 - ✓ Explain the components of GASB's integrated accounting and financial reporting model
 - ✓ Discuss the nature of major fund reporting and the criteria used to determine whether a fund should be reported as a major fund.
 - ✓ Describe the nature and purposes of budget and budgeting
 - ✓ Explain the uses of budget
 - ✓ Explain the different classifications of budget
 - ✓ Explain the different approaches of budgeting

2.1. Activities of government

Dear student, as you remembered chapter one explained that the characteristics of governmental organizations differ from those of for-profit business organizations. One key difference is that governments are not profit seeking but exist to meet citizens' demand for services consistent with the availability of resources to provide those services. Although the types and levels of 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 cultural and social services. Government must also incur costs for general administrative support such as data processing, finance, and personnel. Core governmental services, together with general administrative support, comprise the major part of what GASB *Concepts Statement No. 1* refers to as governmental-type activities. In its more recent pronouncements, GASB refers to these activities as simply **governmental activities**. Chapters 3 through 6 of the text focus on various aspects of accounting for 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.

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

2.1.1 Integrated Accounting and Financial Reporting Model

Chapter one presented a brief overview of the minimum requirements for general purpose external financial reporting under the GASBS 34 financial reporting model. This section expands on the previous discussion and focuses primarily on principles of accounting and financial reporting within the integrated reporting model framework set forth in GASBS 34.

When the GASB was formed in 1984, it adopted 12 accounting and financial reporting principles that had been established by its predecessor standards-setting body, the National Council on

Governmental Accounting (NCGA). GASBS 34 modifies several of the original 12 principles and adds one principle for reporting long-term liabilities. A summary of these principles is presented in the appendix to this chapter. Certain of the principles are also discussed in this chapter.

To understand the basic principles of accounting and financial reporting for state and local governments, one needs first to clearly understand what composes the governmental reporting entity' and the distinctions between the government-wide financial statements and the fund financial statements.

Governmental Financial Reporting Entity

The notion of financial accountability is basic to the definition of a governmental reporting entity. A **reporting entity** consists of the primary government and certain other organizations, identified as component units, for which the primary government is financially accountable. According to GASB standards, the “financial statements of the reporting entity should provide an overview of the entity, yet allow users to distinguish between the primary government and its component units.”

GASB defines a **primary government** as a state government or general purpose local government or a special purpose government that has a separately elected governing body, is legally separate, and is fiscally independent of other state and local governments. General purpose local governments are organizations such as cities, towns, villages, counties, and townships. In many states, public school systems are legally and fiscally independent special purpose governments that are primary governments in their own right.

Component units are legally separate organizations, including organizations such as governmental hospitals, library districts, and public building authorities for which the elected officials of the primary government are financially accountable. In addition, a component unit can be another organization for which the nature and significance of its relationship with the primary government, including its ongoing financial support of the primary government or its

component units, is such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete.

Reporting the financial information of component units in a separate column of the governmentwide financial statements is referred to as a **discrete presentation**. Discrete presentation is the most common method used to report component units and should be used unless the financial activities of the component unit are so intertwined with those of the primary government that they are, in substance, the same as the primary government. In such cases the component unit's financial information should be reported in the same columns as the financial information of the primary government itself. This method of inclusion is known as **blending**.

The notes to the financial statements should contain a brief description of the component units of the financial reporting entity and their relationships to the primary government. This disclosure should also describe the criteria for including the component units and for reporting the component units. Information about individual component units may be presented in condensed financial statements within the notes or in combining statements that provide a separate column for each component unit, along with a total column for all component units. The notes should also include information about how separate financial statements for the individual component units may be obtained.

QUICK CHECK

2. Distinguish between governmental activities, business-type activities and fiduciary activities.
3. Define the following terms: primary government, Component units, discrete presentation, blending

2.1.2 Government-wide and Fund Financial Statements

The minimum requirements for general purpose external financial reporting for state and local governments, as well as a discussion of the contents of the comprehensive annual financial report (CAFR) recommended by the GASB, were discussed in brief in Chapter 1. As depicted in Illustration 1-3, every state and local government should provide a *management discussion and*

analysis and certain other required supplementary information. In addition, every government should provide two kinds of *basic financial statements*, a set of government-wide financial statements and a set of fund financial statements.

The government-wide financial statements report on the governmental reporting entity as a whole but focus on the primary government. The government-wide financial statements present the financial information of the governmental activities and business-type activities of the primary government in separate columns, although there is a total column for the primary government.

The government-wide financial statements present all financial information using the **economic resources measurement focus** and the **accrual basis** of accounting - essentially the same measurement focus and basis of accounting used in the financial statements of for-profit business organizations. Thus, as discussed in Chapter one, the government-wide financial statements report on the *operational accountability* of the government and help to assess whether the government is covering the full cost of its services in the long-run.

Governments must also present fund financial statements or, more precisely, three subsets of fund financial statements, one subset for each of the three fund categories: governmental, proprietary, and fiduciary. These categories correspond approximately to the governmental, business-type, and fiduciary activities described earlier in this chapter. An observant reader will note, however, that although internal service funds are included in the proprietary funds category, they are included as part of *governmental activities* in the government-wide financial statements. Thus, in most cases, only enterprise funds are reported as business-type activities in the government-wide statements. Internal service fund financial information is reported as part of governmental activities in the government-wide financial statements because these funds, although businesslike in operation, predominantly serve departments of the same government rather than the general public. If an internal service fund predominantly serves one or more enterprise funds, its financial information is reported in the business-type activities column of the government-wide financial statements.

Another interesting aspect of the integrated accounting and reporting framework is that fiduciary activities are reported only in the two *fund* financial statements. Fiduciary activities are not reported at all in the government-wide financial statements because the resources held by these activities (funds) belong to private parties and cannot be used to support the services provided by the primary government or its component units.

The discussion to this point has provided a brief overview of the integrated reporting model, which requires both government-wide and fund financial statements. As the following few chapters will make clear, *governmental activities* are reported quite differently in the two types of financial statements. To fully comprehend these differences, one must first become familiar with the concept of a *fund* and the accounting characteristics associated with each fund and activity category. Fund accounting for governmental activities focuses on *fiscal accountability* reporting on whether current financial resources were obtained from authorized sources and expended only for authorized purposes.

2.2. Summary Statement of Governmental Accounting and Financial Reporting Principles

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

1. Accounting and Reporting Capabilities

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

2. Fund Accounting Systems

Governmental accounting systems should be organized and operated on a fund basis. A fund is defined as a fiscal and accounting entity with a self-balancing set of accounts recording cash and other financial resources, together with all related liabilities and residual equities or balances, and

changes therein, which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions, or limitations. Fund financial statements should be used to report detailed information about the primary government, including its blended component units. The focus of governmental and proprietary fund financial statements is on major funds.

3. Types of Funds

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

a. Governmental Funds

- (1) *The General Fund* - to account for all financial resources except those required to be accounted for in another fund.
- (2) *Special Revenue Funds* - to account for the proceeds of specific revenue sources (other than private-purpose trusts or for major capital projects) that are legally restricted to use for specified purposes.
- (3) *Capital Projects Funds* - to account for financial resources to be used for the acquisition or construction of major capital facilities (other than those financed by proprietary funds and trust funds).
- (4) *Debt Service Funds* - to account for the accumulation of resources for, and the payment of, general long-term debt principal and interest.
- (5) *Permanent Funds* - to account for legally restricted resources provided by trust in which the earnings but not the principal may be used for purposes that support the primary government's programs (those that benefit the government or its citizenry). [Note: Similar permanent trusts that benefit private individuals, organizations, or other governments—that is, private- purpose trust funds—are classified as fiduciary funds, as shown below.]

b. Proprietary Funds

- (6) *Enterprise Funds* - to account for operations (a) that are financed and operated in a manner similar to private business enterprises—where the intent of the governing body is that the costs (expenses, including depreciation) of providing *goods* or services to the general public on a continuing basis be financed or recovered

primarily through user charges; or (b) where the governing body has decided that periodic determination of revenues earned, expenses incurred, and/or net income is appropriate for capital maintenance, public policy, management control, accountability, or other purposes.

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

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

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

4. Number of Funds

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

5. Reporting Capital Assets

A clear distinction should be made between general capital assets and capital assets of proprietary and fiduciary funds. Capital assets of proprietary funds should be reported in both the government-wide and fund financial statements. Capital assets of fiduciary funds should be reported in only the statement of fiduciary net assets. All other capital assets of the governmental unit are general capital assets. They should not be reported as assets in governmental funds but should be reported in the governmental activities column in the 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 GASB *Statement No. 34*, pars. 23-26. Inexhaustible assets such as land and land improvements should not be depreciated. Depreciation expense should be reported in the government-wide statement of activities; the proprietary fund statement of revenues, expenses, and changes in fund net assets; and the statement of changes in fiduciary net assets.

8. Reporting Long-Term Liabilities

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

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

a. Government-wide Financial Statements

The government-wide statement of net assets and statement of activities should be prepared using the economic resources measurement focus and the accrual basis of accounting. Revenues, expenses, gains, losses, assets, and liabilities resulting from the exchange and exchange-like transactions should be recognized when the exchange takes place. Revenues, expenses, assets, and liabilities resulting from non-exchange transactions should be recognized

in accordance with [Codification] Section N50. “Non-exchange Transactions.” *b. Fund Financial Statements*

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

- (1) Financial statements for governmental funds should be presented using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues should be recognized in the accounting period in which they become available and measurable. Expenditures should be recognized in the accounting period in which the fund liability is incurred, if measurable, except for unmatured interest on general long-term liabilities, which should be recognized when due.
- (2) Proprietary fund statements of net assets and revenues, expenses, and changes in fund net assets should be presented using the economic resources measurement focus and the accrual basis of accounting.
- (3) Financial statements of fiduciary funds should be reported using the economic resources measurement focus and the accrual basis of accounting, except for the recognition of certain liabilities of defined benefit pension plans and certain postemployment healthcare plans.
- (4) Transfers between funds should be reported in the accounting period in which the interfund receivable and payable arise.

10. Budgeting, Budgetary Control, and Budgetary Reporting

- a.* An annual budget(s) should be adopted by every governmental unit.
- b.* The accounting system should provide the basis for appropriate budgetary control.
- c.* Budgetary comparison schedules should be presented as required supplementary information (RSI) for the general fund and each major special revenue fund that has a legally adopted annual budget.

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

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

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

12. Common Terminology and Classification

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

13. Annual Financial Reports

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

- (b) Fund financial statements.
 - (c) Notes to the financial statements.
 - (3) Required supplementary information other than MD&A.
- c. As discussed in [Codification] Section 2100, the financial reporting entity consists of (1) the primary government, (2) organizations for which the primary government is financially accountable, and (3) other organizations for which the nature and significance of their relationship with the primary government are such that exclusion would cause the reporting entity's basic financial statements to be misleading or incomplete. The reporting entity's government-wide financial statements should display information about the reporting government as a whole distinguishing between the total primary government and its discretely presented component units as well as between the primary government's governmental and business-type activities. The reporting entity's fund financial statements should present the primary government's (including its blended component units, which are, in substance, part of the primary government) major funds individually and nonmajor funds in the aggregate. Funds and component units that are fiduciary in nature should be reported only in the statements of fiduciary net assets and changes in fiduciary net assets.
- d. The nucleus of a financial reporting entity usually is a primary government. However, a governmental organization other than a primary government (such as a component unit, joint venture, jointly governed organization, or other stand-alone government) serves as the nucleus for its own reporting entity when it issues separate financial statements. For all of these entities, the provisions of [Codification] Section 2100 should be applied in layers "from the bottom up." At each layer, the definition and display provisions should be applied before the layer is included in the financial statements of the next level of the reporting government.

QUICK CHECK

1. Discuss the twelve Statement of Governmental Accounting and Financial Reporting Principle.

2.3. Summary Accounting characteristics of fund types

Illustration 2-1 summarizes the characteristics and principles of accounting and reporting for each fund category that have been discussed in this chapter. One topic not discussed in this chapter is budgetary accounting, which is the main subject matter of in the next Chapter. As shown in Illustration 2-1, budgetary accounts are integrated into the accounts of certain governmental funds, primarily the General Fund and special revenue funds, but often other governmental funds as well. The next chapter also covers other important subjects such as how governmental activity revenues and expenses are classified in the government-wide financial statements and how revenues and *expenditures* are classified in the governmental funds. In addition, also the next chapter distinguishes other financial resource inflows and outflows, such as other financing sources and uses, from revenues and expenditures.

QUICK CHECK

1. Discuss the three classification of fund in detail together with their classifications.

Illustration 2-1: Summary of Fund Characteristics

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

2.4. Budgeting and uses of budget

2.4.1. What is Budget and Budgeting?

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

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

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

The second question, “why,” is arguably the most important. Ironically, it is the question which is most often not asked.

Remember Principle # 9 (Chapter Two)

- a) An annual budget(s) should be adopted by every governmental unit.
- b) The accounting system should provide the basis for appropriate budgeting.
- c) Budgetary comparisons should be included in the appropriate financial statements and schedules for governmental funds for which an annual budget have been adopted.

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

budgeted and evaluation of variances. These three budgetary phases and functions – planning, controlling and evaluation – are crucial aspects of all budgetary approaches and processes.

2.4.2. Uses of Budgets

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

Planning is a special concern for the following reasons:

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

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

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

2.5. Classifications of budgets

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

There are five classifications of budgets and two types within each classification.

Capital or Current

Sound governmental fiscal management requires continual planning for several periods into the future. Most governments are involved in programs to provide certain goods and services continuously and/or for acquisition of capital items. Multi-year schedule for acquisition of capital items is called capital program. At the beginning of each year the balance that fall in the current period will be included in the capital budget.

Capital budgets deal with the acquisition of fixed assets. The legislature will likely approve the acquisitions one year at a time. But planning for the acquisitions several years in advance (called the Capital Program) is very helpful to wise management of resources.

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

Tentative or enacted

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

General or Special

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

Fixed or Flexible

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

Fixed budgets are simple to prepare and administer and are more understood than flexible budgets and are important for legislative control to limit the discretion of executives and their

subordinates. Flexible budgets are more realistic when changes in quantities of goods or services provided directly affect resource availability and need change in outlay pattern.

Executive or Legislative

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

QUICK CHECK

1. Define budget and budgeting?
2. What is the main use of budget for governmental entities?
3. Discuss the different classifications of governmental budget.
4. Differentiate government budget and for profit budget

2.6. Approaches to Budgeting

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

2.6.1. Modern (Rational) Approaches to budgeting

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

2.6.1.1. Performance Budgeting

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

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

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

Advantage

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

Limitations

This approach is fundamentally sound but has the following drawbacks

1. Many government services and activities do not appear readily measurable in meaningful output units or unit cost terms

2. This style makes data gathering difficult and impossible
3. Need highly qualified skill man power

2.6.1.2. Planning-Programming-budgeting (PPB)

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

Distinctive characteristics of PPB

1. It focuses on identifying the fundamental objectives of the government and then relating all activities to them
2. Future year implications are explicitly identified
3. All pertinent costs are considered
4. Systematic analysis of alternatives is performed

Advantages

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

Limitations

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

2.6.1.3. Zero-Base-Budgeting (ZBB)

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

Advantages

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

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

Limitations

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

2.6.2. Practical Usefulness of the Modern Approaches

All of these modern approaches are theoretically sound. They have very good ideas about improving performance and analyzing existing programs, which may be used in budgeting.

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

2.6.3. Traditional Approach to Budgeting

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

First, subordinate agencies submit budget requests to the chief executive in terms of the type of expenditures to be made. These requests include the number of people to be hired in each specified position and salary level and the specific goods or services to be purchased during the upcoming period.

Next, the chief executive compiles and modifies the agency budget requests and submits an overall request for the organization to the legislature in the same object – of expenditure terms

Finally, the legislative body usually makes line - item appropriations, possibly after revising the requests, along object - of – expenditure lines.

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

Department of Science

Salaries

1 Department Head	24,000
4 Professors	72,000
3 Lecturers	36,000
1 Secretary	<u>6,000</u>
Total Salaries	<u>138,000</u>

Supplies

Paper	5,000
Chalk	1,000
Other Misc.Supplies	<u>1,000</u>

Total Supplies	<u>7,000</u>	
Equipment		
Computer	12,000	
Printer	<u>5,000</u>	
Total Equipment	<u>17,000</u>	Total
Science Department	<u>162,000</u>	

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

Department of Science

Salaries	138,000
Supplies	7,000
Equipment	<u>17,000</u>
Total Science Dept.	<u>162,000</u>

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

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

Department of Science	<u>\$472,000</u>
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In this last case, as long as the department head stayed within total figure, he/she would have great in management. For example, if he/she decided during the year that the department could get along without a secretary, but would rather have a second computer, then he/she could make that decision him/herself. Without this flexibility, he/she would have to wait until the next year's budget to make the change.

Advantages

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

Limitations

It is overly control centered, to the detriment of the planning and evaluation process

It provides only list of proposed personnel to be hired or goods to be purchased for decision makers. It is only decision makers that are familiar with the departments function and activities do understand the justification

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

Many, if not most, governmental entities, in fact, actually use an Incremental process in preparing an OOE budget. This means that they simply take last year's budget expenditures and add or subtract an arbitrary percentage to each line based on various internal and/or external considerations.

In spite of its weaknesses however, it is the most common approach, and its use will be assumed in the examination of budget procedures which follows.

QUICK CHECK

1. Differentiate Performance budgeting and Plan Programming budgeting
2. What is the base for having different approaches of budgeting?
3. Discuss the qualities of Object of Expenditure approach
4. What make(s) Zero Base Budgeting unique?

Chapter Summary

A reporting entity consists of the primary government and certain other organizations, identified as component units, for which the primary government is financially accountable. GASB defines a primary government as a state government or general purpose local government or a special purpose government that has a separately elected governing body, is legally separate, and is fiscally independent of other state and local governments.

GASB defines a primary government as a state government or general purpose local government or a special purpose government that has a separately elected governing body, is legally separate, and is fiscally independent of other state and local governments.

Component units are legally separate organizations, including organizations such as governmental hospitals, library districts, and public building authorities for which the elected officials of the primary government are financially accountable. The government-wide financial statements present all financial information using the economic resources measurement focus and the accrual basis of accounting - essentially the same measurement focus and basis of accounting used in the financial statements of for-profit business organizations.

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

Budgeting is the process of allocating scarce resources to unlimited demands. More specifically, it can be defined as a plan of financial operation embodying an estimate of proposed expenditures for a given time and the proposed means of financing them. The primary usefulness of FP budgets is planning, i.e. "What resources do we have, and how can we plan to spend them in order to maximize profit?" In governments also, the budget is also used for planning, especially in clarifying priority goals. States and local governments typically prepare and utilize several types of financial plans. It is therefore important to distinguish among the various types of budgets, to understand the phases through which each may pass and to be familiar with commonly used budgetary terminology.

There are five classifications of budgets and two types within each classification. This includes Capital or Current, Tentative or enacted, general or Special, Fixed or Flexible, and Executive or Legislative.

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

Traditional. The modern approaches to budgeting are sometimes called rational. That is because they all advocate thinking carefully about the relationship of inputs, with a special concern for the outputs. Outputs are the goods or services actually provided; inputs are the resources that go in providing those goods or services. The traditional approach, called object-of-expenditure (OOE) is still the most widely used. The objective of the OOE budget has an expenditure control orientation. It is to simply list expected expenditures, and then say how much is required for each one.

SELF-ASSESSMENTS QUESTIONS

Part I: Multiple choice Questions

Choose the correct answer among the given alternatives.

1. Which of the following is *not* an activity category in which general purpose governments typically engage?
 - a. Fiduciary.
 - b. Contractual.
 - c. Business-type.
 - d. Governmental.
2. All of the following are part of the basic financial statements *except*:
 - a. Management's discussion and analysis.
 - b. The government-wide statement of net position.
 - c. The statement of revenues, expenditures, and changes in fund balances—governmental funds.
 - d. All of the above are part of the basic financial statements.
3. Which of the following is a basic fund financial statement?
 - a. Statement of revenues, expenditures, and changes in fund balances.
 - b. Statement of fiduciary net position.
 - c. Statement of cash flows.
 - d. All of the above are correct statements.

4. Which of the following financial statements is required at the government-wide level?
 - a. Statement of activities.
 - b. Statement of revenues, expenditures, and changes in fund balances.
 - c. Statement of cash flows.
 - d. All of the above financial statements are required at the government-wide level.
5. GASB's first accounting and reporting principle requires that the accounting system used by a state or local governments must make it possible:
 - a. To prepare consolidated modified accrual basis statements for the governmental unit as a whole.
 - b. To present fairly and with full disclosure the funds and activities of the governmental unit in conformity with GAAP.
 - c. To demonstrate compliance with finance-related legal and contractual provisions.
 - d. Both B and C.
6. 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, is known as a:
 - a. Public corporation.
 - b. Fund.
 - c. Activity.
 - d. Accounting system.
7. Which of the following basic financial statements is most useful in assessing *fiscal accountability*?
 - a. Statement of activities.
 - b. Statement of cash flows—proprietary funds.
 - c. Balance sheet—governmental funds.
 - d. Statement of fiscal accountability.
8. The basis of accounting under which revenues are recognized when measurable and available is the:
 - a. Modified accrual basis of accounting.

- b. Accrual basis of accounting.
 - c. Cash basis of accounting.
 - d. Modified cash basis of accounting.
9. Depreciation expense for depreciable general capital assets should be reported on the:
- a. Statement of revenues, expenditures, and changes in fund balances.
 - b. Statement of activities.
 - c. Statement of general capital assets.
 - d. All of the above.
10. Which of the following fund types focuses on the measurement of current financial resources and flows thereof?
- a. General fund.
 - b. Capital projects fund.
 - c. Permanent fund.
 - d. All of the above.
11. Which of the following is different?
- a. Appropriation
 - b. Limit to spending
 - c. Authorization to spending
 - d. All
 - e. None
12. The primary use of budget for governmental unit is
- a. Planning
 - b. Source of information
 - c. Budget control
 - d. All
 - e. None
13. A very useful device for ensuring that the budget is completed in time for the new fiscal year is
- a. Budget
 - b. Fund
 - c. Budget Calendar
 - d. All
14. Budget for acquisition and /or construction of long lived assets is
- a. Current budget
 - b. Capital program
 - c. Fixed budget

- d. Capital budget
- e. All
- f. None

15. Budgeting approaches are categorized based on their emphasis on

- a. Planning
- b. Control
- c. Evaluation
- d. All
- e. None

Part II: Discussion questions

Give clear and brief answers for the following questions by yourself by referring material

1. Describe the governmental activities of a state or local government and identify the measurement focus and basis of accounting used in accounting and financial reporting for these activities.
2. Describe the business-type activities of a state or local government and explain how and why accounting and financial reporting for business-type activities differ from those for governmental activities.
3. Describe the fiduciary activities of a state or local government and explain how accounting and financial reporting for fiduciary activities differ from those for governmental and business-type activities.
4. What organizations does the governmental reporting entity include? Define *primary* government. How does a *component unit* differ from the primary government?
5. “If a discrete presentation is used for the financial data of a component unit in the statement of net assets of a governmental financial reporting entity, there is no need for the component unit to issue a separate financial report.” Is this statement true or false? What other method may be allowed to include a component unit’s financial information with that of the reporting entity?
6. What are the three categories of funds prescribed by GASB standards and which fund types are included in each? Do the three fund categories correspond precisely with the three activity categories described in Chapter 2? If not, how do they differ?

7. Explain what is meant by the phrase, “A *fund* is a fiscal and an accounting entity.”
8. Which fund category uses the *modified accrual* basis of accounting? What are the recognition rules for revenues and expenditures under the modified accrual basis of accounting?
9. Explain the criteria for determining if a governmental or enterprise fund must be reported as a *major fund*. What other funds should or may be reported as major funds?

Part III: Fill in the blanks

Fill in the blanks space by providing correct answer.

1. _____ denotes both authorization and limitation of spending.
2. _____ is a follow up phase of budgeting that will be taken to check whether the approved budget is effected as planned or not.
3. _____ are defined precisely as increases in fund financial resources other than from interfold transfers and debit issue proceeds.
4. _____ is a budget officially approved and is a binding legal document.
5. _____ budget focuses on the out puts generated by the department rather than looking at the cost of the inputs.

CHAPTER THREE

ACCOUNTING FOR GENERAL AND SPECIAL REVENUE FUNDS

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.

3.1. Introduction

Dear learner, as discussed in Chapters 1 and 2, the GASB *Statement No. 34* financial reporting model is designed to meet the diverse needs of financial statement users and achieve the broad reporting objectives set forth in GASB *Concepts Statement No. 1*. The fund-based reporting model used for decades by state and local governments, meets reasonably well the *fiscal accountability* needs of users for information about the current financial position and flows of current financial resources through the governmental funds. That model falls far short of meeting users' needs for information about the medium- to long-term impacts of the government's current operating and capital decisions, as well as information about the costs of conducting the government's functions and programs.

To meet users' broader needs for *operational accountability* information, the new reporting model requires—in addition to traditional fund-based financial statements— a management's discussion and analysis (MD&A) and two government-wide financial statements: a statement of net assets (a statement of financial position) and a statement of activities (an operating statement). This chapter focuses on the latter statement as well as on the operating statement prepared for the governmental fund-types.

3.2. Accounting Structure and Characteristics of the General Fund; Classification and Description of Operating Statement Accounts

The General Fund has long been the accounting entity of a state or local government that accounts for current financial resources raised and expended for the core governmental services provided to the people. It is used to account for the general administration and most traditional services of government.

Examples of traditional services: Public safety (e.g., police and fire), Public works (e.g., maintenance of buildings, roads, and bridges), Culture and recreation (e.g., promotion of the arts, parks, and youth activities), Health and welfare (e.g., public health, food facilities inspection, and juvenile counseling) and etc. General Funds are sometimes known as *operating funds* or *current funds*; the purpose, not the name, is the true test of identity. The typical governmental unit now engages 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 a specified purpose only, a governmental unit availing itself of that source may create a 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 a special revenue fund is one used to account for state gasoline tax receipts distributed to a local government; in many states, the use of this money is restricted to the construction and maintenance of streets, highways, 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 current financial resources (cash, receivables, marketable securities, and, if material, prepaid items and inventories). Economic resources, such as land, buildings, and equipment utilized in fund operations, are not accounted for by these funds because they are not normally converted into cash. Similarly, these categories of funds account for only those liabilities incurred for normal operations that will be liquidated by use of fund assets. As discussed in Chapter 2, however, general capital assets and general long-term

liabilities are reported in the Governmental Activities column or the statement of net assets at the government-wide level.

The arithmetic difference between the amount of financial resources and the amount of liabilities recorded in the fund is the Fund Equity. Residents of the governmental have no legal claim on any excess or liquid assets over current liabilities: therefore, the Fund Equity is not analogous to the capital accounts of an investor-owned entity. Accounts in the fund equity category of general funds and special revenue funds consist of reserve accounts established to disclose that portions of the equity are, for reasons explained later, not available for spending; the portion of equity available for spending is disclosed in an account called ***Fund Balance*** (also referred to as ***Unreserved Fund Balance***).

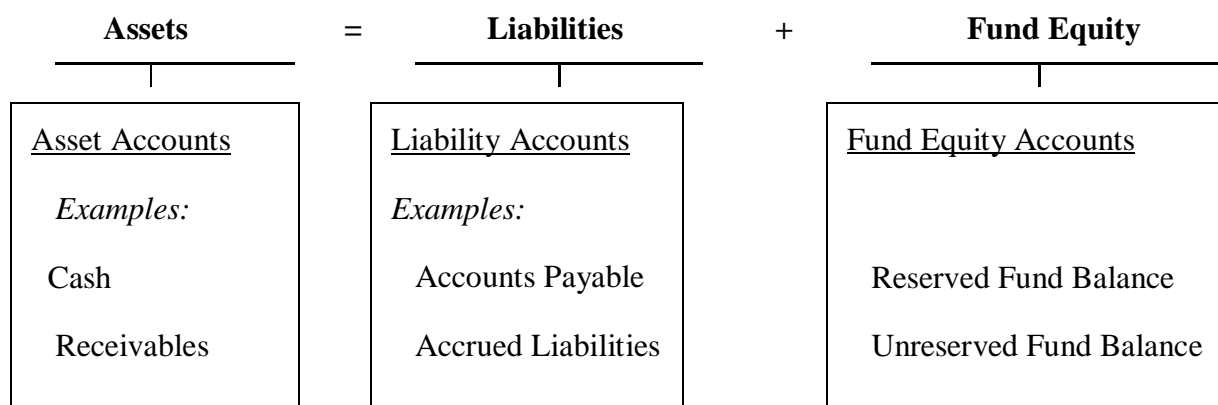
In addition to the balance sheet accounts described above, the General Fund and special revenue funds account for financial activities during a fiscal year in operating statement accounts classified as Revenues, Other Financing Sources, Expenditures, and Other Financing Uses. ***Revenue*** is defined 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.

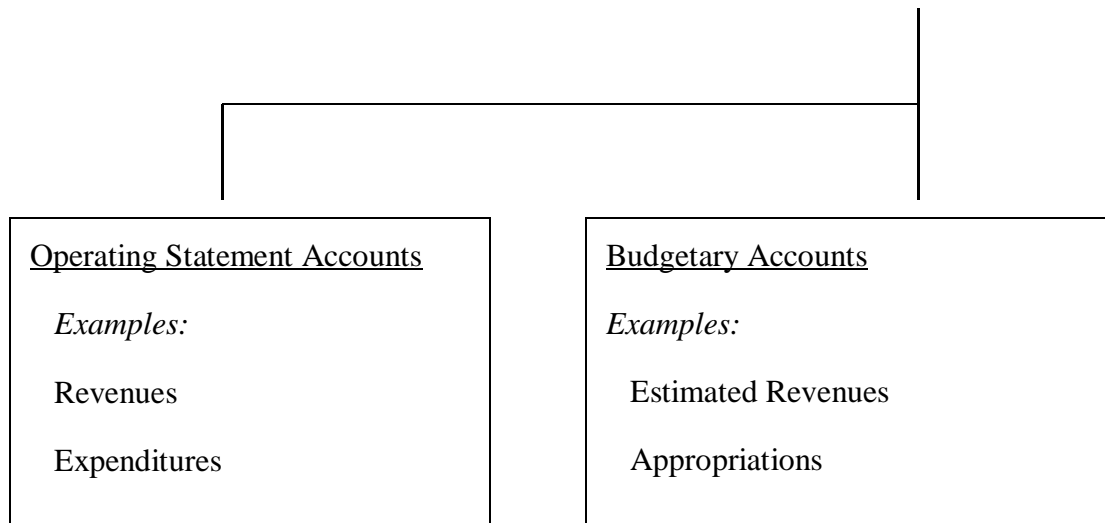
Expenditure is a word that represents the cost to purchase a good or service, whereas *expense* represents the cost of a good or service consumed during the period. Recall that governmental funds are concerned only with flows of current financial resources, not with determination of income or cost of services. Thus, governmental funds report expenditures, not expenses. In the case of employee payroll, utilities, professional travel, and other similar items, expenditures and expenses are essentially the same. In other cases, such as the purchase of equipment using General Fund resources, expenditure is recorded in the General Fund for the full cost of the equipment and differs greatly from the depreciation expense, the cost of the utility of the equipment deemed to have been consumed during the year. Depreciation expense is not recorded in the General Fund because it does not represent the use of current financial resources. At the time of the purchase, the cost of the equipment is also recorded as a capital asset of government activities at the government-wide level, and the related depreciation expense is recorded as an adjusting entry at year-end.

Other financing uses, transfers of financial resources from one fund to another fund, have the same effect on fund balance as expenditures: Both decrease the fund balance at year-end when the temporary accounts are closed. In fact, the word *expenditure* is defined as a decrease in a fund’s current financial resources other than from interfund transfers. As an example, interfund transfers occur in those jurisdictions where a portion of the taxes recognized as revenue by the General Fund is transferred to a debt service fund that will recognize expenditure for the payment of interest and principal on general long-term debt. The General Fund would debit Other Financing Uses—Interfund Transfers Out in the appropriate amount and credit Cash. The debt service fund would debit Cash in the same amount and credit Other Financing Sources—Interfund Transfers In. Thus, the use of transfer accounts achieves the desired objective that revenues be recognized in the fund that raises the taxes and expenditures be recognized in the fund that expends the revenue.

Total inflows and outflows for the operating statement accounts of the governmental funds are reported each period in a statement of revenues, expenditures, and fund balances. As discussed above, both revenues and other financing sources are temporary accounts that *increase* fund balance at year-end when closing entries are made. Similarly, Expenditures and Other Financing Uses are temporary accounts that *decrease* fund balance when closing entries are made. GASB standards emphasize, however, that other financing sources (uses) should be distinguished from revenues and expenditures.

Illustration 4-1: Comparison of Balance Sheet, Operating Statement, and Budgetary Accounts





Accounting standards require that the operating statement accounts of a governmental fund, such as the General Fund, be recognized on the modified accrual basis of accounting. Under this basis, revenues and other financing sources are recognized if they are *measurable* and *available*. *Available* means that the revenue or other financing source is expected to be collected during the current period or soon enough thereafter to pay current period obligations. In the case of property taxes, GASB requires expected collection within 60 days after the end of the current fiscal year for the taxes to be recognized as a current-period revenue. Thus, if a portion of the current tax levy is not expected to be collected within 60 days, it would be recorded in the current period as a credit to Deferred Revenues (a current liability). In the following year, Deferred Revenues would be debited and Revenues would be credited. For all other categories of revenues, as well as for other financing sources, governmental units have the discretion to determine the length of time used to define *available* (presumably not to exceed one year after the current fiscal yearend) but must disclose their policy in the notes to the financial statements.

QUICK CHECK

1. Compare balance sheet, operating statement, and budgetary accounts Governmental fund.

3.3. Budgetary Accounts

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

In order to provide the information needed to prepare budgets and the budgetary comparison schedules (or statements), accounting systems 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 accounts are needed in the General Fund (and other funds for which a budget is adopted) to provide adequate budgetary control: **Estimated Revenues, Appropriations, and Encumbrances**. Subsidiary ledger accounts should be provided in whatever detail is required by law or for sound financial administration to support each of the three control accounts. Budgeted interfund transfers and debt proceeds may be recorded in two additional budgetary control accounts: **Estimated Other Financing Sources** and **Estimated Other Financing Uses**. Again, these control accounts should be supported by subsidiary detail accounts as needed.

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. For that reason, the discussion in this

chapter follows the same sequence. Governmental budgeting was discussed in more detail in Chapter 3.

3.4.1. Classification of Appropriations and Expenditures

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 sometimes 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.

Classification by Fund

The primary classification of governmental expenditures is by fund, since a fund is the basic fiscal and accounting entity of a governmental unit. Within each fund, the other five classifications itemized in the preceding paragraph are used to facilitate the aggregation and analysis of data to meet the objectives of financial reporting set forth in Chapter 1.

Classification by Function or Program

The GASB distinguishes between functions and programs in the following manner: **Functions** group related activities that are aimed at accomplishing a major service or regulatory responsibility. **Programs** group activities, operations, or organizational units that are directed to the attainment of specific purposes or objectives

Examples of common functional classifications are the following:

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

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 a city are these:

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

Classification by Activity

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

- Solid waste collection - residential.
- Solid waste collection - commercial.
- Solid waste disposal - landfill.
- Solid waste disposal - incineration.

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 expenditures
- Capital outlays
- Debt service

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, residents 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.

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	

QUICK CHECK

1. Discuss different classification of expenditure by giving example.

3.4.2. 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 jurisdictions, 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 taxes, licenses and permit fees, fines, forfeits, and other revenue sources described in the following sections of this chapter.

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 these:

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

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 taxes are assessed on the value of underlying property - e.g. personal and real property taxes. Self-assessing taxes are based on income or sales. Taxes due on sales or earnings that have occurred but have not yet been reported at the end of an accounting period are usually estimated and accrued. If rates are below the statutory limit, property taxes may be viewed as a residual source of revenues. The gross tax levy is calculated as the amount of revenue required from property taxes divided by the estimated collectible portion of the levy (e.g., required revenues / .96 = gross levy).

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 day 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 the 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 time financial statements are to be prepared.

Sales Taxes, Income Taxes, and Gross Receipts Taxes

GASB standards provide 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.

Special Assessments

A special assessment tax is levied against certain properties that receive a particular benefit that not all taxpayers receive. Examples include street repair, street cleaning, or snow plowing for taxpayers who live outside the normal service area.

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. 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 when received in cash. 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.

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.

1. ***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.
2. 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.
3. 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, such as a matching requirement, 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 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.

Charges for Services

Charges for Services of the governmental funds (and governmental activities at the governmentwide 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. It should be recognized as revenue when earned if that is prior to the collection of cash.

Assume that use of the paving machine for one day was permitted at a cost of 5,000 Birr. The machine is used on June 1, the bill is sent to the user on July 1, and payment is received on August 1. On Which day should revenue be recognized under the modified accrual basis? It could be recognized on June 1, the day it was earned, but practically, it would probably be recorded on the day the bill was issued.

The entries would be:

Accounts Receivable	5,000	
Revenue from charges for services		5,000
		<i>To accrue revenue from charges for services</i>
Cash	5,000	
Accounts Receivable	5,000	
		<i>To record payment of account receivable</i>

If no time lapses, that is, payment are made at the time the service is made, the cash basis is probably acceptable. Whatever the case, the four accrual criteria discussed criteria should be applied.

Fines and Forfeits

Fines are amounts assessed by the courts against those guilty of statutory offenses and neglect of official duties. On the other hand, ***Forfeits*** arise from deposits or bonds made by contractors,

accused felons, and others to assure performance on contracts or appearance in court. We can accrue if the amount is known prior to the receipt of cash

Miscellaneous Revenues

These are revenues that do not fall into one of the other categories, such as: proceeds from the sale of government assets (if immaterially small in amount; other financing source otherwise), *and* investment income. We can *accrue* if the amount is known prior to the receipt of cash

QUICK CHECK

1. Discuss different classification of revenue by giving example.

3.5. Budgetary Accounting

It is extremely important in governmental accounting that expenditures do not exceed appropriations. The budget is legally binding, and exceeding it usually results in severe penalties. Therefore, two special accounting safeguards have been installed for governmental entities:

1. Recording the budget at the beginning of the year
2. Recording of the purchase orders as placed

To keep from exceeding the budget, the government administrator needs a report that tells him/her the following information. How much has been made available? How much has been used? and how much has been committed (contracts, purchase orders, etc)? The accounting records to be kept are based on these needs.

3.5.1. Recording the Budget

To record the budget (how much has been made available and how much to spend in the budget year) in the ledger, two control accounts are needed - estimated revenues and appropriations. Under these control accounts subsidiary ledgers are used as necessary. For example, for Estimated Revenues, subsidiary ledgers for sales taxes, income taxes, licenses, and fines, etc will be maintained. For Appropriations, subsidiary ledgers for salaries, supplies, equipment, etc, may be needed. Subsidiary ledgers will be required for as much detail as is needed in the reports which are produced from them.

Recording the Budget at the Beginning of the Year

The budget for Clark City authorizes expenditures of \$11,360,000 and forecasts revenues of \$10,972,000 for FY 2011. The entry to record the budget (ignoring subsidiary detail) is:

General Fund:	Dr	Cr
Estimated Revenues	10,972,000	
Budgetary Fund Balance	388,000	
Appropriations		11,360,000

Question: Referring to the budget just recorded in which appropriations exceed estimated revenues by \$388,000, is this an example of poor financial management?

Answer: A budgetary deficit does not necessarily indicate poor financial management. To provide a financial cushion to cover revenue shortfalls or unexpected expenditure needs, governments usually maintain a “target” ratio of Unreserved Fund Balance to General Fund Revenues in the range of 10 to 20 percent. If the reserve is larger than the target level, the City Council (or other legislative body) may intentionally budget a deficit to reduce fund balance

3.5.2. Encumbrance Accounting

When enacted into law, an appropriation is an authorization for administrators to incur on behalf of the governmental unit liabilities in the amounts specified in the appropriation ordinance or statute, 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 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 orders 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 help administrators to avoid over-expending appropriations and to plan to be able to pay liabilities on a timely basis.

Assume that the following departments of Clark City place purchase orders for supplies totaling \$420,000, the entry would be:

General fund	Dr	Cr
Encumbrances	420,000	
Reserve for Encumbrances		420,000

3.5.3. Accounting for Expenditures

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. 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.

Clark City recorded expenditures of \$432,000 for goods received that had been ordered in the preceding transaction. Two entries need to be recorded at this point:

General fund	Dr	Cr
a. Reserve for Encumbrances	420,000	
Encumbrances		420,000
b. Expenditures	432,000	
Vouchers Payable		432,000

Remember: in the first entry the accounts are reversed for their balances recorded when the purchases are ordered. In the second we used the actual price not the encumbered balance. Encumbrances are not necessary for every single expenditure. Expenditures that are regular and predictable, such as payroll are not typically encumbered. However, if payroll has seasonal fluctuations, then it is wise to encumber the estimated payroll.

From the foregoing discussion and illustrative journal entries, 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*.

3.6. Accounting for Allotments

In some jurisdictions, it is necessary to regulate the use of appropriations so only specified amounts may be used from month to month or from quarter to quarter. The purpose of such control is to prevent expenditure of all or most of the authorized amount early in the year without

proving 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.

	General Ledger	
	<i>Debits</i>	<i>Credits</i>
Estimated Revenues	1,277,500	
Fund Balance	359,000	
Unallotted appropriations		1,362,000
Estimated Other Financing Uses		241,500
Unallotted Appropriations	342,000	
Allotments		342,000

3.7. Accounting for Payroll

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

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

Clark City recognized its payroll for the most recent two week pay period for employees paid from the General Fund:

General fund	Dr	Cr
Expenditures	948,000	
Due to Federal Government		86,000
Due to State Government		49,000
Cash		813,000

The employer's share of FICA is recorded in the General Fund

General fund	Dr	Cr
Expenditures		
Due to Federal Government		

3.8. Accounting for Property Tax Revenue

Taxes are a forced contribution imposed on the citizens by the government to meet public expenditures. Citizens are given no choice but to pay. Taxes must be paid, regardless of whether or not the citizen being taxed is receiving any direct benefit as a result of paying the tax. There is no direct relationship between the tax liability to be paid and the benefits received by the tax payer. There are a number of different kinds of taxes including: property (land use), sales, excise, income, customs duty, capital gains, etc. The Federal and/or Regional governments of Ethiopia currently employ all these types of taxes in some form or another.

Taxes are typically calculated by applying a rate to base. For example, income tax is calculated by applying the income tax rate to an employee's monthly income. Excise taxes are calculated by applying a certain rate to a particular type of good or service.

Giving formal notice of a tax to be paid is called a levy. A tax levy, especially on goods or property, also typically creates a lien, which gives the taxing authority the power to confiscate the goods or property in the event of non-payment of tax. Incorrect calculation of taxes by the

taxpayer may result in penalties. Taxes which are not paid on time usually accrue interest on any unpaid balance. These penalties and interest create an additional revenue source for the government. Since taxes constitute the primary revenue source for most governments, accounting for them will be given the most coverage of the revenue types.

Taxes may be levied in a lump sum, or sub-divided according to the purpose for which they may (or must) be used. Subdividing the levy according to purpose may also require the use of a special revenue fund to account for it. Most taxes however, would be expected to go into the general fund.

In addition to revenue accounts, the following accounts may also be needed to account for tax collections:

Assets Accounts

- ❖ ***Taxes Receivables*** – Current: is used to accrue taxes which are due in the current Year. Taxes which are expected to be collected within the current year are to be recorded in this account.
- ❖ ***Taxes Receivable*** – Delinquent: is used to record any taxes which are past due. Taxes which have been expected to be collected in the current year, but fail to do so are to be recorded in this account.
- ❖ **Tax Lien-Receivable** - is used to record taking possession of goods on which an owed tax has not been paid. This account is used to record the total amount of tax liability that a tax payer fails to pay on the due date, including penalty and interest, for which the taxing agency seized his/her/it's property.
- ❖ **Interest and Penalties Receivable on Delinquent Taxes** - is used, obviously, to record interest and penalties due on unpaid taxes.

Liability Accounts

- ❖ **Deferred Taxes:** account of credited for taxes which are paid in a year before they may legally be used for expenditure.

- ❖ **Trust for Property Owners:** If those possessed goods are sold in an attempt to cover the tax any additional cost incurred in collecting it, the Trust for Property Owners account is used to record any balance remaining from the selling price after the tax and collection cost are deducted. (In Ethiopia, if goods subject to excise tax are taken and sold for nonpayment of tax, the owner of the goods has up to five years to claim any excess from this account).

Contra Asset Account

Allowance for Uncollectible Taxes: is used for recording the estimate of taxes which the government will not be able to collect. As there is no profit to determine, no expenses will be recognized. Hence, Bad debt expense is not used for taxes. Rather any uncollectible taxes are accounted for as a reduction in revenue and the balance is to be recorded in a contra asset account called Allowance for Uncollectible Taxes. Note that this is different from FP accounting.

Example Journal Entries

Land use taxes were assessed in January 2001, and they are levied (formally made due) in June, 2001. They are payable by July 31,2001. They are to be used to meet the year 2002 expenditures. Ninety-nine percent (99%) of the taxes are expenditures to be collected.

Taxes Receivable current	100,000	
Allowance for Uncollectable-Current tax		1,000
Revenues		99,000
<i>To record accrual of tax levy</i>		

Note that the amount recorded as revenue is the net of the receivable less the allowance for uncollectible taxes. This is different from for-profit accounting, where the gross is recorded as income, and the estimated uncollectible amounts are charged to expense.

Assume no collections were made before the due (Feb. 28, in this case), and on the due date, 80,000 birr was received.

Cash	80,000	
Taxes Receivable-Current		80,000
<i>To record collection of taxes</i>		

Any taxes which are not paid by the due date become *delinquent*, and should be reclassified from the current taxes receivable to the delinquent taxes account. This follows.

Taxes Receivable-Delinquent	20,000
Taxes Receivable-Current	20,000

To record taxes becoming delinquent, (Delinquent taxes are those which are not paid by the due date)

The uncollectible allowance related to delinquent taxes should also be reclassified to an allowance for uncollectible delinquent taxes account. This entry follows.

Allowance for Uncollectible-Current Tax	1,000
Allowance for Uncollectible-Delinquent Tax	1,000

To record reclassification of allowance of estimated losses on taxes.

When taxes become delinquent, there is usually some penalty and/ or interest assessed. The penalty and interest may be accrued, although sometimes it is not. Assume a flat penalty of 10%, plus simple interest of 12% per annum (1% per month). The accrual entry is

Penalties and Interest Receivable on Delinquent Taxes	2,000
Revenues	2,000

To record penalties due on delinquent taxes

Monthly, Quarterly, Some other interim period, or at year end, interest could be accrued. If it is accrued monthly, the following entry would be required each month (20,000 Birr* 1% per month=200). The entry would be adjusted each month, of course, for any payments received during that month.

Penalties and interest on Delinquent Taxes	200
Revenues	200

To record monthly interest due on delinquent taxes

Assume that 75% of the delinquent taxes plus applicable interest and penalties on those taxes were received on March 31, 20x2, one month late. [15,000 + 1,500 (10% penalty) + 150 (1% interest)]

Cash	16,650
------	--------

Taxes Receivable-Delinquent	15,000
Penalties and Interest on Delinquent Taxes	1,650

To record collection of delinquent taxes plus penalties and interest

Note that if penalties and interest had not been previously accrued, the credit for 1,650 above would have been to revenues.

After a certain time period had passed from the due date e.g, six months, the lien would come into effect, and the property on which the tax was due could be seized by the governmental unit. Assume that after 6 month the property is seized. At the time of seizure, the following entry would be necessary. [5,000 (tax owed) +500 (penalty) +300 (interest: $5,000 \times 1\% \times 6$ months)]

Tax Lien-Receivable	5,800
Taxes Receivable-Delinquent	5,000
Penalties and Interest on Delinquent Taxes	800

When the seized property is sold, the taxes, plus interest and penalties, plus any cost of the sale should be paid. Any excess is held in trust for the owner of the property. Assume that the property is sold for 7,000. For simplicity, assuming there is no cost associated with the sale, the following entry is needed:

Cash	7,000
Tax Lien Receivable	5,800
Trust for property owners	1,200

To record sale of seized property

When the owner claimed back the Birr 1,200 excess and the payment is made, the following entry is made:

Trust for property owners	1,200
Cash	1,200

To record the payment of claim or return the sales amount in excess of tax owed, penalties, interest and cost of sales

Closing the Books for Revenues and Expenditures

Closing the books in a governmental entity is somewhat complicated by the existence of the budgetary accounts and encumbrance accounts. First, the budgetary accounts should be closed. Assuming there was no change in appropriations or Estimated Revenues during the year, the opening entries are simply reversed. (*Assumed numbers*)

Appropriations	480,000	
Fund Balance	20,000	
Estimated Revenues		500,000

To close the budgetary accounts

Next, the actual Revenues and Expenditures are closed, in a manner similar to profit seeking accounting. (*Assumed numbers*)

Revenues	510,000	
Fund Balance	35,000	
Expenditures	475,000	

To close actual Revenues and Expenditures

Finally, the Encumbrances Accounts is closed, if necessary. (*Assumed numbers*)

Reserve for Encumbrances	12,000	
Encumbrances		12,000

To close the encumbrance account

Note: Under certain expenditure laws, the debit in this closing entry for encumbrances may need to be unreserved Fund Balance. In such a case, the closing would be reversed at the beginning of the next period.

3.9. Accounting for inter Fund transaction

Inter fund transactions are transactions between different entities within the governmental unit. As such, they need to be recorded in two different sets of books. The five types of inter fund transactions commonly encountered in governmental accounting are listed, defined, and illustrated below.

3.9.1. Inter Fund Transaction

1. *Inter fund loans and advances* – Funds sometimes loan money to each other to use idle cash effectively. The money is only temporarily transferred and must be repaid. Since each fund is a fiscal entity, these inter fund payables and receivables must be disclosed in the financial statement of each fund involved. Interest is sometimes charged to or by proprietary funds; it is not normally charged on advances and loans between governmental funds.

For example, if the general fund loaned 50,000 Birr to a special revenue fund, the entries required would be:

On the books of the general fund

Due from the special Revenue fund	50,000	
Cash		50,000

To record a loan to the special revenue fund.

On the books of the special revenue fund

Cash	50,000	
Due to the General fund		50,000

To record a loan from the general fund

2. *Quasi-external transactions* – These are transactions that would be treated as revenues, expenditures, or expenses if they involved organizations external to the governmental unit. They are the only type of inter fund transaction which is considered as revenue and expenditure within the entity. These transactions are typically between an internal service fund and the general or a special revenue fund. The fund giving the service recognizes revenue; the fund receiving the service recognizes expenditure. An example of a quasi-external transaction is a shared garage for the governmental unit which repairs any of its cars regardless of which fund is responsible for it. The garage will charge the respective fund for work done, and recognize revenue from it. The fund which is responsible for the vehicle recognizes expenditure.

The quasi-external transactions are recognized as revenue and expenditure only on the individual and (sometimes) combining fund statements. These transactions are eliminated on the combined statement of the government unit, and not included as revenue or expenditure for the unit as a whole.

If a car repair of 1,000 Birr was done to a vehicle the general fund was responsible, the following entries would be needed

On the books of the General Fund

Expenditures	1,000	
Due to Internal service Fund		1,000
<i>To record the cost of repairing a vehicle</i>		

On the books of the Internal service fund

Due from the General fund	1,000	
Revenues		1,000
<i>To record repair of a vehicle</i>		

3. Reimbursements – These are transactions that reimburse a fund for expenditures made by it on behalf of another fund, i.e. one fund pays a bill on behalf of another and is then reimbursed.

For example, the Ministry of Health operates clinic in Addis Ababa and South Omo. The Addis Ababa Clinic, for convenience, might pay a bill of 3000 Birr for medicine on behalf of South Omo clinic. The South Omo clinic would then reimburse the AA clinic. The AA clinic would charge expenditure at the time of purchase, and then credit expenditures to zero (0). Payment of the reimbursement would then create expenditure for the South Omo clinic.

On the books of the AA Clinic

Expenditure	3,000	
Cash		3,000
<i>To record payment of bill on behalf of south Omo clinic</i>		

Cash	3,000	
Expenditure		3,000

To record reimbursement from south Omo clinic

On the books of the South Omo Clinic

Expenditure	3,000	
Cash		3,000

To reimburse the AA clinic for medicine purchase

4. (Residual) Equity Transfers- These are nonrecurring transfers made in compliance with special statues or ordinances that do not qualify as revenues or expenditures to the receiving or disbursing funds. It is the transfer of fund balance from one fund to another. Not only are they not revenues or expenditures, they are not other financing sources or uses, even though they are technically increases/decreases in fund financing resources. Equity transfers appear in the fund Balance section of the operating Statement. For example, the GF might transfer the amount of 10,000 Birr to an internal service fund to open a central supply store.

On the books of the General fund

Equity Transfers Out	10,000	
Due to Internal Service fund		10,000

On the books of the Internal service Fund

Due from the General Fund	10,000	
Equity transfers In		10,000

5. Operating Transfers- All other inter fund transfers besides equity transfers Operating transfers are recurring periodic transfers made primarily for the purpose of shifting resources from one fund to another. They are legally authorized transfers from a fund which receives revenue to the fund through which the resources are to be expended. These transfers are other financing sources of the receiving fund, other financing uses of the paying fund. For example, the general fund may make an annual transfer of 8,000 Birr to a Debit service Fund for payment of interest on a general long-term debit. At time the transfer is authorized, the following entries are needed:

On the books of the General Fund

Operating Transfers Out	8,000	
Due to Debt Service fund		8,000
<i>To record a transfer to the debit service fund</i>		

On the books of the Debit service fund

Due from General fund	8,000	
Operating Transfers In		8,000
<i>To record a transfer from the general fund</i>		

Note that only numbers 4 & 5 above are called properly called **transfers**, 1, 2 & 3 are merely **transactions**.

Besides these five types of inter fund transactions two other kinds of general and special revenue fund transaction in another accounting entity. They are the 1) acquisition of general fixed assets, and 2) creation of tax supported and special assessment long-term debit or repayment of principal of such long-term debt. These kinds of transactions will be covered in more detail later in the course.

3.9.2. Closing Entries for Inter fund Transactions

1. Inter fund Loans and Advances – Inter fund loans and advances are not increases or decreases in fund net assets. On the creditor fund’s books they only move resources from one current asset (cash) to another (Due from...). On the debtor fund’s books, they increase a current asset (cash) by increasing a current liability (Due to..). In both cases, the effect on net assets is zero. As such inter fund loans and advances are **not closed** at the end of the year.

2. Quasi-external transactions – The revenues and expenditures arising from quasi-external transactions are closed simply as part of closing the other revenues and expenditures for the year. “Due From” accounts are not closed, because they are balance sheet accounts.

3. Reimbursements - Any expenditures arising from reimbursement transactions are closed simply as part of closing the other revenues and expenditures for the year. No special attention is given to reimbursements in the year-end closing process.

4. (Residual) Equity Transfers- These transfers increase the net assets of the receiving fund, and decrease the net assets of the giving fund. Therefore, they must be closed to fund balance at the end of the year. Both funds involved in the transfer must close the equity transfer accounts. Refer back to the example of residual equity transfers above. For those particular transfers, these are closing entries needed.

On the books of the General fund

Fund Balance	10,000	
Equity Transfers Out		10,000

On the books of the Internal Service fund

Equity transfers In	10,000	
Fund Balance		10,000

5. Operating Transfers- These transfers are similar to (residual) equity transfers in that they increase the net assets of the receiving fund, and decrease the net assets of the giving fund. Therefore, they also must be closed to fund balance at the end of the year. Both funds involved in the transfer must close the operating transfer accounts. Refer back to the example of operating equity transfers above. For those particular transfers, these are the closing entries needed.

On the books of the General fund

Fund Balance	8,000	
Operating Transfers Out		8,000

On the books of the Debt service fund

Operating Transfers In	8,000	
Fund Balance		8,000

3.10. Accounting for Special Revenue Funds

The distinguishing feature of a special revenue fund is that its revenues are obtained primarily from tax and non-tax sources not directly related to services rendered or facilities provided for use. Separate special revenue funds are established by governmental units as mandated by legislative enactments, to account for the receipts and expenditures associated with specialized revenue sources that are earmarked by law or regulation to finance specified governmental operations. Ledger account titles, budgetary processes and financial statements for a special revenue funds are similar to those of General funds.

Illustration

To illustrate the accounting for a Special Revenue Fund, Assume that on July 1, year 6, The town council of the town of X authorized the establishment of a special Revenue Fund- its first such fund- to account for Special Assessment against certain residents of the neighboring village of Y. Because the property tax revenue of the town of X, which among other services financed street cleaning and street light maintenance for residents of the town only, could not be used for such services elsewhere, the town council authorized special assessment to finance comparable services for the requesting residents of the village of Y. the town council adopted a budget for the special revenue fund for the year ending June 30 year 7, providing for estimated revenues (from the special Assessments) of 800,000 and appropriations for reimbursement to the General fund for expenditures made by that fund for the services provided to the village of Y residents) of 75,000.

Following are additional transactions or events of the town of X special revenue fund for the year ending June 30 year 7.

1. On July 1, year 6, the town recorded the adopted budget in the books.

Estimated Revenues	800,000
Appropriations	750,000
Budgetary Fund Balance	50,000

To record the annual adopted budget for fiscal year ending June 30 year 7.

2. Special Assessments tax totaling 820,000 were levied which are to be paid in full in sixty days.

Special Assessment Tax Receivable- current	820,000
Revenues	820,000

To record special assessments billed, all of which are estimated to be collectable

3. Cash Receipts from Special Assessment Taxes of 820,000 were collected in full.

Cash	820,000
Special Assessment Tax Receivable- current	820,000

To record collection of special assessment tax in full during the year.

4. Of the cash receipts, 630,000 was invested in Treasury bills with face amount of 650,000. The treasury bills mature on June 30 year 7 and were redeemed in full on that date.

Short Term Investments	630,000
Cash	630,000

To record acquisition of 65,000 face amounts of treasury bills,

Cash	650,000
Short Term investments	630,000
Revenues	20,000

To record receipts of cash for matured U.S treasury bills. Maturity June 30, year 7.

5. Billings from the town of X General fund, requesting reimbursement of expenditures of that fund, totaled 760,000; of that amount, 620,000 was paid to the General Fund by June 30, year 7.

Expenditures	760,000
Payable to General Fund	760,000

To record billings from general fund for reimbursement of expenditures for street cleaning and street light maintenance for residents of the village of x

Payable to General Fund	620,000
Cash	620,000

To records payments of general fund during the year

6. On June 30, year 7, the town council of the town of x designated the fund balance of the Special revenue fund(80,000) for reimbursement of the General Fund during the year ending June 30, year 8.

Unreserved and Undesignated fund balance	80,000
Fund Balance Designated for -	
Reimbursement of General Fund	80,000

To designate the entire fund balance for reimbursement of General Fund during the year ending June 30 year 8.

Because of the 760,000 billings of the town of X General Fund to the Special Revenue Fund were for reimbursement of General fund expenditures, the general fund credited its expenditures ledger account in the journal entry in which it debited receivable from Special Revenue fund.

Closing Entries

Appropriations	750,000	
Budgetary Fund Balance	50,000	
Estimated Revenues		80,000

To close budgetary ledger accounts

Revenue	840,000	
Expenditures	760,000	
Unreserved and Undesignated-	80,000	fund
balance		

To close revenue and expenditures ledger account

3.11. Financial Statements

Similar to business concern, both the general fund and special revenue funds have an operating statement and a balance sheet. In addition they have a statement of revenues expenditure, budget and actual.

Balance Sheet Accounts: Because the focus of these funds (GF and SRF) is only a single year, and because the balance sheet primarily contains only resources which will be required for that year, it follows that only finical resources (current assets-cash, receivables, etc.) are recorded in them. Fixed assets are not capitalized in either type of fund. Since only current assets are recorded in the fund, only the liabilities which will be paid from those resources need be recoded in the fund. This means that only current liabilities are recorded. Long-term debt is not recorded as a liability in either type of fund.

The mathematical difference between the recourses (assets) and liabilities of these funds is the fund Equity ($A-L=FE$). Strictly speaking, this difference is not really equity since the citizens of the entity have no legal claim to it. It is sometimes referred to as fund Balance to avoid this confusion. The fund Balance (FB) is divided into Reserved and Unreserved.

Operating Statement Accounts: Because the focus of the GF and SRFs, as expendable funds, is on the current year, the operating statement is generally the most important of the finical statements. The operating statement shows both increases and decreases in fund financial resources (or net assets). As was said above, decreases are divided into two types, expenditures and other financing uses. Other financing uses refer to operating transfers to other funds. Similarly, there are two types of increases- revenues, and other financing sources. Other financing sources are made up of the proceeds of long term debt, and operating transfers from other funds. The rest of the increases besides two are called revenues. [Note this distinction is not currently being made in FGE financial statements.]

3.11.1. Financial statements for a General Fund

The results of operation (i.e, net income or net loss) are not relevant for a General Fund. Instead, two financial statements- a Statement of Revenues, Expenditures and Change in Fund Balance and a Balance Sheet are appropriate.

Assuming that the total revenue for the town of X is composed of the following sources,

General Property Tax	7,060,000
Licenses and Permits	450,000
Charges for Services	470,000
Fines and Forfeits	310,000
Miscellaneous Revenue	190,000

Also assume that the total expenditures is composed of the following items.

General Government	4,590,000
Public safety	2,000,000
Health and Welfare	1,200,000
Culture and Recreation	210,000

Town of X General fund
Statement of Revenues, Expenditures and Change in Fund Balance
for the Year ended June 30, 19x6

	Budget	Actual	Variance-Favourable
Revenues:			(Unfavourable)
General Property Tax	7,000,000	7,060,000	60,000
Licenses and Permits	400,000	450,000	50,000
Charges For Services	500,000	470,000	(30,000)
Fines and Forfeits	300,000	310,000	10,000
Miscellaneous Revenue	200,000	190,000	(10,000)
Total Revenues	8,400,000	8,080,000	80,000
Expenditures:			
General Government	4,700,000	4,590,000	110,000
Public Safety	1,900,000	2,000,000	(100,000)
Health an Welfare	1,100,000	1,200,000	(100,000)
Culture and Recreation	400,000	210,000	190,000
Total Expenditures	8,100,000	8,000,000	100,000

Excess of Revenue over Expenditures-	300,000	480,000	180,000
Other Financing sources (Uses):			
Operating Transfers In	100,000	100,000	
Operating Transfers Out	(100,000)	(110,000)	(10,000)
Excess of Revenue and O.F.S.-			
Over Expenditures and O.F.U.	300,000	470,000	170,000 Add:
Fund Balance, July 1, 19x5	<u>1,200,000</u>	<u>1,200,000</u>	.
Fund balance June 30, 19x6	<u>1,500,000</u>	<u>1,670,000</u>	<u>170,000</u>

**Town of X General Fund
Balance Sheet,
June 30, Year 6**

Assets

Cash		1,420,000
Taxes Receivable- Delinquent	570,000	
Less: Allowance for Uncollectable Taxes	10,000	560,000
Inventory of Supplies		<u>500,000</u>
Total Assets		<u>2,480,000</u>

Liabilities and Fund Balance

Liabilities

Vouchers Payable	700,000
Payable to Enterprise Fund	50,000
Payable to Internal Service fund	60,000
Total Liabilities	<u>810,000</u>

Fund Balance:

Reserved for Encumbrance	450,000	
Designated for Replacement of Equipment	250,000	
Unreserved and Undesignated	970,000	<u>1,670,000</u>
Total Liabilities and Fund Balance		<u>2,480,000</u>

3.11.2. Financial Statements for a special revenue funds

The financial statements for a special Revenue funds is the same as that of a General fund-a statement of Revenues, Expenditures and change in Fund Balance and a Balance sheet. Following are the financial statements for the town of X Special Revenue fund for the year ended June 30, year (*Assumed number*):

Town of X –

**Special Revenue Fund Statement of Revenues, Expenditures and Changes in Fund Balance
For the year ended June 30, year 7**

Favourable	Budget	Actual	Variance (Unfavourable)
Revenues:			
Special Assessments	800,000	820,000	20,000
Other	<u> -</u>	<u>20,000</u>	<u>20,000</u>
Total Revenues	<u>800,000</u>	<u>840,000</u>	<u>40,000</u>
Expenditures			
Reimbursement of General Fund- expenditures			
	<u>750,000</u>	<u>760,000</u>	<u>(10,000)</u>
Excess of Revenues over Expenditures	.	.	.
(Fund Balance End of year)-----	<u>50,000</u>	<u>80,000</u>	<u>30,000</u>

Town of X Special Revenue fund

Balance Sheet

June 30, year 7

Assets

Cash ----- 220,000

Liabilities and Fund Balance

Payable to General fund ----- 140,000

Fund Balance Designated for Reimbursement of General fund ---- 80,000

 Total Liabilities and Fund Balance ----- 220,000

Chapter Summary

Except for extraordinary or special item expenses, expenses generally are reported by function or program. **Direct expenses** - those that are specifically associated with a function or program should be reported on the line for that function or program. **Indirect expenses** - those that are not directly linked to an identifiable function or program - can be reported in a variety of ways.

Reporting in the net (expense) revenue format requires a government to distinguish carefully between **program revenues** and **general revenues**. *Program revenues* are reported in the functions/programs 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 any specific function or program and thus are reported in a separate section at the bottom of the statement.

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. It is extremely important in governmental accounting that expenditures do not exceed appropriations. The budget is legally binding, and exceeding it usually results in severe penalties.

Therefore, two special accounting safeguards have been installed for governmental entities:

1. Recording the budget at the beginning of the year
2. Recording of the purchase orders as placed

Inter fund transactions are transactions between different entities within the governmental unit. As such, they need to be recorded in two different sets of books. The five types of inter fund transactions include *Inter fund loans and advances*, *Quasi-external transactions*, *Reimbursements*, *(Residual) Equity Transfers*, and *Operating Transfers*.

SELF-ASSESSMENTS QUESTIONS

Part I: Multiple choice Questions

Choose the correct answer among the given alternatives.

1. Committing resources for a certain purpose not to use for serving further needs in fund accounting is termed as
 - a. Expenditure
 - b. Appropriation
 - c. Encumbrance
 - d. All
 - e. None
2. Which of the following is not the purpose of expenditure accounting?
 - a. Controlling in appropriate pace of spending
 - b. Controlling unwise spending
 - c. Controlling misapplication of assets
 - d. Controlling illegal spending
 - e. None
3. One of the following is not a safeguard to keep spending within the budget
 - a. Budget recording
 - b. Encumbrance
 - c. Expenditure
 - d. B and C
 - e. All
 - f. None
4. The correct journal entry when the properties of non tax payers are seized?
 - a. Tax receivable delinquent ----- xxx
 Tax lien receivable ----- xxx
 - b. Tax receivable current ----- xxx
 Cash ----- xxx
 - c. Tax lien receivable ----- xxx
 Tax receivable delinquent ----- xxx

Penalty and interest ----- xxx

- d. All
 - e. None
5. The two exceptions for the governmental expenditure principle are
- a. Supplies when initially recorded as Asset
 - b. Supplies when initially recorded as expenditure
 - c. Long term debts
 - d. B and C
 - e. A and C
 - f. None
6. The correct journal entry when office rent is paid in governmental fund is?
- a. Expenditure ----- xxx
 Cash ----- xxx
 - b. Encumbrance ----- xxx
 Reserve for encumbrance ----- xxx
 - c. Estimated Revenue ----- xxx
 Appropriation ----- xxx
 Fund Balance ----- xxx
 - d. Rent Expense ----- xxx
 Cash ----- xxx
 - e. None
7. The initial transfer of cash from the General Fund in order to establish an Internal Service Fund would be recorded in the general fund as credit to Cash and debit to
- a. Due from Internal Service Fund
 - b. Equity transfer out
 - c. Operating transfer out
 - d. All
 - e. None
8. Which of the following do represent best combinations?
- a. Unwise spending → too slow &/or too quick spending
 - b. Illegal spending → personal usage of government resources

- c. Inappropriate pace → exceeding the total legal appropriation
 - d. Misapplication of assets → using resources for unauthorized government purpose
 - e. All
 - f. None
9. The balance of estimated revenues account of a governmental fund is eliminated when
- a. the budget is recorded
 - b. the budgetary accounts are closed
 - c. expenditures are closed
 - d. property taxes are recorded
 - e. none
10. The reserve for encumbrance account of a governmental unit is decreased when
- a. The vouchers are paid
 - b. A purchase order is approved
 - c. Ordered supplies are received
 - d. Appropriations are recorded
 - e. None

Part II: Workout Questions

Provide neat and clear answer for the following question.

Q1. The following transactions are carried out by the General Fund of the municipality of Agoura city in the year 2004

Jan.1 Budget is recorded for estimated revenue, \$800,000 and appropriation of \$700,000. **Jan 2.** Tax levy is sent to citizens for total balance of \$ 600,000 to be paid on May 31. 2% of the total amount is expected to be uncollectible

Jan 31. Purchase order is issued for acquisition of Supplies, \$100,000

Feb. 12. The entity transfers \$ 20,000 for debt service fund to assist its operation

May 31. Only 70% the citizens meet their obligation

June 30. Vehicle for \$200,000 is ordered

July 10. 3/5th of the supplies ordered are received for \$58,000

July 31. 40% of the delinquent customers become collectible. For being delayed they are obliged to pay 12% flat penalty and 15% interest on the unpaid balances.

August 15. Vehicle is received for \$225,000

Sept 1. Rent is paid, \$250,000

Dec 15. The entity loaned CPF, \$25,000

Dec. 31 The entity seized the properties of non payers Dec 31. The seized properties are sold for \$140,000

Dec. 31 The fund is closed

Required: Record the above transactions

CHAPTER FOUR

ACCOUNTING FOR CAPITAL PROJECT FUNDS

Learning Objectives

At the end of this chapter, learners should be able to:

- ❖ *Explain the nature of Capital Project Funds*
- ❖ *Describe source of finance for Capital Project Fund*
- ❖ *Understand how to keep journal entries for Capital Project Fund*

Introduction

Dear learner, capital projects funds are for construction or acquisition of governmental long lived assets. Usually such undertakings need huge financing. And it is common for governments to involve in to long term borrowings. For the repayment of the principal of these long term debts along with their interest, therefore, Debt Service Funds are to be maintained. In this chapter you are going to be acquainted with the nature, financing source and accounting treatments of both Capital Project and Debt Service funds.

4.1. Accounting for General Capital Projects Funds (CPFs)

General Concept of CPFs

CPFs are established to account for resources that are to be used to acquire major *long-lived capital facilities*. As with other funds, they are useful for holding resource managers accountable, thereby helping to assure that the resources for such projects are used legally and in the most economical manner. Further, they should provide information for *legal compliance* as well as sound *financial management*, and enable good *reporting* to resource providers.

It is important to note that *not all fixed asset* acquisitions are accounted for in Capital Projects Fund'. The *acquisitions* of *smaller fixed assets*, such as cars, office equipment, and the like, are usually recorded in the *General Fund*. It is also possible that a construction project could simply have a subsidiary ledger within the General Fund rather than its own distinct fund. The existence of the CPF, as any other fund, will depend on the legal requirements, and the need for good financial management.

CPFs *exist* only for the *period* of *acquisition/construction* of the fixed asset. After the acquisition/construction is completed, the CPF will be abolished. If the governmental unit has a number of capital projects going on at the same time, they might be accounted for together in one CPF. If the governmental entity has capital projects going on continuously, the capital projects fund would be more or less perpetual. After completion of the acquisition or construction the asset, the asset itself will be accounted for in the General Fixed Asset Account Group (GFAAG).

4.2. Classification of General Capital Assets

The capital asset classifications shown in Illustration 5–2 are typical of those used by state and local governments. Additional or similarly named accounts may be needed to better describe the asset classes of any given governmental entity. As discussed previously in this chapter, general capital assets typically are those acquired using the financial resources of a governmental fund. Many of these assets, however, are not used exclusively in the operations of any one fund, nor do they belong to a fund. Consider, for example, that general capital assets include courthouses and city halls, public buildings in general, the land on which they are situated, highways, streets, sidewalks, storm drainage systems, equipment, and other tangible assets with a life longer than one fiscal year. The following paragraphs present a brief review of generally accepted principles of accounting for each category of capital assets based on applicable GASB and Financial Accounting Standards Board (FASB) standards.

Land

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

Buildings and Improvements Other than Buildings

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

The determination of the cost of buildings and improvements acquired by purchase is relatively simple, although some peripheral costs may be of doubtful classification. The price paid for the assets constitutes most of the cost of purchased items, but legal and other costs plus expenditures necessary to put the property into acceptable condition for its intended use are proper additions.

The same generalizations may be applied to acquisitions by construction under contract; that is, purchase or contract price plus positively identified incidentals, should be capitalized. The determination of the cost of buildings and improvements obtained through construction by some agency of the government (sometimes called **force account construction**) is slightly more difficult. In these cases, costs should include not only all direct and indirect expenditures of the fund providing the construction but also materials and services furnished by other funds.

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

Equipment, or Machinery and Equipment

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

Construction Work in Progress

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

Infrastructure Assets

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

they believed the immovable and nontransferable nature of such assets made financial information about them of limited value for stewardship or decision-making purposes. In its basis for conclusions in GASBS 34, the GASB argued that failure to recognize the benefits associated with investment in capital assets (including infrastructure) in the statement of net assets, while recognizing the long-term debt incurred to acquire the capital assets, would result in a misleading net assets deficit. GASB further argued that the cost of using capital assets (in the form of depreciation) should properly be included in determining the full costs of conducting governmental programs.

Intangible Assets

Intangible assets are defined by the GASB as capital assets that lack physical substance, have a useful life of more than one reporting period, and are nonfinancial in nature. Examples of government intangible assets include patents, copyrights, easements, water rights, and computer software. The GASB standards allow for recognition of intangible assets if the asset is separable or if the asset arises from contractual or other legal rights.⁸ An asset would be considered separable from the government if, for example, it could be sold, transferred, or exchanged, either individually or in combination with a related asset, liability, or contract. Because intangible assets are considered general capital assets, all guidance related to general capital assets is applicable.

General Capital Assets Acquired under Capital Lease Agreements

As will be explained in some detail in Chapter 6, state and local governments generally have limits on the amount of long-term debt they may issue. Consequently, governments that are reaching their legal debt limit often use leases to acquire capital assets.

FASB Statement No. 13 (SFAS 13) defines and establishes accounting and financial reporting standards for a number of forms of leases, only two of which, operating leases and capital leases, are of importance in governmental accounting.⁹ GASB standards accept the SFAS 13 definitions of these two forms of leases and prescribe accounting and financial reporting for lease agreements of state and local governments.¹⁰ If a particular lease meets any one of the following classification criteria, it is a **capital lease**.

- . The lease transfers ownership of the property to the lessee by the end of the lease term.
- . The lease contains an option to purchase the leased property at a bargain price.
- . The lease term is equal to or greater than 75 percent of the estimated economic life of the leased property.

Financing a Capital Project

Capital Projects obviously need large amounts of financing. Typical sources of financing include long-term debt, grants from other governmental units, transfers from other funds within the governmental entity, interest income from temporary investments, gifts from individuals or foundations (common for NGOs), special taxes, or a combination of more than one of those.

As with the GF and SRFs, intergovernmental grants, gifts, special taxes and investment interest are considered revenues and are presented that way on the Statement of Changes. Inter-fund transfers and Long Term debt proceeds are not revenues, and are presented as other financing sources in the financial statements. Whether to have a separate capital fund for each project or to account for all capital projects in one fund depends in part, on what type of financing is involved. Different bond issues and different intergovernmental transfers might well have different legal requirements, and each might require a separate capital projects fund. On the other hand, if one bond issue is used to finance several projects, a single fund may be both permissible and advisable. If there is more than one CPF, then combining financial statements will be issued.

The focus of the CPF is the entire life of the project. It is by definition an expendable fund, and all its resources are expected to be used up. However, CPFs do not have the same year-by-year focus as the General Fund. Capital projects often last more than one year, even up to three, four or five years. Because of the multi-year focus of CPFs, some accountants prefer not to close a CPF annually, but others do. *Whether or not to close the CPF annually will depend on the unique features of each case. In addition, it will be strongly influenced by the requirements of the financing source.*

QUICK CHECK

1. Define capital project fund.
2. List the source of finance for capital project fund.

4.3. Methods to acquire general capital assets

Means of Acquisition: There are **THREE** basic ways to acquire the asset:

1. Outright purchase from fund cash
2. Construction by the government's own work force
3. Construction by a private contractor

Costs included all expenditures for getting the project ready are put in the CFP, including architect fees, transport costs, damages, etc.

Encumbrances:- Because the amounts involved in a capital project are usually large, an encumbrance account is highly recommend, and is very necessary in the case of multi *subcontractors* for a project.

Retained Percentage:- It is common in construction contracts for the entity to hold back a portion of the last payment of the contract. This is to prevent the contractor from doing poor quality work, especially in a rush to finish at the end. Basically, the entity will pay part of the final sum having its own engineers come and inspect the contractor's work. If the contractor's work passes this inspection, the balance of the amount owed is paid. If the engineers find poor quality or undone Work, the contractor must then correct the problem before the final retained sum is paid. The amount withheld is known as *Retained percentage*.

QUICK CHECK

1. Explain what mean by retained percentage?
2. List the three basic ways to acquire the asset:

4.3. Illustration on capital project fund/ CPF/

Consider the building of a bridge. The bridge will cost 1,000,000 Birr and will belong to the Southern Regional State. The Road Transport Authority will contribute 100,000, the EEC will contribute 250,000, the General Fund (**GF**) of the state will contribute 100,000, interest on temporary investments will add another 50,000 and a 10 year 10% bond will be issued by the state for the rest. Construction will be done by Dawit Negussie Corp., a private contractor. Equal payments will be made each month, except for the final month, when 10 % of the final bill will be retained pending until final inspection. Construction is to begin in January 20x1, and require one year completing.

1. If **Budgetary Accounting** is desired, the following entry will be made:

Estimated Revenue from RTA	100,000
Estimated Revenue from EEC	250,000
Estimated Revenue from Investments	50,000
Estimated Bond Issue Proceeds	500,000
Estimated Transfer from GF	100,000
Appropriations	1,000,000

2. The bond issue is sold for a Birr 1,000 premium and **agreements** are **signed** with the **grantors** (RTA, EEC & SNNPR) agencies.

Cash	501,000
Due from RTA	100,000
Due from EEC	250,000
Due from General Fund	100,000
Revenue from RTA	100,000
Revenue from EEC	250,000
Bond Issue Proceeds	501,000
Operating Transfer from GF	100,000

3. By **law**, the **premium** on the sale of the bond **in this case** is required to be **transferred** to **Debt Service Fund(DSF)** that will be used pay off the bond issue.

Operating Transfer to DSF	1,000
Cash	1,000

4. The **contract** is **signed** with Dawit Negussie Corp.

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

5. **Checks** are **received** from each of the **grantor** agencies and from the **SNNP- GF**

Cash	450,000
Due from RTA	100,000
Due from EEC	250,000
Due from General Fund	100,000

6. The cash from *bond issue proceeds* and grants that are not needed immediately are *invested in a short-term interest bearing account*, which pays 12% annually.

Investments	800,000	
Cash		800,000

7. At the end of one month, Dawit Negussie Corp. *sends a bill* for 83,333, one twelfth of the total. The encumbrance for that amount will be reversed.

Reserve for Encumbrances	83,333	
Encumbrances		83,333

Expenditures	83,333	
Contracts Payable		83,333

8. Cash is *withdrawn* from the *investment* to pay the *bill* from Dawit Negussie Co.rp.

Cash	83,333	
Investments		83,333

Contracts Payable	83,333	
Cash		8,333

9. The first month's interest on the investment is paid.

Investments	8,000	
Interest Income		8,000

10. In December, Dawit Negussie submits its *final bill*. 10% (ten percent) is *retained*, pending final inspection by the State's engineers.

Reserve for Encumbrances	83,333	
Encumbrances		83,333

Expenditures	83,333	
Contracts Payable		75,000
Contracts Payable — Retained Pct.		8,333

Contracts Payable	75,000	
Cash		75,000

11. Assume that the total interest from investments over the year was Birr 45,000, and that the Fund is to be closed at December 31. The closing entries will be:

□ **Close the *budgetary* accounts.**

Appropriations	1,000,000	
Estimated Revenue from RTA		100,000
Estimated Revenue from EEC		250,000
Estimated Revenue from Investments		50,000
Estimated Bond Issue Proceeds		500,000
Estimated Transfer from General Fund		100,000

□ **Close the *revenue and expenditure* accounts.**

Revenue from RTA	100,000	
Revenue from EEC	250,000	
Bond Issue Proceeds	501,000	
Operating Transfer from General Fund	100,000	
Interest Income	45,000	
Fund Balance	5,000	
Expenditures	1,000,000	
Operating Transfer to Debt Service Fund	1,000	

Note that in this example, Expenditures equal Appropriations, so the entire amount for appropriations is closed. In a CFP that goes beyond 1 year, only expended appropriations are closed. This is because the CFP has a project focus, and the appropriation made at the beginning of the project is meant to last for the entire project. This is different from the General fund where appropriations typically expire at the end of a fiscal year and are closed whether appropriation typically expire at the end of a fiscal year and are closed whether expended or not

The *balance sheet* should look like this on December 31.

Bridge Project
Balance Sheet
December 31, 20x1

Assets

Cash 3,333

Liability and Fund Balance

Contracts Payable —Retained percent 8,333

Fund Balance (5,000)

Total Liability and Fund Balance 3,333

Bridge Project

The Statement of *Revenues, Expenditures* and *Changes in Fund Balance*

December 31, 20x 1

	Actual	Budget	Variance
Revenues and other financing sources:			
<i>Revenues:</i>			
Grant from EEC	250,000	250,000	0
Grant from RTA	100,000	100,000	0
Interest Income	<u>45,000</u>	<u>50,000</u>	<u>(5,000)</u>
Total Revenues	395,000	400,000	(5,000)
 <i>Other financing sources:</i>			
Proceeds from Bond Issue	501,000	500,000	1,000
Transfer from General Fund	<u>100,000</u>	<u>100,000</u>	<u>0</u>
Total Other Financing Sources	<u>601,000</u>	<u>600,000</u>	<u>1,000</u>
Total Revenue & Other Financing Sources	<u>996,000</u>	<u>1,000,000</u>	<u>(4,000)</u>
Expenditures and other financing uses:			
<i>Expenditures</i>	1,000,000	1,000,000	0
<i>Transfer to Debt Service Fund</i>	<u>1,000</u>	<u>0</u>	<u>(1,000)</u>
Total expenditures & Other Fin. Use	(1,001,000)	1,000,000	(1,000)
 Excess (<i>Deficit</i>) of revenue and other financing			
Sources over expend. & other fin, uses	<u>(5,000)</u>	<u>0</u>	<u>(5,000)</u>
Beginning Fund Balance	0	0	0

QUICK CHECK

1. Where should we record Assets acquired or constructed via Capital Project Funds? Why?
2. How are deficits to be handled in Capital Project Funds?
3. What should be done when there is surplus at the end of construction?

Appendix: This is a table showing how the investment income was calculated. It assumes that the investment was withdrawn in equal amounts throughout the year. The final total is rounded for the Statement of Changes to make the arithmetic simpler.

Interest Rate = 10 %

Month	Total Invested	Monthly Interest	Monthly Withdrawals
January	800,000	8,000.00	83,000
February	725,000	7,250.00	83,000
March	649,250	6,492.50	83,000
April	572,743	5,727.43	83,000
May	495,470	4,954.70	83,000
June	417,425	4,174.25	83,000
July	338,599	3,385.99	83,000
August	258,985	2,589.85	83,000
September	178,575	1,785.75	83,000
October	97,360	973.60	83,000
November	15,334	<u>153.34</u>	
Total		45,487	

Chapter Summary

CPFs are established to account for resources that are to be used to acquire major *long-lived capital facilities*. As with other funds, they are useful for holding resource managers accountable, thereby helping to assure that the resources for such projects are used legally and in the most economical manner. Further, they should provide information for *legal compliance* as well as sound *financial management*, and enable good *reporting* to resource providers.

There are **THREE** basic ways to acquire the asset:

1. Outright purchase from fund cash
2. Construction by the government's own work force
3. Construction by a private contractor

It is common in construction contracts for the entity to hold back a portion of the last payment of the contract. This is to prevent the contractor from doing poor quality work, especially in a rush to finish at the end. Basically, the entity will pay part of the final sum having its own engineers come and inspect the contractor's work. If the contractor's work passes this inspection, the balance of the amount owed is paid. If the engineers find poor quality or undone Work, the contractor must then correct the problem before the final retained sum is paid. The amount withheld is known as *Retained percentage*.

SELF-ASSESSMENTS QUESTIONS

1. Describe how and which kind of activities is accounted for in a Capital Projects Fund.

2. Discuss the concept of budgeting in CPF and its difference with that of GF and SRF.

3. Describe the use of investment as a source of financing in CPF.

4. Explain how financial reporting are made in that of CPF in contrast that of GF.

5. Describe the sources of financing in a CPF by indicate the major and most common sources.

6. Explain the treatments for the remaining residual balance or for a deficit after the Construction of a major capital facility by a CPF.

CHAPTER FIVE

ACCOUNTING FOR DEBT SERVICE FUNDS

Learning Objectives

At the end of this chapter, learners should be able to:

- ❖ Explain how to handle deficit/ surplus
- ❖ Explain how to close Capital Project Fund
- ❖ Explain nature Debt Service Funds
- ❖ Understand the different types of Long term debts
- ❖ Know accounting treatment for serial and term bonds

Know how to close Debt Service Fund

5.1. General Long term liabilities

Debt instruments backed by the full faith and credit of the government are known as general obligation debt: they are obligation of the government not of the individual funds. Usually such types of loans are to be paid from collection of taxes not from the resources of specific fund. The proceeds of general long term debts are to be used by many governmental funds. These are debts that need the establishment of debt service funds for their settlement. And General Long Term Debt Account Group is created to bring such debt under accounting control. All long term debt not serviced by the revenue of a proprietary fund or non expendable trust fund is accounted for by the GLTDAG. But long term debts of proprietary funds backed by the full faith and credit of the government and for which government is contingently liable might be accounted for in this account group. In such cases the contingent liability should be disclosed in a note to the financial statements.

Liability accounts have credit balances and in GLTDAG, though there is no asset assigned to it, debit balances should be maintained. The debit balance accounts that offset the long term liabilities are of two categories:

1. Amounts accumulated in the debt service funds for repayment of general long term debt
2. Amounts that must be provided in future years for repayment of long term debt accounted for by the GLTDAG

5.2. Debt service fund

From time to time, governmental entities have a shortage of cash to carry out their activities. In such cases, governmental entities may turn to borrowing to supply the needed cash. This is especially true when cash is needed for capital projects. The size of the project typically means that cash cannot be easily obtained by taxes or other means of generating revenue. When money is borrowed, there should be a plan to repay it, and the resources which have been designated to repay the debt with its interest should not be used for any other purpose. For the purpose of administering the repayment plan, and to keep separate resources designated for the payment of the debt and its interest, the Debt Service Fund (DSF) was created. Often DSFs are legally mandated. Other times, the government administrator might think a DSF is useful for management of resources being accumulated for debt service.

5.3. Types of governmental Bonds

Bond — a written promises to pay a specified principal sum at a specified future date, usually with interest at a specified rate. They are typically issued in \$1000 and \$5000 denominations.

There are two basic types of bonds, term and serial.

Term bonds - the entire principal is payable at a single specified maturity date.

Serial bonds- have periodic maturities, for example, the principal of a regular serial bond is payable in equal installments over the life of the issue.

Notes are less formal, which have one date of payment, like term bonds, and may be issued for periods of *one month up to five years*. **One note** is issued for the *entire amount*, unlike bonds, which are issued in smaller denominations.

QUICK CHECK

1. Discuss the nature and type of Debt Service Funds
2. Differentiate bonds and notes
3. Differentiate term and serial bonds?
4. Describe the different sources of revenue for Debt Service Fund

5.4 Illustration on debt service/ Sample Entries/

Let us continue with the bridge example introduced with CPFs, and assume that a Debt Service Fund is created to pay off the 1,000,000 bond. Assume further that a toll is charged to all users of the bridge, and that the tolls are to be used to pay off the bond. Assume first that it is a regular serial bond, to be repaid in annual amounts of birr 150, 000. Tolls are expected to be 155,000 each year and are to be accounted for directly in the DSF. Entries for a regular serial bond are simpler than those for a term or other type of bond. Three scenarios will be considered: a regular serial bond, a term bond, and finally additional entries needed if the debt is being repaid from the collection of special assessments.

1) Debt Service Fund for Regular Serial Bond Issue.

If Budgetary Accounting is to be used:

Estimated Revenues	155,000
Appropriations	150,000
Fund Balance	5,000

Toll Revenue will be recorded on a monthly basis, and will fluctuate according to the number of cars and trucks that cross it. It will probably not be accrued. Assume that 13,000 Birr was collected in the first month of use.

Cash	13,000
Toll Revenue	13,000

The fund becomes liable for the payment to be made on bond principal at year-end.

Expenditures	50,000
Matured Bonds Payable	50,000

Note that this is *different* from for-profit accounting. In for-profit accounting, a liability account, such as Bonds Payable, would be debited for the repayment of debt. In a debt service fund, expenditures are debited for the repayment of the debt.

The fund becomes liable for payment of bond interest at year-end.

Expenditures	100,000
Matured Interest Payable	100,000

Payment is made for principal and interest.

Matured Interest Payable	100,000
Matured Bonds Payable	50,000
Cash	150,000

The typical accounts are closed to Fund Balance at year-end: The Budgetary Accounts (Estimated Revenues and Appropriations) and Revenues and Expenditures.

2) Debt Service Fund for a Term Bond Issue

Accounting for a term bond issue is slightly more complicated. If the bond is a term bond, funds must be set aside for repayment of the principal at the end (sinking fund), as well as providing resources for periodic interest payments.

Assume that the bond is issued for 20 years at 12% annual interest. A sinking fund will be established to repay the principal in 20 years. The sinking fund will be invested in marketable

securities yielding 10% per year. This bond will be paid off by periodic transfers from the General Fund, rather than by taxes or tolls that go directly into the DSF. The annual amount to be put into the sinking fund can be figured by use of a present value table, a financial calculator, or a computer spreadsheet. (A model of a sinking fund is found in the Appendix to this handout.

To record the budget: This entry is for the second year of the sinking fund. Sinking fund payments are normally made at the end of the year, so the first year would have no earnings. Note that the account titles are somewhat different from the budgetary accounts of the other funds we have studied, although they could have been combined into one entry to “Estimated Revenues.”

Required Additions	137,460	
Required Earnings	1,746	
Appropriations		120,000
Fund Balance		19,206

Required additions are the **payment** into the sinking fund plus the interest to be paid to the bond holders this year. $(17,460 + (1,000,000 \times 12\%))$ Required earnings is the amount expected to be earned from the investment $(17,460 \times 10\%)$.

Next, the annual transfer is made from the General Fund.

Cash	137,460	
Transfer from General Fund	137,460	<i>Marketable</i>

securities yielding 10% per year are purchased.

Investments	17,460
Cash	17,460

Note that if the rate of interest earned on the investment drops during the life of the sinking fund, a greater amount will need to be invested each year to yield the same amount.

Interest on the investment is recognized by accrual.

Interest Receivable	1,746
Interest Earnings	1,746

Interest to be paid out to bond holders this year is recorded.

Expenditures	120,000
Matured Interest Payable	120,000

Note that in the DSF for a term bond. No entry is made for Matured Principal Outstanding, because it will **all** be paid at the end. This is different from a serial bond, where part of the principal is repaid periodically.

The accounts to be closed at year-end are the same as above, except that the Operating Transfer from General Account will also need to be closed.

3) Debt related to Special Assessments

The primary difference to be considered for special assessment debt is the source of its financing. Assume a project to install water pipes to a new area of the city. The project cost 500,000 Birr. It is to be repaid over 10 years, with 8% interest on unpaid installments. Assume a regular serial bond. The receivable for special assessments needs to be recognized. Assessments to be paid in the current year are treated differently from those to be paid in later years.

Assessments Receivable - Current (10% = 1 year)	50,000	
Assessments Receivable - Deferred (9 years)	450,000	
Revenues		50,000
Deferred Revenues		450,000

Current assessments, along with interest on deferred assessments are collected.

Cash	86,000
Assessments Receivable - Current	50,000
Interest Earnings (8% * 450,000)	36,000

Payment of principal and interest uses the same entries as above, i.e debit expenditure, and credit cash.

The portion of the special assessment that becomes due in the next year needs to be reclassified.

Assessments Receivable - Current	50,000
Assessments Receivable - Deferred	50,000

Appendix: Accumulation of sinking fund with interest (10% per year)

		Annual addition to fund	Interest Earned	Amount of fund at year-end
Year 1	1999	17,460		17,460.00
Year 2	2000	17,460	1,746.00	36,666.00
Year 3	2001	17,460	3,666.60	57,792.60
Year 4	2002	17,460	5,779.26	81,031.86
Year 5	2003	17,460	8,103.19	106,595.05
Year 6	2004	17,460	10,659.50	134,714.55
Year 7	2005	17,460	13,471.46	165,646.01
Year 8	2006	17,460	16,564.60	199,670.61
Year 9	2007	17,460	19,967.06	237,097.67
Year 10	2008	17,460	23,709.77	278,267.43
Year 11	2019	17,460	27,826.74	232,554.18
Year 12	2010	17,460	32,355.42	373,369.59
Year 13	2011	17,460	37,336.96	428,166.55
Year 14	2012	17,460	42,816.66	488,443.21
Year 15	2013	17,460	48,844.32	554,747.53
Year 16	2014	17,460	55,474.75	627,682.28
Year 17	2015	17,460	62,768.23	707,910.51
Year 18	2016	17,460	70,791.05	796,161.56
Year 19	2017	17,460	79,616.16	893,237.72
Year 20	2018	17,439	89,323.77	1,000,000.00

Reserve for encumbrance ----- xx

c. Appropriation ----- xx

Voucher payable ----- xx

d. All

e. None

4. Bonds with periodic maturities are called

a. Term bonds

b. Serial bonds

c. Special assessment bonds

d. Notes

e. None

5. One of the following is not among the methods to deal with surplus resources left at the close of capital project fund

a. Transfer to the Debt Service Fund for retiring the bonds

b. Retain for future maintenance

c. Return to resource providers

d. All

e. None

Part II: Work Out Questions

Provide neat and clear answer for the following workout questions.

1. Lucy governmental organization plans to build a city hall with an estimated cost of \$3,000,000 in the current budget year. The construction is to be financed as follows; grants from Ministry of Inland Revenue \$950,000, USAID 1,250,000, transfer from the general fund 350,000 and for the remained balance bonds are issued. The construction is supposed to begin on January and will be completed by one year time. Construction is to be done by **Abash** Construction (a private contractor). It is agreed that equal payments will be made at the end of each month except for the final month where 12% of the final bill will be retained awaiting final inspection.

Required: Pass the necessary journal entries to record the following transactions that take place for the life of the contract.

- a. Budgetary accounts are recorded
 - b. The bond is issued at \$30,000 premium
 - c. The premium is transferred to DSF for repayment of governmental LTD
 - d. Agreement is signed with the grantor agencies & the general fund
 - e. The contract is signed with **Abash Construction**
 - f. Checks are received from each grantor agencies & the general fund
 - g. At the end of the first month, **Abash** sends a bill and get paid
 - h. After the completion of the contract **Abash** sends the last bill.
 - i. The fund is closed
2. Assume that Malta municipality had issued a 20 years, 15% term bond for \$2,000,000. The money is planned to finance construction of high way across the town. This bond will be paid off by periodic transfers from the General Fund, rather than by taxes or tolls that go directly into the DSF. Sinking fund is established to repay the principal in 20 years. Resources in the sinking fund are invested in marketable securities yielding 12% per year.

Required: based on the information given record the following transactions

- a. Budget is recorded
 - b. The annual transfer is made from the General Fund
 - c. Marketable securities yielding 10% per year are purchased.
 - d. Interest from investment is collected
 - e. Interest to be paid out to bond holders this year is recorded.
3. Assume the data given on question number 2 above, except the bond is serial. Toll revenue is charged from beneficiaries to repay the liability, which amounted in the year, \$425,000.

Required: Record the necessary journal entry to record the possible transaction of the fund

CHAPTER SIX

Accounting for general long term assets and general long term liabilities

Learning Objectives

At the end of this chapter, learners should be able to:

- ❖ Explain the nature of General Fixed Assets Account Group
- ❖ Know how to keep journal entries for General Fixed Assets Account Group
- ❖ Know how to handle acquisition, use and disposal of general fixed assets
- ❖ Know the relation between Capital Project Fund and General Fixed Asset Account Group
- ❖ Explain the nature of General Long Term Debt Account Group
- ❖ Know how to keep journal entries for General Long Term Debt Account Group
- ❖ Know accounting treatment for general obligation bonds
- ❖ Know the relation between Debt Service Fund and General Long Term Debt Account Group

6.1. Nature of general long term assets and Liabilities

Dear students, as we discussed in the previous chapter capital projects funds are maintained to account resources designated for construction or acquisition of governmental long lived assets. These assets are usually long lived; that would serve for more than one year and benefit many governmental funds. They are not resources for current year consumption – not expendable. So it is difficult to record them in one of the governmental funds. Hence, we have a separate account group, only to keep record of these assets, called General Fixed Asset Account Group. Likewise, such undertakings need huge financing usually financed by long term governmental borrowings. These long term debts do not represent resources of current year consumption, nor benefit specific fund. So, similar to general fixed assets they should be recorded separately in General Long Term Debt Account Group. Therefore, in this chapter we will see the nature and accounting treatment of both account groups.

6.1.1. General long term assets

General fixed assets are all assets used for general government purposes, including land, buildings, equipment's, and etc. with the exception of fixed assets acquired by proprietary funds and some fiduciary funds, all fixed assets are recorded in the general fixed asset account group. These general purpose fixed assets are also recorded as expenditures in the governmental funds. Governmental fixed assets are generally defined as tangible items that will be used for more than a year or operating cycle. Governmental entities usually establish a threshold to distinguish between fixed assets, repairs or current assets (supplies). But the threshold may be different from one entity to the other. In conformity with GAAP, general fixed assets are recorded at acquisition cost (or fair market value at the time of receipt if the assets are received by donation). If the cost of fixed assets was not recorded when the assets were acquired and is unknown when accounting control over the assets is established, it is acceptable to record them at estimated cost. Cost of general fixed assets includes

- ❖ Legal and title fees
- ❖ Appraisal fees
- ❖ Site preparation; including demolition
- ❖ Freight
- ❖ Closing costs
- ❖ Installation costs
- ❖ Interest and insurance during construction

GFAAG is only an accounting entity, not a fiscal entity- it can take no transaction by itself. It helps to keep records regarding one of the transactions of a fund; general fixed assets. It records no current assets and no liabilities of any type. So it is not fund, nor equivalent to fund.

The offset to the fixed asset accounts is the set of equity accounts that indicate the sources from which the fixed assets were acquired. Investment in General Fixed Assets from Capital Project Funds – Bonds or Investment in General Fixed Assets from General Fund Revenue are examples of typical equity accounts of a GFAAG. Balance sheets of this account group display the total cost of each category of general fixed assets and the total amount contributed by each source used for the acquisition of these fixed assets. Unlike for profit entities, governmental entities have an option of reporting infrastructure assets: canals, dams, streets, sidewalks, bridges etc.

QUICK CHECK

1. What are General Fixed Assets? And General Fixed Asset Account Group?
2. GFAAG is only an accounting entity, not a fiscal entity. Explain.

6.1.2. General Long Term Debt Account Group (GLTDAG)

Debt instruments backed by the full faith and credit of the government are known as general obligation debt: they are obligation of the government not of the individual funds. Usually such types of loans are to be paid from collection of taxes not from the resources of specific fund. The proceeds of general long term debts are to be used by many governmental funds. These are debts that need the establishment of debt service funds for their settlement. And General Long Term Debt Account Group is created to bring such debt under accounting control. All long term debt not serviced by the revenue of a proprietary fund or non expendable trust fund is accounted for by the GLTDAG. But long term debts of proprietary funds backed by the full faith and credit of the government and for which government is contingently liable might be accounted for in this account group. In such cases the contingent liability should be disclosed in a note to the financial statements.

Liability accounts have credit balances and in GLTDAG, though there is no asset assigned to it, debit balances should be maintained. The debit balance accounts that offset the long term liabilities are of two categories:

Amounts accumulated in the debt service funds for repayment of general long term debt

Amounts that must be provided in future years for repayment of long term debt accounted for by the GLTDAG

6.2.2. Records for and Reporting of General Long Term Debt

Record keeping for general long term obligations begins when the debt is issued. A separate file should be established for each debt issue. The file should disclose the general description of the debt, the covenants, if applicable, debt service requirements, call provisions, if any, and maturity, issuance or call dates. All correspondence related issues should also be disclosed. The file should be maintained and updated until the debt matures and the obligation is paid in full.

GLTDAG is included in the combined balance sheet, but the statement provides information only about broad classes of debt and the total amounts to be provided for repayment or available in the debt service fund. Other than increasing or decreasing the obligation balances, no transactions are reported in the account group; therefore, no operating statement is prepared.

Supplementary schedules are far more useful than balance sheet to financial statement users. One of Such schedule shows the changes in the general long term debts. Changes in each type of debts and the related debits are displayed for an entire fiscal year. And another shows comparative data for consecutive periods. The debit and credit balances are displayed for each type of debt. This type of schedule helps information users assess the total changes in debt and comparative amounts available or to be provided, to pay the entity's total obligations.

6.2. Accounting for general long term assets

6.2.1 Acquisition, Use, Additions and Betterments and Disposal Acquisition

Unless acquired by gift, fixed assets are recorded at cost. Cost includes all set up and transportation charges. If acquired by gift, fair market value is used. The entry to record purchase of general fixed assets is made when the expenditure occurs in the governmental fund. For example, if general fund expends \$100,000 on equipment, the entries are

On the books of the GF

Expenditure	100,000	
	Cash (A/P)	100,000

One the books of GFAAG

Equipment	100,000	
	Investment in General Fixed Assets from GF	100,000

The credit side of the GFAAG entry explains the character of the debit, that is, an investment, and the source of the funds –general fund. If the asset were gift no expenditure entry would be made in the general fund books.

For constructed assets, the amounts expended are initially recorded in the capital project fund. At the end of each period or when construction is completed an entry is made in the GFAAG. If the entry is made annually, the account title used during construction is construction in progress, when construction is completed; the cost is transferred to an asset account. For example if a building is constructed over two years with \$80,000 expended in the first year and \$120,000 in the second year, the following entries are made in the books of GFAAG:

Year 1	Construction in progress	80,000	
	Investment in General Fixed Assets from CPF		80,000
Year 2	Building	200,000	
	Investment in General Fixed Assets from CPF		120,000
	Construction in progress		80,000

But if the entry is made when construction is completed, the only entry to be made in the GFAAG is

Year 2	Building	200,000	
	Investment in General Fixed Assets from CPF		200,000

Lump sum purchases

When several assets are acquired together for a single price, allocation of the total cost is made to the individual asset accounts in the same manner as the for profit entities do. The purchase price is allotted among the assets in relation to each one's proportional share of the total market value.

Use of the Assets (Depreciation)

The general use of general fixed assets does not decrease financial resources and consequently has no relevance in the accounting for governmental funds. But, depreciation is hotly arguing issue in governmental arena.

Depreciation is an expense account to be matched against revenue in the income statement. It is cost expired for generating additional income for the entity. Bur governmental funds have no revenue to generate through the use of these general fixed assets. And the cost is already recorded as expenditure when the assets are acquired. So there no need of recognizing or recording depreciation. But it is calculated merely to simplify and give information for the preparation of fixed asset replacement, repair and maintenance schedules.

Some argue that the issue can be accommodated by simply showing the accumulated depreciation in the general fixed asset account group. If an entity suits this option, at the end of each year it will record the following entry in the books of GFAAG:

Investment in General Fixed Assets from CPF/GF	20,000	
Accumulated Depreciation Building		20,000

Disposal for Cash

Disposal of fixed assets for cash increases fund financial resources. The fund receiving the cash debits ash and credit miscellaneous revenue or other financing sources. The gain or loss in disposition does not change financial resources; so will not be regarded. For example if equipment costing \$150,000 and showing accumulated depreciation of \$120,000 is sold for \$50,000; the entry in GFAAG would be:

Investment in General Fixed Assets from CPF/GF	30,000	
Accumulated depreciation	120,000	
Equipment		150,000

If the entity does not use the option of showing depreciation, the entry would look like:

Investment in General Fixed Assets from CPF/GF	150,000	
Equipment		150,000

Disposal -Trade in

Some assets are not sold outright but traded for newer items. The value of the asset is recorded in the GFAAG and the amount of expenditure in the GF. In such situations there two options to record the exchange:

1. **Net method**
2. **Gross method**

Assume the following details relate to purchase involving a trade in

Book Value of Old Asset	100,000
-------------------------	---------

Cash paid from GF	350,000
Invoice price of New Asset	500,000

The net method: record the cash paid in addition to the trade in expenditure

On the books of GFAAG

Investment in General Fixed Assets from GF	100,000
Equipment	100,000
Equipment	500,000
Investment in General Fixed Assets from GF	500,000

On the books of GF

Expenditure	350,000
Cash	350,000

2. The Gross method: record the value of the new asset as expenditure and recognize another financing source for the fair value of the trade in.

On the books of GFAAG

Investment in General Fixed Assets from GF	100,000
Equipment	100,000
Equipment	500,000
Investment in General Fixed Assets from GF	500,000

On the books of GF

Equipment	500,000
Cash	350,000
Other Financing Sources – Trade in Proceeds	150,000

Additions and Betterment

Additions and betterment add to existing fixed assets by extending their lives, enhancing their value, or improving their efficiency. Accordingly, such expenditures should be increased the book value of the assets reported in the GFAAG. Most governmental entities have threshold to distinguish capital and repair and maintenance items.

6.2.2. Sample Entries

1. Office equipment is purchased for \$40,000 for the treasurer's office from the general fund resources

Equipment	40,000	
Investment in General Fixed Assets from GF		40,000

2. Building, \$1,540,000, constructed by government own forces are completed. The construction was financed by bond issue, \$1,040,000, and contribution from other Government units, 500,000 and handled by Capital project fund.

Building	1,540,000	
Investment in General Fixed Assets from CPF		
General obligation Bond		1,040,000
Contribution by other Governmental units		500,000

3. Construction expenditures of \$250,000 had been made on building project during the given year

Construction work in progress	250,000	
Investment in General Fixed Assets from CPF		250,000

4. Depreciation of \$75,000 is recorded on Equipment

Investment in General Fixed Assets from GF	75,000	
Accumulated Depreciation – Equipment		75,000

5. Assume the building from CPF is retired without revenue or expenditure to the governmental unit. Accumulate depreciation, 1,200,000.

Investment in General Fixed Assets from CPF	340,000
Accumulated Depreciation	1,200,000
Building	1,540,000

QUICK CHECK

1. What depreciation is not recorded in the books of GLDAG?
2. What are the two options to deal with disposal of general fixed asset
In exchange to other asset? Discuss.
3. What construction in progress account? When is it to be used?
4. How are additions and betterments to be treated?

6.3. Accounting for general long-term liabilities (GLTDAG)

Assume that at the end of 2008 Manila city had bonds outstanding for \$1,200,000 issued to finance construction of a fire station:

Assume that at the end of 2008 Manila city had bonds outstanding for \$1,200,000 issued to finance construction of a fire station

On the books of CPF

Cash	1,200,000
Bond proceeds	1,200,000

On the books of GLTDAG

Amounts to be provided for payment of bonds	1,200,000
Bonds payable	1,200,000

When the general long term debt matures it is transferred to the debt service fund and paid. The following entry is to be recorded:

On the books of GLTDAG

Bonds payable	1,200,000	
	Amounts provided for payment of bonds	1,200,000

On the books of DSF

Expenditure	1,200,000	
Matured bonds payable		1,200,000
Matured bonds payable	1,200,000	
Cash		1,200,000

QUICK CHECK

1. What is General Long term Debt? And General Long Term Debt Account Group?
2. Why should General Long Term Debts to be accounted in a separate account group?
3. What are the different schedules of GLTDAG? Explain what they would disclose.
4. Explain the relation of Debt Service Fund and GLTDAG.

Chapter Summary

General fixed assets are all assets used for general government purposes, including land, buildings, equipments, and etc. with the exception of fixed assets acquired by proprietary funds and some fiduciary funds, all fixed assets are recorded in the general fixed asset account group.

GFAAG is only an accounting entity, not a fiscal entity- it can take no transaction by itself. It helps to keep records regarding one of the transactions of a fund; general fixed assets. It records no current assets and no liabilities of any type. So it is not fund, nor equivalent to fund.

Debt Account Group is created to bring such debt under accounting control. All long term debt not serviced by the revenue of a proprietary fund or non expendable trust fund is accounted for by the GLTDAG. But long term debts of proprietary funds backed by the full faith and credit of the government and for which government is contingently liable might be accounted for in this account group. In such cases the contingent liability should be disclosed in a note to the financial statements.

Liability accounts have credit balances and in GLTDAG, though there is no asset assigned to it, debit balances should be maintained. The debit balance accounts that offset the long term liabilities are of two categories:

1. Amounts accumulated in the debt service funds for repayment of general long term debt
2. Amounts that must be provided in future years for repayment of long term debt accounted for by the GLTDAG

SELF-ASSESSMENTS QUESTIONS

Part I: Multiple choice Questions

Choose the correct answer among the given alternatives

1. Mr Belete donated a building to Arba Minch city. Belete's original cost was \$100,000. Accumulated depreciation at the date of gift amounted \$60,000. Fair market value at the date of the gift was \$250,000. At what amount should Arba Minch city record the donated building?
 - a. \$100,000
 - b. \$250,000
 - c. \$40,000
 - d. \$0
 - e. None
2. A statement required for general fixed asset account group is:
 - a. Statement of changes in financial resources

- b. Statement of operating results
 - c. Statement of changes in fund balance
 - d. Statement of changes in general fixed asset
 - e. None
3. The liability for proprietary fund bonds should be recorded in the
- a. General Fund
 - b. Capital Project Fund
 - c. General Long Term Account Group
 - d. Debt Service Fund
 - e. None
4. The general fixed asset account group is:
- a. An accounting entity
 - b. A fiscal entity
 - c. A legal entity
 - d. All of the above
5. Accumulated depreciation of general fixed assets:
- a. should be recorded in the books of governmental funds
 - b. may optionally recorded in the books of governmental funds
 - c. should be recorded in the books of General Fixed Asset Account Groups
 - d. all
 - e. none
6. General fixed assets should be recorded at
- a. cost
 - b. estimated cost, if cost is not practically determined
 - c. fair value if they are donations
 - d. all of the above
7. Proceeds of a general obligation bond issued for construction of civic center is to be recorded at
- a. General Fund
 - b. Debt Service Fund

- c. Capital Project Fund
 - d. General Long Term Debt Account Group
 - e. None
8. Liability of a general obligation bond issued for construction of civic center is to be recorded at
- a. General Fund
 - b. Debt Service Fund
 - c. Capital Project Fund
 - d. General Long Term Debt Account Group
 - e. None
9. If \$2,000,000 of the proceeds from issuance of general obligation bond is expended in the first year of the three year dam construction project, at the end of the first year the GFAAG should
- a. Make no entry, at all
 - b. Debit dam, and credit Cash
 - c. Debit construction in progress, credit investment in General Fixed Asset - CPF d.
All
 - e. None
10. Amount to be provided for retirement of general long term debt is an account of a governmental unit that would be included in the:
- a. Asset section of the general long term debt account group
 - b. Asset section of the debt service fund
 - c. Liability section of the general long term debt account group
 - d. Fund balance section of the general long term debt account group
 - e. None

CHAPTER SEVEN

ACCOUNTING FOR PROPRIETARY FUNDS

Learning Objectives

At the end of this chapter, learners should be able to:

- ❖ Explain the nature of principle of accounting for proprietary fund
- ❖ Justify Financial statements of proprietary funds
- ❖ Accounting treatment for Internal Service Fund
- ❖ Explain the nature of Enterprise Funds
- ❖ Understand the different accounts of Enterprise Fund
- ❖ Accounting treatment for Enterprise Funds

Introduction

Dear learner, unlike governmental funds which provide goods and service for the public, there are funds, proprietary funds, which provide goods and services on charge basis. But the charge should be reasonable and would only enough to cover operating costs and other maintenance and replacement needs of the fund. These funds are non-expendable and are equated to be equivalent with for profits entities. Hence, in this chapter we are going to see the accounting treatments of the two proprietary funds and their unique nature.

7.1. Accounting principles of proprietary funds.

All of the funds discussed in the previous chapters (GF, SRF, CPF, DSF) 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 facilities to aid in provision of services. It become apparent that efficiency should be improved if services used and given by several governmental units were combined in a single administrative unit. Internal Service Fund (ISF) and Enterprise Fund (EF) are both classified by the GASB as Proprietary funds. Internal service funds, as indicated on the principles of governmental accounting, are used to account for services provided by one department or Agency of a governmental unit to other department or

agencies, or to other governmental units on a user charge basis. Enterprise Funds are used by governmental units to account for services provided to the general public on a user charge basis. Enterprise Funds may also be used to account for any operations “where the governing body has decided that periodic determination of revenues earned, expenses incurred and/or net income is appropriate for capital maintenance, public policy, Management Control, Accountability or other purposes. Proprietary funds are accounted for in the same manner to investor owned Business Enterprise. Accordingly such funds recognize revenues and expenses (not Expenditures on the accrual basis. they account for all fixed assets used in their operations and for long term debt to be serviced from revenues generated from their operations as well as for all current assets and current liabilities. the equity account of proprietary funds are composed of

1. Contributed equity
2. Retained Earnings

Proprietary funds differ from Governmental funds in that they are not required by GASB standard to record the budget in their accounting system, which is treated as a managerial control device rather than a legislative control tool.

7.1.1. Internal Service Funds (ISF)

Internal Service Funds (ISF) arose to meet the need to offer services within the entity. ISFs are established to meet some need within the entity, if it is believed the entity can provide the service to itself in a more reliable or/and less expensive manner than obtaining the same service outside. An example, as noted before, is a common garage that repairs all the vehicles the entity regardless of which fund uses the vehicle. Another example is a central purchasing department. Note that internal service funds are especially common in NGOs which operate in Ethiopia.

Justification of Internal Service Funds

Generally speaking, the cost of an internal service fund should be less than the cost of purchasing the same service from an external provider. In some cases, the use of an internal service fund with a higher cost can be justified if it is thought that external service providers are unreliable. Even if the justification of the internal service fund is reliability, it is still important to know the cost of the services the ISF provides, in order to make good decisions regarding the fund.

With proprietary funds in general and ISFs in particular, the focus of the accounting system is different from that of expendable funds. You will recall that the focus of accounting in the expendable funds was keeping within the budget. In contrast, for *proprietary funds*, the accounting system should focus on providing sufficient information regarding cost. More specifically, the accounting system should be able to answer the following questions:

In practice, a decision might be made to subsidize the cost of an ISF from another fund. Perhaps a surplus in the general fund would subsidize the ISF in order to make it cheaper for other funds. A below cost charge could then be made by the internal Service Fund to the other funds, so that those other funds receive the service at a discount, and are thereby be able to operate their own funds at a surplus. The deficit in the ISF could then be covered from the General Fund. This may be an acceptable decision, but the exact amount of the subsidy needs to be known, and the bookkeeping system should be able to provide that information.

While cost savings are very important, and should be that focus of the accounting system, it is also important to keep in mind that there may be reasons to start an internal service fund other than just cost savings — and a number of Ethiopian NGOs have made this decision. One is perceived lack of skill on the part of external providers; another is the fear of theft and deceit on the part of external providers. A good example of this is an auto workshop. A number of NGOs have hired and trained their own mechanics, and stock their own parts, accounting for the activity in an internal service fund.

Two Cautions against Starting an Internal Service Fund

First of all, Internal Service Funds tend to become less efficient, and therefore more costly, over time. Once the ISF is established, administrators often tend to overlook it unless the other departments complain about its cost, or it runs a deficit. Lack of competition, along with job security, can lead to laziness on the part of the employees• of internal service funds. Giving individual departments within the entity the option to use the Internal Service Fund or go outside might helped to make Internal Service Funds more efficient. However, the dangers in this are two: One, the department managers might give business to their friends outside without considering the cost. Two: the salaries of the. Internal Service Fund still needs to be paid. If departments are going outside for the service, the employees of the ISF may be idle, leading to wastage of money.

Secondly, Internal Service Funds tend to be difficult to shut down, even when external circumstances have changed so as to make them no longer necessary. The biggest reason for this is that closing an Internal Service Fund costs one or more employees their jobs. The second reason is that a large investment might have been made in fixed assets which may be sold at a loss if the Fund is shut down.

Considerations in calculating the cost of an ISF

Pricing of the service to other departments is very important in the internal service fund. In a profit-seeking business, the main determinant of price is - WHAT THE MARKET WILL BEAR. However, since an internal service fund serves a “captive” market, and since it is ultimately meant to save money for the entity as a whole, pricing should be done according to the cost of providing the service. As was mentioned above, the price charged should be high enough to cover all the costs of the ISF, while being less expensive than purchasing outside. But what does “all the cost” mean? It means that the full cost must be considered, including “overheads” like depreciation, as well as “visible” costs like wages, supplies, etc. There are several approaches for the costing of assets used in the ISF. Depending on the situation, any one or a combination of these approaches may be used.

Historical cost: The cost is determined based on the historical cost, of both fixed assets and current assets like inventory, to the ISF. In applying this approach, it should be remembered that the amount of the historical cost can be calculated in different ways. For example, is the historical cost on inventory based on FIFO, LIFO, Average cost, or the specific identification method?

Replacement Cost: This method asks the question, “How much would it cost to replace the assets in the internal service fund at today’s prices?”

Interest opportunity cost: If the money required to buy assets for the internal service fund was invested instead in marketable securities, how much could be earned in annual interest?

Future replacement, upgrading and expansion of equipment: What are we going to have to pay in the future for new equipment when our current equipment wears out or becomes obsolete?

Closing an Internal Service Fund

As continual review is made of the ISP, it is quite possible to discover that either the ISF has become inefficient, and or that external conditions have changed significantly and that the ISF is no longer necessary or cost effective. At that point, the decision should be made to close the internal service fund. If the ISF is closed, what should be done with its assets and fund balance?

There are three basic ways in which to dispense with the ISF's assets, of course, its creditors are paid.

1. Transfer the fund's assets to another fund (like the General Fund) which will carry on the activity as its subsidiary.
2. Give the fund's assets in kind to another fund or entity.
3. Sell the assets of the fund and give the cash to another fund or entity.

Practically speaking there is often a deficit in an internal service fund which is closed down. Internal service funds aren't normally discontinued when they are running well and/or have a surplus fund balance. In actual fact, ISFs aren't usually reviewed on a regular basis as they should be; their performance is only reviewed if they begin to have deficits which attract the attention of management. In the case of a deficit, the ISF manager would probably be fired, a big fight would probably ensue, and in the end it would probably be the general fund which covered the deficit.

7.1.1.1. Accounting Issues

After the opening of the fund has been carefully considered, the next step is to set up the accounts for it to insure its accountability.

The ISF is a fiscal entity as well as accounting entity, and it will most likely be subject to legislative or board approval. Otherwise an ISF should be accounted for in virtually the same manner as a profit-seeking business. Note, however, that this may lead to conflict between the fund's manager, who wants to operate the fund according to his professional judgment, and the legislative body, which is accustomed to making a line item appropriation for each fund.

In starting the fund, the legislature or board should specify the source of financial resources for its beginning. The start-up money could be borrowed by bonds, but more likely internal financing will be used. This financing could be an internal advance (to be repaid) or an internal contribution (not repaid). All concerned, including the accountant, should be clear at the beginning about whether the start-up money represents an advance or a contribution.

Fixed assets are sometimes given to the ISF in kind, either instead of or in addition to cash. This is especially done at the time of start-up, although it may be done after establishment of the ISF. These donated fixed assets should be recorded at fair market value (FMV) as of the date of the gift. If fixed assets are purchased for cash, they should, of course, be recorded at historical Cost. If a grant is given specifically for the purchase of fixed assets, it should be recorded as contributed equity, not as revenue. Note that this is different from governmental funds where a grant for fixed assets is recorded as revenue, the same as a grant received for operations.

As was mentioned earlier, cost is the focus of ISF accounting, rather than budgetary control. A budget should be prepared as management tool, as in a for-profit business. However, budgets are not usually formally recorded in the books of account for ISFs. Since the entity does not use budgetary accounting, it follows that encumbrances are also not normally recorded in an ISF. *Expenses* (not expenditures) are recorded in an ISF. These expenses are often divided by function in an internal service fund. For example, if the ISF was established to handle office supplies it will have three basic functions— Purchasing, Warehousing, Delivery, as well as Administration. The expenses will be divided and reported on in these categories. For example, rather than reporting “Salary Expense,” the salaries will be divided up by the different functions. Depreciation is normally recorded in an ISF and it would be similarly divided. Also, any inventory adjustments required by the physical count would be counted as a Warehousing expense.

In keeping with their similarity to profit-seeking entities, ISFs not only record expenses (not expenditures) and fixed assets (including depreciation) as noted above; they also record longterm liabilities, if any, **on their own books**. They also have retained earnings in their equity accounts. In contrast to profit-seeking entities,

However, ISFs may have contributed equity from other governmental funds. This contributed equity should keep. Separate from retained earnings on the balance sheet. ISFs don't have owner's equity, because they are owned by the governmental entity as a whole, not by individual investors.

7.1.1.2. Illustrative entry for proprietary propriety funds/ISF/

To start the fund, the General Fund gives cash of 50,000 (contribution - not to be repaid) and its supplies inventory of 80,000 to the 1SF. The first entry on the ISFs books is:

Cash	50,000
Inventory of Supplies	80,000
Equity Transfers In	130,000

On the books of the General Fund, the following entry would be needed. Note that this equity transfer. It is a one-time transfer, not expected to be repeated.

Equity transfers out	130,000
Cash	50,000
Inventory of Supplies	80,000

Next, the DSF of the entity has extra cash in its sinking fund. Rather than invest this cash externally, and force the 1SF to borrow from outside, it loans the money to the 1SF (advance - it will need to be repaid).

Cash	200,000
Advance from DSF	200,000

Next the entity purchases a suitable building, and equipment for carrying out its function. Note that these purchases are not expenditures, as would have been the case for a governmental fund. The purchases are recorded as fixed assets, just as they would have been if they had been purchased by a profit-seeking entity.

Buildings	200,000	
Equipment	30,000	
Cash		230,000

Next it “sells” 50,000 Birr worth of its inventory to other funds. Cost data have been studied, and it is determined that a markup of 40% on the cost of the supplies that it purchases will be sufficient to cover its other costs - wages, depreciation, administration, etc. A perpetual inventory system will be used. A Billings to Departments account will serve the function of the “Sales” account which would be used in a private business.

Cost of Supplies Issued	50,000	
Inventory of Supplies		50,000

Due from General Fund	70,000	
Billings to Departments (Cost x 140%)		70000

The General Fund settles its obligation in cash at a later date. The General Fund would, of course, charge Expenditures on its books.

Cash	70,000	
Due from General Fund		70,000

The ISF purchases 70,000 Birr worth of supplies for its inventory with cash:

Inventory of Supplies	70,000	
Cash		70,000

Various expenses are paid by the ISF.

Administrative Expenses	2,000	
Purchasing Expenses	3,000	
Warehousing Expenses	2,000	
Cash		7,000

Supplies worth 40,000 are “sold” to other funds. Cash is paid at delivery.

Cost of Supplies Issued	40,000	
Inventory of Supplies		40,000
Cash	56,000	
Billings to Departments (Cost x 140%)		56,000

The DSF's advance is partly re-paid (\$20,000)

Advance from DSF	20,000	
Cash		20,000

Depreciation is recorded on the Building and Equipment on the straight-line method, it is charged as each function uses them.

Administrative Expenses	3,000	
Purchasing Expenses	5,000	
Warehousing Expenses	8,000	
Allowance for Depr-Bldg		10,000
Allowance for Depr-Equip		6,000

The fund is closed at year-end. Note the use of the account title "Excess of NetBillings over costs "rather than" Income summary"

Billings to Departments	126,000	
Cost of Supplies Issued		90,000
Administrative Expenses		5,000
Purchasing Expenses		8,000
Warehousing Expenses		10,000
Excess of Net Billings over Costs		13,000
Excess of Net Billings over Costs	13,000	
Retained Earnings		13,000

QUICK CHECK

1. What make(s) ISF different from for profit entities?
2. What is the base of classification of expenses in ISF?
3. What is Billing to Departments account?

7.1.2. Enterprise Funds

Enterprise funds (EF), like internal service funds, are proprietary funds. The fundamental difference between the two funds is that while ISF, provide service within the governmental entity, Enterprise fund provide services to the general public. Enterprise funds provide service on a user-pays basis. EFs provide services that are either should not be, cannot be, or otherwise are not provided by for-profit entities. The difference between EFs and governmental funds is that governmental funds typically provide service to citizens as needed (e.g. the police) regardless of the citizens ability to pay, while EFs provide services on the basis that the user of the service pay at least part of the cost. Common examples of enterprise funds include public utilities (e.g. water, sewer, electricity, etc.). National parks, hospitals, airports, and public transportation may also be accounted for in enterprise funds. EFs are accounted for in virtually the same way as for-profit businesses. They use full accrual accounting and are self-contained, i.e., they account for their fixed assets and long- term liabilities.

Similar to a business, regular budgets are extremely useful in enterprise funds for the sake of good management. Normally these budgets are not formally entered in the ledger as budgetary accounts. (Note that sometimes budgetary accounts are required by law.) One key difference between enterprise funds and businesses is that an enterprise fund may be partially subsidized by transfers from other governmental funds. Therefore, it will want to account for earnings from operations separately from transfers from other governmental entities.

7.1.2.1. Key points in accounting for enterprise (esp. public utility) funds.

It very common example of an enterprise fund in the USA is a public utility, e.g. water, sewage, electricity, etc. Because they are so common, many accounting texts use utility accounting to illustrate enterprise funds. While the author is not certain as to whether or public utilities are accounted for as enterprise funds in Ethiopia, they nevertheless form a convenient example. Most other Enterprise Funds would be less complicated than utilities, so the principles learned can easily be applied to any other type of enterprise fund.

Assets

Accruals are important for some enterprise funds public utilities in particular. Utilities can't normally read all the meters on the last day of the month, so they either:

- 1) Prepare an estimated or nominal bill each month, reading the meter every few months and calculate the exact bill when the meter is read, or
- 2) They read meters continuously during the month, and stagger the bills through the month (for example 21 June to 20 July, or 05 May to 04 June). This is called cycle billing.

In either case, there will often be a large amount of revenue to accrue at year-end, For example, if the fiscal year is from January to December, and the meter is read on December 2, 29 days usage would need to be estimated and recorded as accrued income. The Accrual Entries should, of course, be reversed as the first entry for the New Year, in the same way as for-profit accounting.

Construction in Progress is shown as an asset on the books of the enterprise fund. (Note that this is different from a Capital Projects Fund.) Interest for the construction is capitalized — it is not shown as interest expense.

Liabilities

Deposits Public Utilities typically require deposits from their customers. There are two types of deposits 1) Deposits for security and 2) Deposits for constructions-

Deposits for security are often required by a utility before beginning service to a new customer.

These deposits are security to prevent the customer from moving away without paying his final

bill. The deposit must be returned to the customer when the last bill is paid, so these deposited should be separated from current liabilities and listed as Liabilities payable from restricted assets. It may be wise (or even required by law) to have a separate **cash** account strictly for deposits.

Deposits for construction are amounts paid by customers to help finance construction. As far as the author knows, to date this type of customer deposit finance has not been employed in Ethiopia, but perhaps it should be considered as a means of alleviating the chronic shortage of electricity in the country! Examples of construction that may be partly or wholly financed by customer deposits are a new water purification plant, a new electricity generation plant, or new transmission facilities such as pipes or wires. This type of deposit is normally put in current liabilities, although they may be restricted in the same manner as deposits for security. Depending on the Utility's policy, these deposits may be either 1) refunded or 2) applied to subsequent bills or 3) kept by the utility after the construction is finished. If they are not refunded or applied to subsequent bills, they should be reclassified to **Contribution from customers** after completion from the project.

Long-term debt: **Revenue bonds** might be issued to finance construction long-term assets. Revenue bonds are secured by future billings of the utility. General obligation bonds (secured by full faith and credit of governmental entity) might be also be used. General obligation bonds would ordinarily be accounted for in the GLTDAG, but if they are expected to be serviced by the revenues of the enterprise fund, they will be carried on the enterprise fund books. General obligation debt that is carried on the enterprise fund books should also be disclosed by note as a contingent liability to the GLTDAG.

Inter fund Loans and Advances. Sometimes an enterprise fund will be given an Advance from the General Fund or other governmental fund. An advance is different from a contribution in that an advance must be paid back. If the advance is payable within one year, it is a current liability, if it is payable after more than one year, it is long term debt.

Fund Equity

The fund equity of an enterprise fund will include both Retained Earnings and Contributed Equity.

Retained Earnings: What is the appropriate level of Retained Earnings for an Enterprise Fund?

Operating Revenues should cover operating expenses, debt service, and routine capital projects. Retained earnings should not normally accumulate beyond those levels. If they do, the citizens will probably complain that they are being overcharged for the service. On the other hand, if Operating Revenues do not cover the aforementioned, then a subsidy will likely be required from the General Fund. Such a subsidy would probably prove politically unpopular. Retained earnings should therefore be monitored to ensure that it is neither too large nor too small.

The retained earnings in an enterprise fund may be reserved for a certain for example, for future debt service. Reservations of retained earnings are shown on the balance sheet.

Contributed Equity differs from an advance, in that it need not be repaid. Contributed Equity (which would be called an Equity Transfer Out on the books of the paying fund) can come from another unit of the government, or it can be from customers (see deposits for construction above). A particular type of contributed equity is Contributed Capital. These are contributions restricted to acquisition and construction of capital assets. The accounting complication with these contributions is in regard to depreciation. Depreciation Expense on the assets purchased with contributions may either be closed to Retained Earnings, or to the Contributed Equity account. The theory is that since the contributions do not have to be repaid, they should not affect the operating performance of the fund. In any case, all the types of contributions should be shown separately under the heading of contributed Equity on the balance sheet.

Expenses

Since a government entity can't really charge taxes to itself, it may have its enterprise funds pay some agreed Contribution in lieu of taxes to the governmental entity. This would be considered as an operating expense for the enterprise fund, and revenue for the receiving fund.

Enterprise funds may use functional division for expenses. In other words, expenses are classified by what you get, rather than what you spent. For example, the following expense categories may be used for a Water Supply Enterprise Fund: Source of Supply, Pumping, Transmission and Distribution (pipes), Administrative, etc, rather than the "natural" expense categories such as salary expense, rent expense, etc.

QUICK CHECK

1. What make(s) EF similar to ISF? What make(s) them different?
2. What makes different from governmental funds?
3. What is cycle billing?

7.1.2.2. Illustrative entry for proprietary propriety funds/ enterprise fund/

The entries in an enterprise fund are almost identical to a business or an internal service fund only the entries related to a grant for the purchase of a capital asset are illustrated here, because they are somewhat different from those of a business or an internal service fund.

A grant is made for the purchase of a capital asset.

Cash	100,000
Contributed Capital	100,000

That grant

is put into a restricted asset account.

Construction Grant Account	100,000
Cash	100,000

The capital asset is purchased.

Equipment	100,000
Construction Grant Account	100,000

Depreciation is

taken on the capital asset.

Depreciation Expense	10,000
Accumulated Depreciation	10,000

Depreciation expense is closed. (**It could be closed to Retained Earnings.**)

Contributed Capital	10,000
Depreciation Expense	10,000

7.2 Financial Statements of proprietary funds

There are really only four points to make about Enterprise Fund financial statements, as they differ from FP statements.

- 1) The Balance Sheet may contain Contributed Equity. This comes in the Equity section just before retained earnings. (In the same place that stockholders' equity would be found in an FP Balance Sheet.)
- 2) The second Balance Sheet item is restricted assets, as noted above with the capital contribution grant. These restricted assets appear as the last item in the asset section of the balance sheet.
- 3) The, operating is titled Statement of Revenues, Expenses, and Changes in Retained Earnings. This mimics the inclusion of Changes in Fund Balance in the operating statement for expendable funds.
- 4) Retained Earnings are divided into Reserved and Unreserved on the operating statement. The Balance Sheet shows total Retained Earnings.

QUICK CHECK

1. What is deposit for construction? What is its special purpose?
2. Contributed capital is different from Owners' Equity. Discuss.

Chapter Summary

Internal Service Funds (ISF) arose to meet the need to offer services within the entity. ISFs are established to meet some need within the entity, if it is believed the entity can provide the service to itself in a more reliable or/and less expensive manner than obtaining the same service outside.

Historical cost: The cost is determined based on the historical cost, of both fixed assets and current assets like inventory, to the ISF. In applying this approach, it should be remembered that the amount of the historical cost can be calculated in different ways. For example, is the historical cost on inventory based on FIFO, LIFO, Average cost, or the specific identification method?

Replacement Cost: This method asks the question, “How much would it cost to replace the assets in the internal service fund at today’s prices?”

Interest opportunity cost: If the money required to buy assets for the internal service fund was invested instead in marketable securities, how much could be earned in annual interest?

Future replacement, upgrading and expansion of equipment: What are we going to have to pay in the future for new equipment when our current equipment wears out or becomes obsolete?

Enterprise funds (EF), like internal service funds, are proprietary funds. The fundamental difference between the two funds is at while ISF, provide service within the governmental entity, Enterprise fund provide services to the general public. Enterprise funds provide service on a user-pays basis. EFs provide services that are either should not be, cannot be, or otherwise are not provided by for-profit entities.

SELF-ASSESSMENTS QUESTIONS

Part I: Multiple choice Questions

Choose the correct answer among the given alternatives.

1. When an ISF is closed its assets will be
 - a. Transferred to another fund which will carry on the activity as its subsidiary.
 - b. Given in kind to another fund or entity to employ to realize its own objectives.
 - c. Sold and the Cash would be given to another fund or entity
 - d. All
 - e. None
2. Enterprise Funds are different from Internal Service Funds, because they
 - a. are proprietary funds
 - b. provide service within the governmental entity,
 - c. provide services to the general public
 - d. use accrual basis of accounting

- e. All
 - f. None
3. One of the following is not element of fund equity of an enterprise fund
- a. Retained earning
 - b. Owners equity
 - c. Contributed capital
 - d. All
 - e. None
4. If Deposits for construction are not refunded or applied to subsequent bills, they should be reclassified as
- a. Liability
 - b. Revenue
 - c. Contribution from customers
 - d. Assets
 - e. All
 - f. None
5. One should think thoroughly before opening an ISF. This is because
- a. Internal Service Funds tend to become less efficient
 - b. Internal Service Funds tend to be difficult to shut down
 - c. They are profitable undertakings
 - d. A&b
 - e. All
 - f. None

Part Two: Work Out

Provide neat and clear answer for the following workout questions.

1. XZ governmental unit has an internal service fund that use perpetual inventory system and compute any depreciation based on straight line method. Besides, all expenses of the fund are assigned to Administrative, Purchasing and Warehousing departments at 3:5:2 ratios.

Record the following selected transaction carried out in the year 2007.

- i. To start the fund the General Fund of the organization transfers cash of \$300,000
- ii. DSF of the entity loaned, extra cash in its sinking fund, to the ISF, \$250,000.
- iii. SRF transfers supplies of 100,000 to the ISF.
- iv. The ISF purchases additional Supplies for \$130,000.
- v. The ISF purchases building, and equipment for carrying out its function for \$215,000 and \$45,000 respectively. It is estimated that the building will have a 20 years useful life; and the equipment 8 years. No salvage value to the building but \$3,000 for the Equipment.
- vi. The ISF sales 80,000 Birr worth of its inventory to General Fund. Markup of 25% on the cost of the supplies will be sufficient to cover its other costs.
- vii. The General Fund settles its obligation in cash at a later date.
- viii. Expenses are paid, \$20,000.
- ix. Supplies worth 120,000 are sold to other funds. Cash is paid at delivery.
- x. Half of the DSF's advance is paid
- xi. Depreciation is recorded on the Building and Equipment.
- xii. The fund is closed at year end.

CHAPTER EIGHT

Accounting for fiduciary funds

Learning Objectives

This unit indicates the fiduciary funds and the different types of funds under this category.

There are 4 types of Fiduciary Funds:

1. Agency Funds
2. Expendable Trust Fund
3. Nonexpendable Trust Funds
4. Pension trust Funds

The four types of funds will be discussed in brief since a detail discussion of these Fund types is beyond the scope of the course, but the student should at least be aware of their existence and nature.

After completion of this unit, the student should be able to;

1. Clearly understand the concept of Fiduciary funds
2. Determine and analyses between Trust and Agency funds.
3. Explain theoretical and other important issues related to these funds.

8.1 Features of fiduciary funds

The principle indicates that “Fiduciary Funds account for assets held by governmental unit, acting as trustee or an agent for individuals, organizations, other governmental units or other funds of the same governmental unit”. For that reason fiduciary funds are often identified in governmental financial report as **Trust and Agency Funds**. Generally, the word agent indicates some body or a person who acts on behalf of another. Trustee means someone

holding legal title to property but is not its beneficial owner. They may not profit from their position, but act for the benefit of the beneficiary, who is the real owner of the property. The term fiduciary also means one who acts not for his own profit but to safeguard the interest of another. In law there is a clear distinction between an Agency relationship and a Trust relationship. In accounting practice, the legalistic distinctions between Trust Funds and Agency Funds are not of major significance. The important and perhaps the sole consideration from an accounting stand point is: what can and what cannot be done with the fund's asset 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. In fact the word trusts and Agency funds are frequently omitted from the titles of funds in this classification. Examples are "Public Employees Retirement System". And "Condemnation and Grading Fund": the former, a Trust fund, the later, an Agency Fund, each classified according to the circumstances under which its assets are held. It is sometimes said that practical basis for distinguishing between the two types is the length of time specific assets are held. But this is not a wholly reliable guide, since there is no generally recognized pronouncement stating the maximum time restriction for holding assets to constitute an Agency Fund; nor is there a minimum time to constitute a fund of the trust variety. As suggested earlier if not explicitly stated, the exact name of designation of a given fund is of little significance in establishing its accounting procedure and limitations. This depends on the enactment that brought about creation of the 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, statement of purposes of the fund, kinds and amounts of assets held and others. This aggregate of factors, or such as are applicable to a given fund, determines the transaction in which it may and should engage.

8.2 Accounting principles of fiduciary funds

GASB standard provides as one of the four types of Fiduciary funds, Agency funds. Agency funds are used to account assets held by a governmental unit acting as agent for one or more other governmental unit 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 belongs 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.** Typically, there are no Revenues, Expenditure or Expenses recognized by an Agency Fund. GASB's standard require Agency fund to use the modified accrual basis of accounting. As with Governmental Funds, unless an agency fund is required law or administrative decision, the funds which are held maybe simply accounted for within governmental or Proprietary funds. Even if the nature of the case is fiduciary, if the agency relationship is only incidental (not vital or essential), no agency fund is needed. For example, Payroll tax withholdings from deductions from salary until payment to the tax authority need no special agency fund, even though their nature is fiduciary.

Agency Fund for Special Assessment Debt Service - A *Special Assessment* is a compulsory levy made against a certain property to defray part or all of the cost of a specific improvement or service that is presumed to be of general benefit to the public and a particular benefit to the property against which the special assessment is levied. GASB's standard specify that a governmental unit which has no obligation to assume debt service on special assessment debt in the event of property owners' default, but does perform the functions of billing property owners for the assessments, collecting instalment of assessments and interest on the assessment, and from the collections, paying interest and principal on the special assessment debt, should account for those activities by use of an Agency Fund. if the special assessment debt is special-special assessment debt, then the government acts only as an agent to collect the special assessment and pay the creditors. The government as a whole does not take

responsibility for the debt. The collections and payments of it should therefore be accounted for in an Agency Fund.

Tax Agency Funds - An agency relationship that does, logically, result in creation of an agency fund is the collection of Taxes, or other Revenues, by one governmental unit for the several of the funds it operates and for other governmental units.

To record the assessment of the taxes, the collecting fund may deduct a fee (often a percentage of the amount collected) in order to cover its cost of collecting the taxes:

Mailing bills, Receiving Payments, bookkeeping, etc... (This is Revenue for the collecting fund). If the fee deduction is assumed to be a certain percentage, the remaining percentage balance amount will be payable to the funds for which the taxes are collected.

Cash and Investment Pools- Earnings on pooled investments and gains or losses on sales of investments are allocated to the funds having an equity in the pool in proportion to their relative contributions to the pool. To ensure an equitable division of earnings, gains and losses, it is customary to revalue all investments in the pool, and all investment being brought into the pool or removed from the pool, to market value as of the time that investments of a fund are being brought into or removed from the pool. (Some pools carry investments at market, revaluing them daily).

8.3 Accounting for trust funds and agency funds

Trust funds differ from agency funds primarily in degree. Frequently a trust fund is in existence over a longer period of time than an agency fund; it represents and develops vested interest to a greater extent and it involves more complex administrative and financial problems.

An important reason as to why governmental units accept assets in trust is that the donation of assets to be used to produce income for some cultural or educational purpose. The donations are sometimes made at the death of a person, as part of the will. Other times, they are made while the person is still living. For example, suppose a wealthy elderly person wants his name to be remembered long after his death, he could make a large donation to an organization,

insisting that the donation be invested in an income generating Investment. Each year the income could be used for different humanitarian or other developmental activity, while the principal is reinvested to earn income for the years, which follow. These types of donations are called **Endowment Funds**.

The basic idea of an Endowment Fund is that the principal must be held intact, either forever or for a predetermined length of time, so that it continually produces income for the desired purpose. The principal is therefore **Nonexpendable**. The income generated by the principal is to be used according to the trustor's purposes, so it is **Expendable**. Since the nature of the principal and the income is different, accounting treatment in separate fund is required.

The Pension Trust Funds on the other hand are expendable for a specified purpose in both principal and income, retirees may be paid from both. They are account for like a proprietary fund. Pension Trust Funds are sometimes called - Public Employee Retirement Systems (PERS) when a pension trust fund is considered to be part of the governmental reporting entity, its financial data are included in the combined financial statements and the combining financial statements prepared for fiduciary funds accounted for on the full accrual basis.

Accounting for pension trust Funds should be distinguished from the governmental unit's responsibility as an employer to account for Expenditures, Expenses and liabilities related to Pension plans, and to disclose in the notes to the financial statements a long list of items specified in GASB's statements. Reporting requirements are complex and are in a process of change. Further, reporting requirements vary depending on whether the plan is administered by a unit of the reporting entity or by another entity. The GASB's disclosure standards are based on the conclusions that the primary objectives of pension disclosures by Pension Trust Funds and governmental employers is to provide users with information needed to assess:

- A. Funding Status of a Pension Trust Fund on a Going-concern Basis,
- B. Progress made in accumulating sufficient Assets to pay Benefits when due,
- C. Whether Employers are making actuarially determined contributions.

Check Your Progress

1. Explain the concept of Fiduciary funds in relation to Governmental Accounting.

2. Compare and Contrast Agency and Trust funds

3. Describe how the collection of Taxes would be accounted for in Fiduciary Funds.

4. Discuss the similarities and differences between Expendable and nonexpendable Trust Funds.

5. Explain the concept of an Endowment Fund as part of the Trust fund.

6. Explain the nature of the accounting characteristics of Fiduciary Funds and their resemblance with that of Gov`tal funds and Proprietary Funds.

SUMMARY

Full treatment of accounting and reporting requirements for both governmental employers and pension trust funds particularly is considerably beyond the scope of this course. This unit is intended to introduce the topic and present a general overview of current standards and concepts of fiduciary Funds.

CHAPTER NINE

ACCOUNTING FOR NON PROFIT ORGANIZATIONS (NPOs)

Learning Objectives

At the end of this chapter, learners should be able to:

- ❖ Explain what is Non Profit Organization
- ❖ Describe types of Non Profit Organizations
- ❖ Describe the characteristics of Non Profit Organizations
- ❖ Describe types of funds for Non Profit Organizations
- ❖ Identify the different accounts of unrestricted current fund

8.1. Introduction

Dear learner, so far we have discussed accounting treatments for governmental funds and entities. In this chapter we are going to see accounting for Non Profit Organizations. These are NFPs not owned by government. They are, like governmental entities, not profit driven and operate just to serve the vital needs of the society through provision of goods and services for the general public usually for free. Their accounting treatments and fund types are somewhat similar with the governmental entities, with some difference in naming. Yet, the nature, characteristics and types of funds for Non Profit Organizations are discussed.

A Non Profit Organization is a legal and accounting entity which is operated for the benefit of society as a whole, rather than the benefit of an individual proprietor or a group of partnership or shareholders. Thus, the concept of net income is not meaningful for Non Profit Organizations.

Instead, they strive only to obtain revenue sufficient to cover their operating expenses.

Non profit organizations comprises off Colleges, Universities, Voluntary Health and Welfare Organizations, Foundations, Professional Societies and Civic Organizations, Museums, Religious Organizations etc.

8.2. Characteristics of Non Profit Organizations

Non Profit Organizations are hybrids in certain respects. They have some characteristics comparable to those of governmental entities, and other characteristics similar to those of business enterprises.

Characteristics Comparable to Governmental Entities

1. Service to the society – Non Profit Organizations render services to society as a whole. Like the service rendered by governmental units, the services of Non Profit Organization are of benefit to the many rather than the few. Members of the society can range from a limited number of citizens of a community to almost entire population of a city, state or nation.
2. No profit Motivation – Non Profit Organizations do not operate with the objective of earning a profit. Consequently, they are exempted from income taxes.
3. Financing by the citizen – like government units, most Non Profit Organizations depend on the general population for the substantial portion of their revenue, because charges for their services are not designed to cover all their operating costs. The citizenry's contributions to government revenue are mostly involuntary taxes, but their contributions to Non Profit Organizations are voluntary donations.
4. Stewardship for resources – because of the substantial portion of the resources of Non Profit Organizations are donated, the organizations must account for the resources on a stewardship basis similar to that of governmental entities. The stewardship requirement makes fund accounting appropriate for most Non Profit Organizations as well as governmental entities.
5. Importance of budget – the above characteristics of Non Profit Organizations causes their operating budget to be as important as for governmental entities. Non Profit

Organizations may employ a traditional, performance, planning and programming or zero base budgeting.

Characteristics Comparable to Business Enterprises

1. Governance by board of directors – like a business entities, Non Profit Organizations are governed by elected or appointed directors, trustees or governors.
2. Measurement of cost expiration – governance by board of directors means that Non Profit Organizations do not answer to lawmaking body as does a governmental unit. One consequence is that cost expiration or expense rather than expenditure usually are reported in the operations statement of Non Profit Organizations. Allocation of expenses (including depreciation) and revenue to the appropriate accounting period is a common characteristic of Non Profit Organizations and business enterprises.
3. Use of Accrual basis of accounting- Non Profit Organizations employ the same accounting technique used by business enterprises.

8.3. Accounting for Non Profit Organizations

The basic accounting unit for most Non Profit Organizations is fund. Separate funds are necessary to distinguish between assets which may be used as authorized by the board of directors and assets whose use is restricted by donors. Funds commonly used by Non Profit Organizations include the following:

- ✓ Current Fund
 - Unrestricted Current Fund ○
 - Restricted Current Fund
- ✓ Endowment Fund
- ✓ Agency (Custodian) Fund
- ✓ Annuity and Life Income Fund
- ✓ Loan Fund

- ✓ Plant, Land, Building and Equipment Fund

1. Current Funds

Funds maintained to account resources to be used for the entire operations of the organizations (in realizing the main objectives of the entity).

Unrestricted Current Fund

In many respects, the unrestricted fund of a Non Profit Organization is similar to the General fund of the governmental unit. The Unrestricted fund includes all the assets of a Non Profit Organization which are available for use as authorized by the Board of Directors and which are not restricted for specific purposes.

Assets and Liabilities of Unrestricted Current Fund

The balance sheet of a Non Profit Organization typically represents the assets, liabilities and fund balances of each fund either one below another or in adjacent column. Most assets and liabilities of a Non Profit Organization's unrestricted funds are similar to the current assets and liabilities of a business enterprise. Cash, Investments, Account Receivables, Receivables from Other Funds, Inventories, and Short term prepayments are typical assets of an unrestricted funds

Plant assets should be accounted in separate funds. The liabilities of unrestricted funds include Payables, Accruals and Deferred Revenues comparable to those of business enterprise, as well as Payables to other Funds accounts.

Revenues of Unrestricted Current Fund

The revenues of unrestricted fund of a Non Profit Organization are derived from a number of sources. For example, a hospital derives unrestricted fund revenue from patient services, educational programs, research and other grants, unrestricted gifts (donations) etc. A university's unrestricted fund revenue includes student tuition and fees, governmental grants, private grants etc.

Donated Merchandises and Services

In addition to cash Non Profit Organizations receive donations of merchandises and services from public. For example, a hospital may receive free drugs. The donated merchandises should be recorded in the inventory account in the unrestricted fund.

Donated services should be recorded in the unrestricted fund as salary expense, with an offset to a revenue accounts if the services are rendered to the Non-Profit Organization in an employee employer relationship. The value assigned to services should be the going salary rate for comparable salaried employees of the entity, less any meals or other living costs absorbed for the donor of the services by the Non-Profit Organization.

Pledges

A pledge is a commitment by a prospective donor to contribute a specific amount of cash to a Non-Profit Organization at a future date or in installments. Because the pledge is written and signed by the pledgor, it resembles in form the promissory note used in business. However, pledges generally are not enforceable contracts.

Under the accrual basis of accounting, unrestricted pledges are recorded as receivables and revenue in the unrestricted fund of a Non Profit Organization, with appropriate provisions for uncollectible.

Expenses of Unrestricted Current Fund

The expenses of unrestricted funds are similar in many respects to those of business enterprises – salaries and wages, supplies, research, maintenance and etc. Depreciation should be recorded as an expense by a Non Profit Organization in each accounting period.

Designated Fund Balances of Unrestricted Current Fund

The Board of Directors of a Non Profit Organization may designate a portion of an unrestricted fund's assets for specific purposes. The earmarked portion should be accounted for as a segregation of unrestricted fund balance, rather than as a separate restricted fund. For example, if Board of Directors earmarked \$5,000 of the unrestricted fund's asset for the purchase of new office equipment, the following journal entry would be prepared:

Unrestricted Fund Balance.....	5,000
Designated Fund Balances Office Equipment.....	5,000

➤ **Restricted Current Fund**

Non Profit Organizations establish restricted funds to account for assets available for current use but expendable only as authorized by the donor of the asset. Thus, the restricted funds of a NonProfit Organization resemble the Special Revenue Fund of governmental units, as the assets of both types of funds may be expended only for the specified purpose.

The assets of restricted funds are not derived from the operations of the Non-Profit Organization. Instead, the assets are obtained from restricted gifts or grants of individuals or government units, gain on sale of restricted fund investments, revenue from restricted fund investments etc. These assets are transferred to the unrestricted fund as revenue of that fund at the time the designated expenditure is made.

Example: assume that on Aug1, 2004 Ato kebede donated \$50,000 to ZY hospital, a Non-Profit Organization, for acquisition of beds. On September 10 the hospital expended \$52,500 for the beds. These activities would be recorded on the books of ZY hospital as follows:

In Ato kebede Restricted Fund

2004

Aug 1 Cash	50,000
Fund Balance	50,000

2004

Sept 10	Fund Balance	50,000
	Payable to Unrestricted Fund	50,000

In Unrestricted Fund

2004

Sept 10	Plant Asset	52,000
	Cash	52,000

2004

Sept 10	Received from Ato kebede Restricted Fund	50,000
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QUICK CHECK

1. What make(s) Non Profit Organizations different from Governmental entities?
2. What is the difference between restricted and unrestricted current fund?
3. What is unique with revenues of restricted current fund?

2. Endowment Fund

An endowment fund of a Non Profit Organization is comparable to a non expendable trust fund of a governmental unit. A **pure endowment** fund is one for which the principal must be held indefinitely in revenue producing investments but can not be expended. Only the income from the pure endowment fund's investments may be expended by the Non Profit Organization.

In contrary, the principal of a **term endowment** fund may be expended by the Non Profit Organization after the passage of a period of time or the occurrence of an event stipulated by the donor of the endowment principal.

A **quasi endowment** fund is established by the Board of Directors of a Non Profit Organization, rather than by outside donor. At the option of the board, the principal of a quasi endowment fund later may be expended by the entity which established the fund.

The income of endowment funds is handled in accordance with the instructions of the donor or the Board of Directors. If there are no restrictions on the use of the endowment fund income, it is transferred to the Non Profit Organization's unrestricted fund. Otherwise, the endowment fund income is transferred to an appropriate restricted fund.

3. Agency Fund

An Agency fund of a Non Profit Organization is identical to its counterpart in governmental units. An Agency fund is used to account for assets held by a Non Profit Organization as a custodian. The assets are disbursed only as instructed by their owner.

4. Annuity and Life Income Funds

Annuity Funds: - assets may be distributed to Non Profit Organization with the stipulation that the organization pay specified amounts periodically to designated recipients, for a specified time period.

Annuity fund is established by Non Profit Organization to account for this arrangement. At the end of the specified time period for the periodic payments, the unexpended assets of the Annuity fund are transferred to the unrestricted fund or to a restricted or to endowment fund specified by the donor.

Life Income Funds: - Like an annuity fund, this fund is used to account for stipulated payments to a named beneficiary (or beneficiaries) during the beneficiary's life time. The payments from the annuity fund are made directly from principal of the fund, but in life income fund only the income is paid to the beneficiary. Thus, payments to a life income fund's beneficiary vary from one accounting period to the next. In contrast, payments from an annuity fund are fixed in amount.

5. Loan Funds

A loan fund may be established by any Non Profit Organization, but loan funds most frequently are included in the accounting records of Colleges and Universities. Student loan funds usually are revolving: - as old loans are repaid, new loans are made from the receipts. Loan receivables are carried in the loan fund at estimated realizable value; provisions for doubtful loans are debited directly to the fund balance account, not to an expense account. Interest on loan is to the fund balance account, ordinary on cash basis of accounting.

Example of transactions and journal entries

1. Donation of \$100,000 was received for the purpose of making loans to students

Cash- Restricted for Loan.....	100,000
Revenue – Gift	100,000

2. Loan of \$50,000 was granted

Loan Receivable.....	50,000
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Cash- Restricted for Loan..... 50,000

6. Plant, Land, Building and Equipment Fund

These are funds used to account for financial resources restricted by donors or grantors for acquisition or construction of capital asset.

8.4. Financial Statements

All Non Profit Organizations issue a balance sheet that incorporates all funds of organization. The assets, liabilities and fund balances for each fund are listed in the single balance sheet.

As Non Profit Organizations do not operate for gain, income statement is inappropriate. Instead, a statement of revenue and expense is issued with final amount labeled 'Excess of revenues over expenses' or a similar caption charges in fund balances may be summarized with a separate statement or may be annexed to the statement of revenues and expenses.

QUICK CHECK

1. Differentiate annuity income and life income funds.
2. Differentiate pure, term and quasi endowment funds.

Chapter Summary

A Non Profit Organization is a legal and accounting entity which is operated for the benefit of society as a whole, rather than the benefit of an individual proprietor or a group of partnership or shareholders. Thus, the concept of net income is not meaningful for Non Profit Organizations. Instead, they strive only to obtain revenue sufficient to cover their operating expenses.

The basic accounting unit for most Non Profit Organizations is fund. Separate funds are necessary to distinguish between assets which may be used as authorized by the board of directors and assets whose use is restricted by donors. Funds commonly used by Non Profit Organizations include the following:

- ✓ Current Fund ○ Unrestricted Current Fund ○ Restricted Current Fund
- ✓ Endowment Fund
- ✓ Agency (Custodian) Fund

- ✓ Annuity and Life Income Fund
- ✓ Loan Fund
- ✓ Plant, Land, Building and Equipment Fund

All Non Profit Organizations issue a balance sheet that incorporates all funds of organization. The assets, liabilities and fund balances for each fund are listed in the single balance sheet.

As Non Profit Organizations do not operate for gain, income statement is inappropriate. Instead, a statement of revenue and expense is issued with final amount labeled 'Excess of revenues over expenses' or a similar caption charges in fund balances may be summarized with a separate statement or may be annexed to the statement of revenues and expenses.

SELF-ASSESSMENTS QUESTIONS

Part I: Multiple choice Questions

Choose the correct answer among the given alternatives.

1. A fund used to account resources of an NGO that are available to be used in carrying out activities directly related to the organizations objective is:
 - a. Loan funds
 - b. Current funds
 - c. Endowment funds
 - d. Agency funds
 - e. All
 - f. None
2. Resources of NGOs available for current operating purposes but subject to limitation by organizations outside the entity are accounted in :
 - a. Agency funds

- b. Loan funds
 - c. Current restricted fund
 - d. Current unrestricted fund
 - e. None
3. Resources of NGOs available for acquisition of long lived assets and subject to limitation by organizations outside the entity are accounted in:
- a. Agency funds
 - b. Land, Building and Equipment Fund
 - c. Current restricted fund
 - d. Current unrestricted fund
 - e. None
4. If the Board of Directors of a Non Profit Organization designates a portion of unrestricted fund's assets for specific purposes, the earmarked portion should be
- a. accounted in a separate restricted fund
 - b. accounted for as a segregation of unrestricted fund balance
 - c. accounted along with other resources of the unrestricted fund
 - d. All
 - e. None
5. _____ is a commitment, but not an enforceable contract, by a prospective donor to contribute a specific amount of cash to a Non Profit Organization at a future date
- a. Notes Receivable
 - b. Endowment
 - c. Pledge
 - d. Restricted current fund
 - e. None

SOLUTIONS FOR SELF TESTS

CHAPTER ONE

1. B 2. D 3. C 4. B 5. A 6. D 7. C 8. A 9. D 10.B

CHAPTER TWO

Part I

1. B 2. A 3. D 4. A 5. D 6. B 7. C 8. A 9. B 10.D

11. E 12. C 13. C 14. B 15. D

Part III

1. Appropriation
2. Administration
3. Revenues
4. Enacted budget
5. Performance

CHAPTER THREE

Part I

1. C 2. E 3. C 4. C 5. E 6. A 7. B 8. F 9. B 10. C

Part II

Q1

2004 Jan 1	Estimated Revenue	800,000	
	Appropriation		700,000
	Fund Balance		100,000
	(To record the budget)		
Jan 2	Taxes Receivable current	600,000	
	Revenues		588,000
	Allowance for Uncollectible Current tax		12,000
	(To record accrual of tax levy)		
Jan 31	Encumbrance	100,000	
	Reserve for Encumbrance		100,000
	(To record purchase orders for supplies)		
Feb 12	Operating Transfers Out - DSF	20,000	
	Cash		20,000
	(To record transfers to DSF)		
May 31	Cash	420,000	
	Taxes Receivable-Current		420,000
	(To record collection of taxes)		
	Taxes Receivable-Delinquent	180,000	
	Taxes Receivable-Current		180,000
	(To record delinquent taxes)		
	Allowance for Uncollectible Current Tax	12,000	
	Allowance for Uncollectible Delinquent Tax		12,000
	(To record reclassification of allowance of estimated losses on taxes)		
June 30	Encumbrance	200,000	

	Reserve for Encumbrance	200,000	
	(To record purchase order issued for vehicle)		
July 10	Reserve for Encumbrance	60,000	
	Encumbrance		60,000
	Expenditure	58,000	
	Cash/ Accounts Payable		58,000
	(To record payment for supplies received)		
July 31			
	Delinquent tax = \$180,000 *40% = 72,000		
	Penalty = 72,000 * 12% = 8,640		
	Interest = 72,000 * 15%*2/12 = 1,800		
	Total to be collected from the tax payers = 82, 440		
	Cash	82,440	
	Taxes Receivable-Delinquent		72,000
	Penalties and Interest on Delinquent Taxes		10,440
	(To record collection of delinquent taxes plus penalties and interest)		
Aug 15	Reserve for Encumbrance	200,000	
	Encumbrance		200,000
	Expenditure	225,000	
	Cash/ Accounts Payable		225,000
	(To record payment for Vehicles received)		
Sept 1	Expenditure	250,000	
	Cash		250,000
	(To record payment for rent)		
Dec 15	Due from CPF	25,000	
	Cash		25,000
	(To record loan to the Capital Project Fund)		

Dec 31 Delinquent tax = \$180,000 * 60% = 108,000

Penalty = 108,000 * 12% = 12,960

Interest = 108,000 * 15% * 7/12 = 9,450

Total amount to be claimed from tax payers = 130,410

Tax Lien-Receiveable	130,410	
Taxes Receivable-Delinquent		108,000
Penalties and Interest on Delinquent Taxes		22,410
(To record seized of property of delinquent tax payers)		

Dec 31 Cash	140,000	
Tax Lien Receivable		130,410
Trust for property owners		9,590
(To record sale of seized property)		

Dec 31 Appropriations	700,000	
Fund Balance		100,000
Estimated Revenues		800,000
(To close the budgetary accounts)		

Revenues 620,850

 Expenditures 533,000

 Fund Balance 87,850

(To close actual Revenues and Expenditures)

Fund Balance	20,000	
Operating transfer out-DSF		20,000
(To close the transfer out accounts)		

Reserve for Encumbrances	40,000	
Encumbrances		40,000
(To close the encumbrance account open for supplies)		

CHAPTER FOUR

1. Refer to the topic 4.1
2. Refer to the topic 4.2
3. Refer to the topic 4.2, 4.3
4. Refer to the topic 4.4
5. Refer to the topic 4.4

CHAPTER FIVE

1. C 2. B 3. B 4. B 5. E

Part II

Q1.

1. Estimated Revenue from MOR	950,000	
Estimated Revenue from USAID	1,250,000	
Estimated Bond Issue Proceeds	450,000	
Estimated Transfer from General Fund	350,000	
Appropriations		3,000,000
(To record budgetary accounts)		
2. Cash	480,000	
Bond Issue Proceeds		480,000
(To record issuance of bond)		
3. Operating Transfer to DSF	30,000	
Cash		30,000
(To record transfer of bond premium to DSF)		
4. Due from MOR	950,000	
Due from USAID	1,250,000	

Due from General Fund	350,000	
Revenue from MOR		950,000
Revenue from USAID		1,250,000
Operating Transfer from General Fund		350,000
5. Encumbrances	1,000,000	
Reserve for Encumbrances		1,000,000
(To record signing of the contract)		
6. Cash 2,450,000		
Due from MOR 950,000		
Due from USAID 1,250,000		
Due from General Fund 350,000		
(To record receipt of cash from all grantor agencies and GF)		
7. Reserve for Encumbrances	250,000	
Encumbrances		250,000
Expenditures	250,000	
Contracts Payable		250,000
(To record payment of the first bill)		
8. Reserve for Encumbrances	250,000	
Encumbrances		250,000
Expenditures	250,000	
Contracts Payable — Retained Pct.		30,000
Cash		220,000
9. Appropriations	3,000,000	
Estimated Revenue from MOR		950,000
Estimated Revenue from USAID		1,250,000
Estimated Bond Issue Proceeds		450,000
Estimated Transfer from General Fund		350,000
(To close budgetary accounts)		

Revenue from MOR	950,000	
Revenue from USAID	1,250,000	
Bond Issue Proceeds	480,000	
Operating Transfer from General Fund	350,000	
Expenditures		3,000,000
Operating Transfer to Debt Service Fund		30,000
(To close the revenue and expenditure accounts)		

Q2.

i. Required Additions	327,758	
Required Earnings	3,331	
Appropriations		300,000
Fund Balance	31,089	
ii. Cash	327,758	
Operating Transfer in - General Fund		327,758 iii.
Investments	27,758	
Cash		27,758
iv. Cash	3,331	
Interest Income		3,331
v. Expenditures	300,000	
Matured Interest Payable		300,000

Q3.

Total LTD = 2,000,000

Periodic maturities = $\$2,000,000/20 = \$100,000$

Interest = $\$2,000,000*15\% = \$300,000$

Total amount to be available in the DSF each year = $\$400,000$

i. Estimated Revenues	425,000	
Appropriations		400,000

Fund Balance	25,000
(To record the budget)	

ii. Expenditures 50,000

Matured Bonds Payable	50,000
(To record resources ready for payment of principal)	

iii. Expenditures 100,000

Matured Interest Payable	100,000
(To record resources ready for payment of bond interest at year-end) iv.	

Matured Interest Payable	100,000	
Matured Bonds Payable	50,000	
Cash		150,000
(To record payment is made for principal and interest)		

CHAPTER SIX

1. B 2. D 3. E 4. A 5. C 6. D 7. C 8. D 9. C 10. C

CHAPTER SEVEN

Part I

1. D 2. C 3. B 4. C 5. D

Part Two

i.	Cash	300,000
	Equity Transfers In - GF	300,000

ii.	Cash	250,000
	Advance from DSF	250,000

iii.	Inventory of Supplies	100,000		
	Equity Transfers In – SRF		100,000	
iv.	Inventory of Supplies	100,000		
	Cash		100,000	
v.	Buildings	210,000		
	Equipment	45,000		
	Cash		260,000	
vi.	Cost of Supplies Issued	80,000		
	Inventory of Supplies		80,000	
	Due from General Fund	100,000		
	Billings to Departments (Cost x 140%)			100,000
vii.	Cash	100,000		
	Due from General Fund		100,000	
viii.	Administrative Expenses	6,000		
	Purchasing Expenses	10,000		
	Warehousing Expenses	4,400		
	Cash		20,000	
ix.	Cost of Supplies Issued	120,000		
	Inventory of Supplies	120,000	Cash	150,000
	Billings to Departments (Cost x 140%)	150,000	x.	
	Advance from DSF	20,000		
	Cash	20,000		
xi.	Administrative Expenses	4,800	Purchasing Expenses	
		8,000		
	Warehousing Expenses	3,200		

	Allowance for Depreciation -Building		10,750
	Allowance for Depreciation-Equipment	5,250	
xii.	Billings to Departments	250,000	
	Cost of Supplies Issued	200,000	
	Administrative Expenses	10,800	
	Purchasing Expenses	18,000	
	Warehousing Expenses	7,200	
	Excess of Net Billings over Costs		14,000 Excess of Net Billings over
Costs	14,000		
	Retained Earnings		14,000

CHAPTER EIGHT

1. B 2. C 3. B 4. B 5. C

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Arba Minch University

Continuing and Distance Education Program

Accounting & Finance Department

Name.....	Center.....
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Government and NFP Accounting (Acct. 332)

ASSIGNMENT MATERIAL

Target group: **Distance Learners/students/**

Instructions:

- 1. Attempt all questions**
- 2. Your answers must be clear, specific and to the point/relevant/ along with necessary steps**
- 3. Maximum Load 30%**

Part One: Choose the best answer

1. One unique characteristics of most government and non profit organizations is
 - a) their primary source of revenue is sale of goods and services to customers
 - b) there is no direct relation between the amount of goods and services that resource providers received and the amount of resources provided by them
 - c) they are profit driven
 - d) they have ownership title so be sold and or transfer to third party
 - e) None
2. The General Fixed Asset Account Group should be used to account for fixed assets constructed or acquired to be used in the operations accounted for by
 - a) An internal service fund
 - b) An enterprise fund
 - c) A non expendable trust fund
 - d) A special revenue fund
 - e) None
3. A city collects property taxes for the benefit of the local sanitary, park, school districts and periodically remits collection to these units. The activity should be recorded in
 - a) An agency fund
 - b) A general fund
 - c) An internal service fund
 - d) A special revenue fund
 - e) None
4. A transaction in which a municipal electric utility issues bonds (to be repaid from its own earnings) should be recorded in
 - a) A general fund
 - b) A debt service fund
 - c) Enterprise and debt service fund
 - d) Enterprise, debt service fund and general long term debt account group
 - e) None

5. An expenditure account appears in
 - a) The general fixed asset account group
 - b) The general long term debt account group
 - c) The special revenue fund
 - d) An internal service fund
 - e) All
6. Under governmental accounting, capital assets are
 - a) Recorded as fixed asset when purchased and depreciated
 - b) Recorded as expenditure in the debt service fund and listed in the general fixed asset account group
 - c) Record as expenditure in the capital project fund only
 - d) Recorded as expenditure in the capital project fund and listed in the general fixed asset account group
 - e) None
7. The major difference between accrual and modified accrual basis of accounting is on
 - a) The treatment of fixed assets
 - b) The recognition of revenue
 - c) The recognition of expenditure
 - d) The treatment of long term debt
 - e) B and C
 - f) None
8. An inter fund transfer to debt service fund for the payment of long term debt principal and interest should be recorded as
 - a) Inter fund loan and advance
 - b) Equity transfer
 - c) Operating transfer
 - d) Reimbursement
 - e) All

9. An exchange transaction is one in which
- a) Both parties receive something of value
 - b) One party receives something of value
 - c) Neither parties receive something of value
 - d) All
 - e) None
10. Legal authority to expend budgeted resources is called
- a) Budget development
 - b) Expenditure
 - c) Appropriation
 - d) Allotment
 - e) None
11. The required additions and the required earnings budgetary accounts are used for
- a) Bond issue involving transfer from general fund
 - b) Bond issue involving contribution from other funds
 - c) Debt for which sinking fund has been established
 - d) All
 - e) None
12. How would customers' security deposit be classified in the balance sheet of an enterprise fund?
- a) As liability and restricted asset
 - b) As liability and other asset
 - c) As a restricted asset and deferred revenue
 - d) None of the above

Part Two: Work Out Questions

Q1. ABC city council general fund performed the following transactions in 2004/2005 Ethiopian budget year.

July 1. The city council approved the budget for the year as follows

Estimated Revenue

Property tax	2,440,000
Services and charges	140,000
Licenses and permits.....	<u>20,000</u>
Total	<u>2,600,000</u>

Appropriation

Public Safety	750,000
Health and Welfare	100,000
General Governmental activities	<u>1,200,000</u>
Total	<u>2,050,000</u>

July 5. The city issued a tax anticipations note and borrowed birr 200,000

July 15. The city has placed a purchase order for the following activities: supplies birr 850,000 and vehicle birr 500,000

Aug. 1. Salary is paid, birr 415,000

Aug.15. Property tax for birr 2,400,000 is levied for the fund. The balance is to be collected on Nov.15, 2004. And birr 100,000 is estimated to be uncollectible.

Sept.1. The vehicle and 80% of supplies ordered are received for actual prices of birr 490,000 and birr 700,000 respectively

Sept.15. Revenues from licenses and permits are collected in cash, birr 15,000

Nov.15 Collections of property taxes levied in current budgetary period amounted birr 2,100,000

Nov.30. Tax anticipation notes which was borrowed on July 5, is paid with interest of birr 20,000

Dec. 15. All goods and supplies for which encumbrances were outstanding as of June 30, are received at a total invoice cost of birr 165,000

Jan 1. The general Fund received services from Internal Service Fund for birr 15,000. The balance is not yet paid

Feb. 20. Enterprise fund contributes birr 10,000 to the general fund. The contribution is to be used for payment of office rent

June 30. The fund seized the properties of non tax payers. The entity has a policy to charge 8 % flat penalty and 9 % interest on the unpaid balances

June 30. The fund is closed

Required: Record the above transactions

Q2. Assume that Zorich city had issued a 15 years, 12% term bond for \$3,000,000. The money is planned to finance construction of public library in the city. The bond will be paid off by periodic transfers from the General Fund and sinking fund is established to repay the principal in 15 years. Resources in the sinking fund are invested in marketable securities yielding 15% per year.

Required: record the necessary journal entry to record the possible transaction of the fund

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