Chapter 2

Principles of Accounting and Financial Reporting for State and Local Governments
Learning Objectives

After studying Chapter 2, you should be able to:

✓ Explain the nature of the three major activity categories of a state or local government: governmental activities, business-type activities, and fiduciary activities

✓ Explain the components of GASB’s integrated accounting and financial reporting model, including:
  - The reporting entity
  - Government-wide financial statements
  - Fund financial statements
Learning Objectives (Cont’d)

After studying Chapter 2, you should be able to:

☞ Explain the components of GASB’s integrated accounting and financial reporting model:
  - Definition of fund and principles of fund accounting
  - Types of funds in each fund category and characteristics of each fund type

☞ Explain major fund accounting
Activities of Government

- Governmental
- Business-type
- Fiduciary

Q: What activities are included in each of the above categories? Discuss.
Reporting Entity

A *reporting* entity consists of:

- A primary government (including fiduciary funds) **and**
- Component units
A primary government is:

- A state government,
- General purpose local government (e.g., a city, town, village, township, borough, county, etc.), or a
- Special purpose government that has a separately elected governing body, is legally separate, and is fiscally independent of other state or local governments.
A component unit

- Is a legally separate organization for which the elected officials of a primary government are financially accountable
- Also, report as a component unit if the organization’s relationship with a primary government is such that exclusion would cause the reporting entity’s financial statements to be misleading
Reporting Entity (Cont’d)

- Financial information of a component unit can be reported by:
  - Discrete presentation (i.e., in a separate column), or by
  - Blended presentation (combined in the same columns with financial information of the primary government)
- Notes to financial statements should describe the reporting entity
Required Financial Statements

Two sets of “basic” financial statements are required (in addition to MD&A and other required supplementary information)

- Government-wide financial statements (see Illustrations A1-1, A1-2, and 2-1)
- Fund financial statements (see Illustrations A1-3 through A1-11 and 2-1)
Required Financial Statements (Cont’d)

Government-wide financial statements:

- Statement of net assets (see III. A1-1)
- Statement of activities (see III. A1-2)
Required Financial Statements (Cont’d)

Government-wide financial statements (Cont’d):

- Prepared on the accrual basis using economic resources measurement focus
- Primary government financial information reported in two columns—governmental activities and business-type activities
- Internal service fund information is usually reported in the Governmental Activities column
- Fiduciary activities are *not* reported in the government-wide financial statements
Required Financial Statements (Cont’d)

Fund financial statements (see Ill. 2-1):

- Two governmental fund financial statements (see Ill. A1-3 and A1-5)
- Three proprietary fund financial statements (see Ill. A1-7, A1-8, and A1-9)
- Two fiduciary fund financial statements (see Ill. A1-10 and A1-11)
Definition of “Fund”

- A “fund” is a separate fiscal and accounting entity
  - Self-balancing set of accounts
  - Segregates financial resources, liabilities payable from fund resources, and fund equities to attain objectives specified by regulations, restrictions, or limitations

- Conceptually, a fund has its own set of books and statements (i.e., chart of accounts, general journal, general ledger, trial balances, and financial statements)
Categories and Types of Funds

- **Governmental funds (5 types) – Chapters 3-6**
  - General Fund, special revenue funds, capital projects funds, debt service funds, permanent funds

- **Proprietary funds (2 types) – Chapter 7**
  - Internal service funds, enterprise funds

- **Fiduciary funds (4 types) – Chapter 8**
  - Agency funds, investment trust funds, private-purpose trust funds, pension trust funds
Governmental Funds

General Fund (GF)

- Only one per government
- Most financial transactions related to general government operating activities are recorded in the GF
Governmental Funds (Cont’d)

Special Revenue Funds (SRF)

- Are used when required by law or by policy to account for financial resources earmarked for a specified operating purpose
- Accounting and budgeting are identical to GF
Governmental Funds (Cont’d)

Debt Service Funds (DSF)

- Account for financial resources segregated to pay principal or interest on long-term general liabilities

I.O.U.
Capital Projects Funds (CPF)

- Account for financial resources segregated to pay for construction or acquisition of long-lived capital assets
Governmental Funds (Cont’d)

Permanent Funds

- Account for resources provided by trust for which the principal is not spendable, but the earnings on the principal are required to be used for a *public* purpose
Governmental Funds — Common Characteristics

- Current financial resources measurement focus
- *Modified accrual* basis of accounting is used
- Account for *expenditures* of financial resources (*not expenses*)
- Capital assets and long-term liabilities are *not* recorded in governmental funds
Governmental Funds — Required Financial Statements

- Balance sheet—governmental funds (Ill. A1-3)
- Reconciliation of total fund balances of governmental funds to total net assets of governmental activities at the government-wide level (Ill. A1-4)
- Statement of revenues, expenditures, and changes in fund balances—governmental funds (Ill. A1-5)
- Reconciliation of total changes in fund balances of governmental funds to total changes in net assets of governmental activities at the government-wide level (Ill. A1-6)
Proprietary Funds

Internal Service funds (ISF)

- Account for activities in which goods or services are provided to other departments of the same government for a charge

- Examples: central stores, central computing, motor pools, and printing

- Usually reported as governmental activities in the government-wide statements because they primarily serve departments financed by governmental funds
Enterprise Funds

- Account for activities in which goods or services are provided to the general public for a charge
- Examples: electric and water utilities, airports, parking garages, transportation systems, and liquor stores
- Reported as business-type activities in the government-wide financial statements
Proprietary Funds
Common Characteristics

- Accounting and reporting are similar to those of for-profit entities, including use of *accrual* accounting
- Capital assets and long-term liabilities are recorded in the funds
- Depreciation expense is recorded in the funds
- *Expenses* are recorded, not *expenditures*
Proprietary Funds
Required Financial Statements

Similar to those of for-profit entities

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

Agency Funds

- Account for financial resources for which the government is acting in an agency capacity
- Accounting is simple: assets = liabilities
- Since there are no net assets, there are no additions to, or deductions from net assets
- Examples: tax agency funds and pass-through agency funds
Fiduciary Funds (Cont’d)

Investment Trust Funds

- Account for external investment pools in which the assets are held for other (external) governments, along with funds of the sponsoring government.

- Assets, liabilities, net assets, and changes in net assets related to the equity of the external participants are reported in this fiduciary fund.
Fiduciary Funds (Cont’d)

Private-purpose Trust Funds

To account for financial resources (expendable or nonexpendable) in which the government is acting in a trustee capacity for private individuals, organizations, or other governments.
Fiduciary Funds (Cont’d)

Pension (and other employee benefits)
Trust Funds (one or more)

To account for financial resources in which the government (or other designated trustee) is acting in a trustee capacity for the employees of the government to provide retirement benefits
Fiduciary Funds
Characteristics and Financial Reporting

- Accounting is similar to that for proprietary funds; i.e., full accrual accounting and focus on flows of economic resources
- Capital assets and long-term liabilities are recorded in the funds, if applicable
- Additions (to net assets) and deductions (from net assets) are recorded instead of revenues and expenses
- Fiduciary activities are reported in two fund financial statements: statement of fiduciary net assets and statement of changes in fiduciary net assets
Reporting of Major Funds

- Financial information for each *major* governmental and enterprise fund is reported in a separate column of the respective fund financial statements.
- Aggregate financial information for all *nonmajor* governmental and enterprise funds is reported in a single column of the respective fund financial statements.
Determination of Major Funds

- General Fund is always a *major fund*

- Any governmental or enterprise fund that a government considers of significant importance can be designated as a *major fund*
Any governmental or enterprise fund that meets the following criteria is a major fund:

- Total assets, liabilities, revenues or expenditures of that fund are at least 10 percent of the corresponding element total for all governmental or enterprise funds, as applicable.

- The same element that met the 10 percent criterion is at least 5 percent of the corresponding element total for all governmental and enterprise funds combined.
Reporting Capital Assets

General capital assets should be distinguished from capital assets of proprietary and fiduciary funds

- General capital assets are reported only in the Governmental Activities column of the government-wide financial statements.
- Proprietary capital assets are reported in both the government-wide and fund financial statements.
- Fiduciary capital assets are reported only in the statement of fiduciary net assets, a fund financial statement.
Valuation of Capital Assets

- Capital assets should be recorded at historical cost, or estimated cost if actual cost is unknown.
- Donated assets should be recorded at estimated fair value at time of gift.
Depreciation of Capital Assets

- Capital assets should be depreciated over their estimated useful lives, except inexhaustible assets such as land.

- An election can be made to use the “modified approach” for certain infrastructure assets instead of depreciation.

- Report depreciation expense for general capital assets only in the government-wide financial statements.
General long-term liabilities should be distinguished from fund long-term liabilities

General long-term liabilities should be reported in the government-wide statements but not in the fund financial statements

Long-term liabilities to be repaid from proprietary funds should be reported in the proprietary fund statements and at the government-wide level

Long-term liabilities to be repaid from fiduciary funds should be reported only in the fiduciary fund statements
Measurement Focus
What is measured?

- **Economic resources** measurement focus
  - Measure inflows and outflows of economic resources (current and noncurrent)
  - Focuses on *operational accountability*; whether management efficiently uses resources in providing services

- **Current financial resources** measurement focus
  - Measure inflows and outflows of current financial resources
  - Focuses on *fiscal accountability*; whether managers have met budgetary and other legal financial requirements
Basis of Accounting

When are elements recognized?

When should revenues and expenses/expenditures be recognized?

- **Modified accrual** basis of accounting
  
  Revenues recognized when measurable and available; expenditures when incurred

- **Accrual basis** of accounting
  
  Revenues recognized when earned or as specified by GASB standards; expenses when incurred
## Measurement Focus & Basis of Accounting Summary

<table>
<thead>
<tr>
<th></th>
<th>Measurement Focus</th>
<th>Basis of Accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government-wide statements</td>
<td>Economic resources</td>
<td>Accrual</td>
</tr>
<tr>
<td>Governmental fund statements</td>
<td>Current financial resources</td>
<td>Modified accrual</td>
</tr>
<tr>
<td>Proprietary fund statements</td>
<td>Economic resources</td>
<td>Accrual</td>
</tr>
<tr>
<td>Fiduciary fund statements</td>
<td>Economic resources</td>
<td>Accrual</td>
</tr>
</tbody>
</table>
Concluding Comments

- GASB standards require both government-wide financial statements and fund financial statements.
- Government-wide financial statements and fund financial statements for proprietary and fiduciary funds are prepared using accrual accounting and the economic resources measurement focus (similar to commercial accounting).
- Fund financial statements for governmental funds are prepared using the modified accrual basis of accounting and a current financial resources measurement focus.