Chapter 7

Accounting for the Business-Type Activities of State and Local Governments
Learning Objectives

After studying Chapter 7, you should be able to:

👀 Distinguish between the purposes of internal service funds and enterprise funds

👀 Describe the characteristics of proprietary funds, including those unique to internal service and enterprise funds
Learning Objectives (Cont’d)

☞ Explain the financial reporting requirements, including the differences between the reporting of internal service and enterprise funds in the government-wide and fund financial statements

☞ Describe accounting procedures and prepare journal entries and financial statements for an internal service fund

☞ Describe accounting procedures and prepare journal entries and financial statements for an enterprise fund
Proprietary Funds

Reasons for use

- Enhances management of activities in which goods or services are provided on a cost-reimbursement basis to departments of the same government or to the general public on a user charge basis.
- To compare benefits and costs of the business-type activities of a government.
Proprietary Funds
Accounting Equation

Assets - Liabilities = Net Assets

- Unrestricted
- Restricted (e.g., for payment of debt service)
- Invested in Capital Assets, Net of Related Debt
Proprietary Funds—Accounting Characteristics

- Use accrual basis
- Capital assets and long-term liabilities recorded within the funds
- Flexible rather than fixed budgets recommended; generally budgetary accounts are not integrated into the general ledger
- Depreciation expense and accumulated depreciation are recorded and reported
- For accounting guidance look to accounting procedures used by similar type private enterprises
Proprietary Funds—Required Financial Statements

Similar to those of a for-profit entity:

- Statement of net assets (or balance sheet)
- Statement of revenues, expenses, and changes in fund net assets (operating statement)
- Statement of cash flows (differs under GASB)
Proprietary Funds—Statement of Net Assets

- A classified statement is prepared, with current assets shown in the order of liquidity
- Net assets are divided into three categories
  - Invested in capital assets, net of related debt—calculated as the value of net capital assets less any outstanding debt related to capital asset acquisitions or construction
  - Restricted—restrictions are placed on asset use by external parties through contracts, legal requirements, or donor stipulation
  - Unrestricted—the residual after adjusting for the preceding two net asset categories
Proprietary Funds—Operating Statement

- GASB requires that revenues and expenses be identified as operating or non-operating.

- Operating activities relate to the primary functions of the proprietary fund.

- Separate subtotals are to be provided for operating information.
Similarities between GASB and FASB standards:

- Cash flows statement shows cash inflows/outflows relating to operating, financing, and investing activities

- Both sets of standards define cash flows as cash and cash equivalents (i.e., time deposits, marketable securities, and other items readily convertible to cash)
Proprietary Funds—Statement of Cash Flows (Cont’d)

Differences between GASB and FASB standards:

- GASB cash flow statement divides financing activities into noncapital, and capital and related financing.
- Acquisition of capital assets is a capital and related financing transaction under GASB rather than an investing activity.
- Interest expense on long-term debt is a capital and related financing activity under GASB rather than an operating activity.
- Cash flows from operating activities must be shown using the direct method.
Internal Service Funds

**Used**

- When authorized by legislative approval
- To account for provision of goods and services to departments of the same government—generally on a cost reimbursement basis
- To improve management of common resources by placing them under centralized management and control
Common Types of Internal Service Funds

- Motor pools
- Central purchasing
- Storage
- Issuance of supplies
- Self-insurance pools
- Central data processing
- Printing
Pricing is set by local management or by legislative policy

Pricing objectives vary; full cost recovery (direct and indirect), direct cost recovery, or whatever management desires

Because legislative bodies do not want purchasing to occur outside the budget, the bodies are sometimes reluctant to establish internal service funds

Q: Is the legislative concern justified?
Q/A: Is the legislative concern justified?

- Even if an internal service fund is created for central purchasing and sales of supplies, the legislative body maintains budgetary control over the expenditures made by most departments and programs via the General Fund and special revenue funds’ budgets.

- See and discuss Illustration 7-1.
Generally, use the same accounting procedures that a similar for-profit entity would use. (Review illustrative transactions in the text for a supply fund and compare to business accounting)

Billings to Departments is a revenue account, similar to Sales in a for-profit entity

Revenues and expenses are closed at year-end to Excess of Net Billings to Departments over Costs (or Excess of Costs over Net Billings to Departments) rather than to Income Summary
Other than slight differences in terminology, the fund financial statements are essentially the same as those of a comparable for-profit entity

- Statement of net assets (see III. 7-2)
- Statement of revenues, expenses, and changes in fund net assets (see III. 7-3)
- Statement of cash flows (see III. 7-4)
Internal Service Funds—External Reporting

- Internal service funds are aggregated and reported in a separate column in the proprietary fund financial statements (see III. A1-7 through A1-9)—internal service funds are never considered major funds.

- In the government-wide financial statements, internal service funds are reported as a part of the governmental activities column—interfund activity between internal service funds and governmental funds must be eliminated.
Internal Service Fund—Risk Management

If a government uses an internal service fund (ISF) for a risk management (self-insurance) pool:

- The ISF should recognize claims expense and a related liability when:
  - it is probable that an asset has been impaired or a liability has been incurred and the amount is reasonably estimable, or
  - if an estimable loss has been incurred and it is probable that a claim will be asserted

- Disclose other loss contingencies in the notes
Internal Service Fund—Dissolving a Fund

- Transfer ISF assets to another fund that will continue the activity
- Terminate activity and distribute assets in-kind to another fund or funds
- Convert ISF assets to cash and distribute cash to another fund or funds
Enterprise Funds

Reasons for use:

- When GASB standards require
- To account for services provided to the general public on a user charge basis
- When the governing body has determined that periodic determination of revenues earned, expenses incurred, and/or net income is appropriate for capital maintenance, public policy, management control, accountability, or other purposes
Enterprise Funds

GASB requires use of an enterprise fund if the following criteria are met:

- An activity is financed with debt that is secured solely with revenues from the activity

- Law or regulation requires that the costs of the activity, including capital costs, be recovered with revenue from the activity, rather than taxes or other revenues
Common Types of Enterprise Funds

- Water and sewer
- Gas and electric utilities
- Transportation systems
- Airports
- Ports
- Toll roads and bridges
- Parking garages and lots
- Golf courses
- Hospitals
- Liquor stores
GASB standards provide guidance on business-type activities

However, GASB also requires that proprietary funds follow pronouncements of the FASB and its predecessors issued before November 30, 1989, unless they conflict with a GASB standard.

Additionally, enterprise funds may *opt* to follow all FASB and predecessor standards that pertain to businesses, both those issued before and after November 30, 1989, unless the standard conflicts with a GASB standard.
Assets whose use is restricted by contractual agreements or legal requirements

Typical examples:
Customer deposits of utilities, assets set aside for repayment of revenue bond principal, reserves for maintenance of plant, and funding of depreciation

Although not required by GAAP, ideally liabilities to be paid from restricted assets should be reported separately from liabilities to be paid from unrestricted assets (see next slide)
Enterprise Funds—Restricted Assets (Cont’d)

From Illustration 7-5

Restricted Assets = Liabilities Payable from Restricted Assets + Net Assets, Restricted for Payment of Debt Service

= $562,600 = $23,700 + $538,900
Q: Should interest incurred on debt during construction be capitalized?

A: Yes. Notice that this policy differs from the interest capitalization policy for self-constructed general capital assets.
Q: Should an imputed amount equivalent to interest be capitalized if a utility’s own funds are used for construction?

A: Capitalizing an “equity” component of Allowance for Funds Used During Construction (AFUDC) is permitted both by utility regulators and the FASB.
In addition to the usual Accounts Payable and Accrued Expenses, two special current liability accounts are:

- **Customers Advances for Construction**
  - Usually up-front deposits required to be made by builders to provide all or part of the cost of connecting new structures to utility lines
  - May or may not be refunded in part upon completion

- **Customer Deposits**
  - Usually reported as Liabilities Payable from Restricted Assets
  - Even if not refundable until service is terminated, AICPA guidance defines this as a current liability
Bonds or other debt that are repaid from proprietary fund resources are reported as long-term debt of the fund.

Bonds whose interest and principal are repaid from the revenues of a proprietary fund are called “revenue bonds”.

If bonds primarily or secondarily have general obligation backing, but are being serviced by a proprietary fund, they are treated as revenue bonds. The general obligation contingency is disclosed in the notes to the financial statements.
As indicated previously, there are many types of enterprise funds, thus accounting procedures vary greatly.

Transactions and related financial statements for a water utility fund are illustrated in the textbook (review and discuss).

- Generally, the same account titles are used as those recommended by the utility regulatory body.
- Accounting is essentially business accounting. Note, however, the capitalization of interest (Entry 9) and entries to restricted assets (Entries 11, 12, 13, and 18).
In a few states, municipally-owned utilities are subject to rate regulation by a state regulatory agency, which also regulates investor-owned utilities that operate in the state.

Those states may require government-owned utilities to follow the regulatory accounting principles specified by organizations such as NARUC and FERC.

If so, financial statements may appear quite different from those shown in Ill. 7-6 through 7-8.
Financial statement differences

- Plant assets and long-term liabilities are often reported above current assets and current liabilities, respectively.

- Plant assets may be reported at depreciated *original cost*. Subsequent transfers of ownership require new owners to report assets at depreciated original cost; any excess of purchase price above the net book value of the assets on the old owner's books is reported as "Utility Plant Acquisition Adjustment" in the new owner’s accounts. Regulators may require this account to be amortized at a different rate than used for depreciation.
Q: Why are plant assets and long-term debt reported above current assets and current liabilities under RAP?

A: This is because in regulated utilities, the magnitude of plant assets and long-term debt is great in relation to current assets and liabilities. Current assets and liabilities tend to be comparatively immaterial.
An EPA rule requires all municipal landfills to meet stringent location, design, and operating requirements. Operators must also provide financial assurance they can properly close landfills when full and provide post-closure ground water monitoring for 30 years after closure. These stringent rules are designed to protect the environment from irresponsible handling of hazardous materials.
Estimate the current cost of hiring a qualified third-party to close the MSWLF and care for it for 30 years after closure.

Recognize a portion of this cost proportionate to the ratio of estimated capacity utilized during a year over the total capacity of the landfill as an expense of the enterprise fund and as a liability.

Annual adjustments are made as estimates change from year to year. Several required note disclosures are described in Chapter 7.
A segment is an identifiable activity or group of activities within an enterprise fund.

GASB requires segment reporting within an enterprise fund if the segment:
- has one or more bonds or other debt instruments outstanding, and
- there is a revenue stream pledged to support the debt.

Condensed financial information must be presented in the notes to the financial statements.
Proprietary funds (internal service and enterprise) are used to account for the business-type activities of a government.

Accrual accounting is used for proprietary funds and the required financial statements are quite similar to those used by for-profit entities.

Internal service funds are usually reported as governmental activities on the government-wide statements.

Regulatory accounting terminology and principles are used by some government-owned utilities.

END