**CHAPTER FOUR & FIVE**

**ACCOUNTING FOR CAPITAL PROJECT AND DEBT SERVICE FUNDS**

* 1. **Introduction**

The previous unit indicated that long lived assets such as office equipment, government vehicles and other relatively minor items may be acquired by a governmental unit by expenditures or appropriations of the general fund or one or more of its special revenue funds. Long – lived assets used by activities accounted for by a governmental fund types are called General fixed assets. Acquisitions of General fixed assets that require major amounts of money ordinarily cannot be financed from general fund or special revenue fund appropriations. Major acquisitions of General fixed assets are commonly financed by the issuance of long-term debt to be repaid from tax revenues, or by special assessments against property deemed to be particularly benefited by the long-lived asset. Other sources of financing the acquisitions of long-lived assets include grants from other governmental units, transfers from other funds, gifts from individuals or organizations or by a combination of several of these sources. If money received from these sources is restricted, legally or morally to the acquisition or construction of specified capital assets, it is recommended that a capital project fund be created to account for these resources to be used for major construction or acquisition projects. Long term debts will mature in the future and have to be repaid. The repayments of long-term debts are accounted in a debt service fund. In general, this chapter will discuss how capital project fund, and debt service fund funds are accounted.

* 1. **Capital Project Fund**

Capital project Funds account for financial resources to be used for the acquisition or construction of major capital facilities (other than those financed by proprietary funds & trust funds). Examples of major capital facilities are Administration Buildings, Civic Centers and libraries etc. These funds do not account for the acquisition of smaller fixed assets, such as vehicles, machinery & office equipment which are normally budgeted for & recorded as expenditure 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 capital project fund, as any other fund will depend on the legal requirement and the need for good financial management.

Capital project fund do not account for the fixed assets acquired only for the construction of the fixed assets. It exists only for the period of acquisition or construction of the fixed assets. After the acquisition or construction is completed, the capital projects fund will be abolished. The fixed assets constructed are accounted for in the general capital asset account at the governmental wide level. It does not also account for the repayment & servicing of any debt obligations issued to raise money to finance the acquisition of capital facilities. Such debt & debt related servicing activities are accounted for in the General long term debt accounts & Debt service funds. Since the purpose of capital project fund is to account for the acquisition and deposition of revenues for specific purpose, it contains balance sheet accounts for only liquid assets and for the liabilities to be liquidated by those assets.

* + 1. **Operation of Capital Project Funds**

Capital project funds are usually established on a project – by – project basis, because legal requirements may vary from one project to another. So, the existence of capital project fund as any other fund will depend on the legal requirement & the need for good financial management.

The focus of capital project fund 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, capital project funds do not have the same year – by – year focus as the General fund. Because of the multi – year focus of capital project fund, some accountants prefer not to close a capital project fund annually, but others do. Whether or not to close the capital project fund annually will depend on the unique factors of each case & will be strongly influenced by the requirement of the financing source.

**1. Financing Capital Project Funds:** Capital projects obviously need large amount of financing. Typical source of financing includes:

* Long term debt issue proceeds
* Grants from other governmental units
* Transfers from other funds with in the governmental entity
* Interest income from temporary investments
* Gifts from individuals or foundations
* Special taxes
* A combination of more than one of the above

Intergovernmental grants, gifts, special taxes & investment interests are considered as revenues, whereas, Inter Fund Transfers & Long-Term Debt issue proceeds are not revenues and are presented as other financing sources and are presented that way on the statement of changes in financial position.

Whether to have a separate capital project funds for each project or to account for all capital project funds in one fund depends in part on what type of financing involved. Different bond issues & different inter-governmental transfers might will have different legal requirements & each might require a separate capital project fund. On the other hand, if one bond issue is used to finance several projects, a single fund may be both permissible and advisable.

**2.** **Means of Acquisition:** Accomplishment of capital acquisition or construction project may be brought about in one or more of the following ways:

1. Outright purchase from Fund’s cash.
2. By construction, utilizing the governmental units own force.
3. By construction, utilizing the services of private contractors.
4. By capital lease agreement.

**3. Costs Included:**  All expenditures for setting the project ready are put in the capital project fund, including architect fees, transport costs, damages, etc. Usually, major capital facilities are constructed by contracted labor. Construction costs incurred are charged to expenditures. At the completion of the project, the cost of the facility is recorded as a fixed asset in the general capital asset account at the governmental wide level. Until then, any costs incurred are shown as construction work in progress in the general capital asset account. Generally, the year – end closing entry in the capital project fund triggers the recording of an amount in the General capital Asset Account equal to the credit to the expenditures account.

**4. Retained Percentage:** It is common in construction contracts for the entity to hold back some percentage of the last payment of the contract and to require contractor on large scale contract to give performance bond. This is to prevent the contractor from doing a poor quality work, especially in a rush to finish at the end. Basically, the entity will pay part of the final sum, and then have its own engineers come and inspect the contractor’s work. If the contractor’s work passes the inspection, the balance of the amount owed is paid. If the engineer finds poor quality or undone work, the contractor must then correct the problem before the final retained sum is paid. This amount withhold by the governmental entity is known as retained percentage.

**5. Encumbrance:** Some governmental units include annual capital budgets as part of their annual appropriated budget in which case the annual capital is recorded in the general ledgers of the various capital project funds. However, since the amount involved in a capital project is usually large, an encumbrance account is highly recommended & it is necessary in case of multiple subcontractors for a project. Because of this, an encumbrance accounting procedure alone are usually deemed sufficient for control purposes. So, recording of the budget in the general ledger might not be necessary. In capital project fund, encumbrance is also recorded by the same amount in which the construction contract agreement is made between the governmental unit and the contractor and also in the same manner as that of the general and special revenue fund.

**6. Treatment of Residual Equity or Deficits:** If necessary expenditures & other financing uses are planned & controlled carefully, actual does not exceed plans. Revenues & other financing source of the capital project fund should equal or slightly exceed the expenditures and other financing uses leaving a residual equity (surplus) and if long term debt had been incurred for the purpose of the capital project fund and under this case, there are three possible options;

1. The balance could be transferred to the debt service fund, as residual equity transfer for retiring the debt, which has been incurred for the purpose of the project.
2. If the residual equity were deemed to have come from grants or shared revenues restricted for capital acquisitions or constructions, legal advice may indicate that any residual equity may return to its source in proportional amount or;
3. The balance might be retained for future maintenance purpose.

In some situations, in spite of careful planning and cost control, expenditures and other financing use of a capital project fund may exceed its revenues and other financing source resulting in a negative fund balance (deficit). If the deficit is small, an additional transfer will probably be requested from one or more other funds. If the deficit is relatively large and/or intended transfers are not feasible, the governmental unit may seek additional grants or shared revenues from other governmental units to cover the deficits. If no other alternative is available, the governmental unit would need to finance the deficit by issuing bonds. Under these circumstances, a legal or disciplinary action might have been sought against the project manager, since public money was being used.

**7. Investment:** All the money necessary to pay for capital project is usually raised near the inception of the project by issuing bond; but contractors are paid as work in progresses. Excess cash, therefore, may be temporarily invested in high-quality interest-bearing securities such as: Treasury bills, Bank notes, Certificates of deposit and government bonds with short maturities.

* + 1. **Accounting for Capital Project Fund**

Financial activities such as revenues earned and expenditures incurred for the construction or acquisition of capital projects are recorded in almost the same manner as that of the General and Special Revenue funds. At the end of each fiscal year prior to a completion of a capital project, the Revenues, other financing sources, Expenditures, other financing uses and encumbrance ledger accounts of the capital projects fund are closed to the unreserved and undesignated fund balance account. Upon completion of the project, the entire capital project fund is closed by a transfer of any unused cash to the Debt Service fund or to the General fund, as appropriate. The unreserved and undesignated fund balance ledger account of the receiving fund would be for Residual equity transfer. Any cash deficiency in the capital projects fund probably would be made up by a General fund. This operating transfer would be credited to the other financing sources ledger account of the capital projects fund and debited to the other financing uses account of the general fund. The assets constructed with the resources of the capital projects fund are not included in that funds balance sheet. The constructed plant assets are recorded in the governmental units general capital assets account at the governmental wide level. Furthermore, the bonds issued to finance the capital projects fund are not a liability of the fund. Prior to maturity date of the bond, the liability is carried to the General Long-Term Debt account and when the bond matures, it will be transferred to Debt service fund. The following illustration will show how the construction and related activities are accounted for in a capital projects funds.

**Illustration - 6.1**: Assume the town of Bonga wants to construct a new library on the site owned by the town. The construction is expected to cost Br.50, 000,000. It is expected to be completed within two years on June 30, year 7. In a special meeting held on July 2, year 5, the members of the town council approved a Br.30,000,000 issuance of general obligation Bonds maturing in 20 years. The proceeds of this sale will be used to help finance the construction of the new library. The remaining Br.20, 000,000 will be financed by an irrevocable state Grant that has been awarded. The following transactions occurred during the fiscal year ended June 30, year 6.

1. The General fund loaned Br.500, 000 to the library capital projects fund for Drafting, Engineering and other preliminary expenses by receiving a note which is later to be settled from the bond issue proceeds. The journal entry to record this will be:

Cash------------------------- 500,000

Bond anticipation Notes Payable----- 500,000

1. Out of the irrevocable grant of Br.20, 000,000, the state contributed Br.5, 000,000 and the remaining is deemed to be susceptible to accrual. This will be recorded as

Cash ----------------------- 5,000,000

Due from state grant-------- 15,000,000

Revenue-------------------- 20,000,000

1. Preliminary Engineering and Planning costs of Br.320, 000 were paid to the contractor. There had been no encumbrances for this cost.

Construction Expenditure--------- 320,000

Cash ---------------------------- 320,000

1. The Bonds were sold at 101%. The bond indenture agreement requires that any premium to be set aside in the related Debt Service fund.

Cash [101%\*30,000,000] ------------------ 30,300,000

Other Financing source- Bond proceeds ---------- 30,000,000

Due to debt service fund ------------------------------- 300,000

1. The town of Bonga library capital project fund invested its Br.10,000,000 bond proceeds on the federal Government treasury bills.

Short Term Investment – Treasury Bills ---------10,000,000

Cash ----------------------------------------- 10,000,000

1. A construction contract for Br.44, 270,000 is authorized and signed with the contractor.

Encumbrances ---------------------44,270,000

Fund balance Reserved for Encumbrances ------ 44,270,000

1. Orders were placed for materials estimated to cost Br.550, 000.

Encumbrances ------------- 550,000

Fund Balance Reserved for Encumbrances------- 550,000

1. The materials previously ordered (transaction 7) were received at a cost of Br.510, 000.

a) Fund balance reserved for Encumbrance ---- 550,000

Encumbrance --------------------------------550,000

b) Construction expenditure------------------------- 510,000

Construction Payable ----------------------------510,000

1. In addition to the construction contract of transaction 6, Br.3, 900,000 was incurred for the services of the architects and engineers; of this amount Br.3, 100,000 was paid.

No Encumbrance was recorded.

Construction expenditure -------------------- 3,900,000

Construction payable --------------------------------- 800,000

Cash ------------------------------------------------- 3,100,000

1. Received cash of Br.1, 000,000 from the General fund as an operating transfer.

Cash -----------------------------------------1,000,000

Other financing source- Operating Transfers In----1,000,000

1. A partial payment of Br.10, 000,000 was received from the state irrevocable grants and the General fund loan was repaid with interest amounting to Br.10, 000.

Cash ------------------ 10,000,000

Due from state grant ------------------- 10,000,000

Bond anticipation notes payable-------500,000

Interest Expenditure --------------------- 10,000

Cash ---------------------------------- 510,000

1. When the project was approximately half finished, the contractor submitted billing for a payment of 12,000,000.

Fund balance Reserved for Encumbrance------- 12,000,000

Encumbrance ---------------------------------------- 12,000,000

Construction Expenditure---------------------------12,000,000

Construction payable ---------------------------------12,000,000

1. The contractor’s initial claim was fully verified and paid.

Construction payable ----------------------- 12,000,000

Cash---------------------------------------------- 12,000,000

* + 1. **Financial Reporting for Capital Project Fund.**

Each capital project fund that meets the definitions of major fund must be reported in a balance sheet and statement of revenue, expenditure and change in fund balance. These two financial statements are prepared for the town of Bonga after posting and preparing trial balance for the forgoing transactions as follows:

**Town of Bonga**

**Library Capital Project Fund**

**Trial Balance**

**June 30, Year 6**

**Account Title** **Debit Credit**

Cash Br.20, 870,000

Short term investment – Treasury Bills 10,000,000

Due from state Grant 5,000,000

Construction payable Br.1, 310,000

Due to DSF 300,000

Fund balance Reserved for encumbrance 32,270,000

Unreserved and Undesignated fund balance -

Revenues 20,000,000

OFS – Bond Proceeds 30,000,000

OFS – Operating transfers 1,000,000

Construction Expenditures 16, 730,000

Interest Expenditures 10,000

Encumbrances 32, 270,000 \_\_\_\_\_\_\_\_\_

**Total**  Br.84, 880,000 Br.84, 880,000

**Town of Bonga**

**Library Capital Projects Fund**

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

**For The Year Ended, June 30, year 6**

Revenues:

Irrevocable State grant Br20, 000,000

Expenditures:

Construction Expenditures Br.16, 730,000

Interest Expenditure 10,000 16,740,000

Excess of Revenue over Expenditure 3,260,000

Other financing sources (Uses)

OFS – Bond Issue Proceeds 30,000,000

OFS – Operating transfers in 1,000,000 31,000,000

Excess of Revenue and OFS over Expenditure 34,260,000

Add: Fund balance – July 1, Year 5 \_\_\_\_\_-\_\_\_\_

Fund balance – June 30, year 6 Br.34, 260,000

**Town of Bonga**

**Library Capital Projects Fund**

**Balance Sheet**

**June 30, Year 6**

**Assets**

Cash Br.20,870,000

Short Term Investment – Treasury bills 10,000,000

Due from state Grant 5,000,000

Total Asset Br.35,870,000

**Liabilities and Fund Balance**

Construction Payable Br.1,310,000

Due to DSF 300,000

Fund Balance:

Reserved for Encumbrance 32,270,000

Unreserved and undesignated 1,990,000

Total Liabilities and Fund balance Br.35,870,000

After preparing the financial reports, some of the accounts which require closure will be closed as follows:

1. Revenues 20,000,000

Other financing source – Bond Proceeds 30,000,000

Other financing source– Operating Transfer In 1,000,000

Construction Expenditure 16,730,000

Interest Expenditure 10,000

Unreserved and undesignated-fund Balance 34,260,000

2. Unreserved and Undesignated – fund balance. 32,270,000

Encumbrance 32,270,000

* 1. **Debt Service Fund**

Governmental entities might face cash shortage while they carry their regular activities. In such a case, these Governmental entities may issue general obligation debt in the form of liabilities usually bonds that are secured by the full faith and credit of the governmental unit. The payment of the principal and interest should be well planned in advance and made timely. The payment of principal and interest on debt is called **servicing the debt.** This sub topic will discuss how government’s long-term liability is serviced and how such debt servicing activities are accounted in a separate fund. Thus, debt service funds are used to accumulate resource that will be used to pay the principal and interest on general obligation long-term debt. General obligation debt does not include debt that will be serviced from resource accumulated in proprietary funds and non-expendable trust funds**.** Accounting for Debt service fund is similar to those of the General funds and Special revenue funds. However, the budgetary account of encumbrance is not necessary for Debt service funds.

* + 1. **Characteristics of Debt Service Fund**
* Debt service fund is used to account for both the repayment of the principal and payment of interest of the long-term debt when they are due.
* Debt service fund are government funds and therefore, are expendable. Debt service funds are created for general long-term debt which has been used to provide resource for one of the other government funds.
* Debt service fund use modified accrual basis. An application of modified accrual basis has to do with interest payable. Interest payable is not accrued in the debt service fund. It is only recorded as liability in the period when it becomes due. For example, Interest due on January 31, 2008 would not be accrued and recorded on December 31, 2008 balance sheet.
* Accounts recommended for use by Debt service fund are almost similar with accounts of other funds.
* The operations of Debt service fund do not involve the use of purchase orders and contracts for goods and service, so encumbrance accounting is not needed.
* Timing of Debt service payment mostly due to both political and financial management consideration, the payment should be kept consistent. The life of the issue with serial bond is easy but with term bonds, it takes planning.
* Although each issue of long term or intermediate debt is a separate obligation, GASB standard suggests a single Debt service fund be used to service all debts as much as possible if not as few numbers of funds as possible.
* For convenience of bondholders, the payment of interest and the redemption of matured bond is handled through banking system.
  + 1. **Types of Long-Term Debts**

Bond is a written promise to pay a specified principal sum at a specified future date with interest. They are typically issued in 1,000 and 5,000 denominations. Most long term debt of governmental units consists of one of the following two basic types of bonds:

1. **Term Bond:** Term bonds are bonds whose principal is repaid in lump sum at their maturity date. Such lump sum payments are usually made possible through accumulation of money in the Debt service fund on an actuarial basis over the life of the bond issue in a sinking fund.
2. **Serial bonds**: These are bonds which have periodic maturities. The principal of a serial bond are repaid at various or determined dates over the life of the issue. There are four types of serial bonds: Regular serial bond, Deferred serial bond, Annuity serial bond and Irregular serial bond.

In addition to bonds, debit service fund may be required to service debts arising from:

* Long term debt which arise because of different activities of governmental unit.
* Debt arising from the use of notes or warranty having a maturity period of more than a year.
* Periodic payments required by capital lease agreements.

**Source of finance for Debt service fund**:

* Special taxes
* Periodic transfer from General fund
* Investment made for purpose of repaying long term debt.
* Issuing new bond to refinance a matured bond
* Bond premium and accrued interest on bond sold
* Residual equity transfer from other funds
  + 1. **Accounting for Debt Service Fund**

As with all government type funds, the measurement focus of Debt service fund is available and spendable resources. This means that the accounting system centers on the accumulation of resource and expenditure of those resources. As a result, long lived assets and long-term liabilities are not found in Debt service fund. The available spendable criteria focus on assets currently available and the claims due and payable against those assets. The timing of the recognition of revenues and expenditure is the same for Debt service fund as for all other governmental type funds-modified accrual bases. Therefore, the rules for recognition discussed before are applicable to debt service funds. In general, revenues are recorded when they are measurable and available, and expenditures are recorded when due and payable. The following examples will illustrate the accounting for Debt service fund.

**Illustration-:** Assume that Bonga town administration issued Br 5,000,000 serial bonds on Jan 1, 2007 for the construction of recreational park. The bond bear semi- annual interest rate of 5% to be paid on Jan 1 and August 1 and the face value of the bond is to be retired over 10 years by making equal installment payments on Jan 1 of each year.

Farther, burden of servicing the debt on the tax payers were distributed evenly throughout the life of bond. Accordingly, it is determined that tax payers should provide Br 625,000 as revenue in 2007. It is also agreed that the General fund will transfer Br 125,000 to the debt service funds on July, 2007.

Appropriations for the year incurred only one semi-annual interest payment to be made on August, 2007.

The entry to record the legally adopted budget is as follows:

1. Estimated revenue ………………………………… 625,000

Estimated other financing source …………………...125,000

Appropriations (5%X5000, 000) ………………….250, 000

Fund Balance ……………………………… ……...500,000

During the year 2007, the debt service fund levied property tax of Br 650,000 of which 3.85% is estimated to be uncollectible. The entry would be:

2. Property tax- receivable current ………………… 650,000

Allowance uncollectible 3.85 % (650,000) ………...25,025

Revenues ……………………………………………624,975

If cash in the amount of Br 575,000 is realized from the property tax during the current year, the entry in the debt service fund should be:

3. Cash ……………………………………………575,000

Property tax receivable current……………………….575,000

If Br 1,250 of uncollectible taxes are written off, the following entries should be passed

4. Allowance for un collectible property tax ……………………1,250

Property tax receivable current ………………………………1,250

To generate asset, in addition to those contributed by the tax payers and the General fund, the tax receipts are invested in marketable securities. If Br. 500,000 is invested, the entry would be:

5. Investment……………………………… 500,000

Cash……………………………………………. 500,000

When some of the investments are sold for Br. 250,000 of which Br. 25,000 is interest earned on investments, the following entry should be made:

6. Cash…………………….. …………250,000

Investment ……………………………………… 225,000

Revenue (interest on investment)…………………. 25,000

For investments due to the town bond holders, checks are issued in August after vouched for the amount of the semiannual interest. The entries to record the due is as follows:

7. Expenditure- interest ………………………… 250,000

Interest payable……………………………………………250,000

To record the payment of the expenditure

8. Interest payable………………………………… 250,000

Cash……………………………………………….250, 000

To record the issuance of checks for payment of the transfer of Br. 125,000 from the General fund, classified as an operating transfer in and recorded to the Debt service fund book as follows:

9. Cash …….……………………. 125,000

Operating Transfer In ………………………125,000

On Dec 31, 2007, the balance sheet date of the interest earned but not yet received on the investment amounted to Br. 12,500. This transaction should be recorded as:

10. Interest receivable on investment……………… 12,500

Revenue-interest earned on investment………………. 12,500

If the remaining Br. 275,000 of the marketable securities previously acquired and still held on Dec 31, 2007 had market value of Birr 287,500, the following journal entries should be passed to record the increase in value.

11. Investments………………….. …12,500

Revenue from increase in fair market value of investment... 12,500

After posting the above transactions, a pre-closing trial balance for the debt service fund of the town at the end of the year 2007 is presented as follows:

**BongaTown Administration**

**Debt Service Fund**

**Pre- closing Trial Balance**

**As of Dec 31, 2007**

**Debit Credit**

Cash……………………………………… Br. 200,000

Property tax receivable current …………. 73,750

Allowance for uncollectible tax……………………………… Br.23,750

Investments ………………………………. 287,500

Interest receivable………………………… 12,500

Revenue property tax …………………………………………… 625,000

Revenue interest earned…………………………………………. 37,500

Revenue from increase in mkt value of security --------------------- 12,500

Operating transfer in ……………………………………………. 125,000

Expenditure (interest)……………………… 250,000

Estimated revenue………………………… 625,000

Estimated other financial source…………… 125,000

Appropriations……………………………………………………. 250,000

Fund balance……………………………………………………… 500,000

**Total ………………………………… Br.1,573,750 Br. 1,573,750**

The statement of revenue, expenditure & change in fund balance and Balance sheet for Bonga town can be prepared from the forgoing transaction as follows:

**BongaTown Administration**

**Debt Service Fund**

**Statement of Revenues Expenditures and Change in Fund Balance**

**For the year Ended Dec 31, 2007**

Revenues :

Property tax ………………………………….. Br.625,000

Interest on investment ……………………….. 37,500

Increase in fair mkt value of invest…………... 12,500 ………… Br.675, 000

Expenditures :

Semi annual interest ………………………….. …………………… (250,000)

Excess of revenue over expenditure…………………………………… 425,000

Add: Other financing sources:

Operating transfer in ……………………………. 125,000

Less: Other financing uses ……………………….. 0……………………125,000

Excess of revenue and other financing sources

Over expenditure and other financing uses…………………………………550,000

Add beginning fund balance……………………………………………… 0

Ending fund balance……………………………………………………Br.550,000

**BongaTown Administration**

**Debt Service Fund**

**Balance sheet**

**Dec 31, 2007**

**Assets**

Cash ………………………………………………….…Br. 200,000

Property tax receivable ……………………73,750

Less allowance for uncollectible accounts (23,750)………. 50,000

Investments………………………………………………….287,500

Interest receivable…………………………………………… 12,500

**Total assets ………………………………………… 550,000**

Liabilities ………………………………………………….. 0

Fund balance ……………………………………………… 550,000

**Total liability & fund equity………………………… Br.550,000**

After preparing the different financial statements, the following closing entries will be made:

1. Appropriations …………………………… 250,000

Fund balance …………………………….. 500,000

Estimated revenue ……………………… ….625,000

Estimated other financing source…………. ..125,000

2.Revenue -property tax ………………….. 625,000

Revenue-interest on investment …………… 37,500

Revenue increase in mkt value………… 12,500

Other financing source-OTI……………… 125,000

Expenditure ……………………………… 250,000

Fund balance……………………………… 550,000