**CHAPTER 1**

**FINANCIAL REPORTING FOR GOVERNMENTAL AND NFP ENTITIES**

**Unit objectives**

Dear students at the end of this chapter you will be able to:

* Identify and explain the characteristics that distinguish governmental and not-for-profit entities from for-profit entities.
* Identify the authoritative bodies responsible for setting financial reporting standards for (1) state and local governments, (2) the federal government, and (3) not-for-profit organizations.
* compare and Contrast the objectives of financial reporting for (1) state and local governments, (2) the federal government, and (3) not-for-profit organizations.
* Explain the minimum requirements for general purpose external financial reporting for state and local governments and how they relate to 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. **Introduction**

Governmental and not-for-profit organizations are vast in number and range of services provided. In the United States, 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).

Accounting and financial reporting for governments and nonprofit organizations are based on distinctive concepts, standards, and procedures designed to accommodate their environments and the needs of their financial report users. Dear students This chapter describes about the major environmental characteristics of governmental and nonprofit organizations. It also describes about users, standard-setters, the characteristics of accounting and financial reporting for governmental and nonprofit organizations and objectives of financial reporting. The chapter ends with a brief discussion of the financial reporting of state and local governments.

* 1. **Characteristics and Types of Governmental & Not for Profit Organizations**
* *Dear students before reading the following paragraphs think for a moment about features and types of governmental and not for profit organizations?*

Governments and other nonprofit organizations are unique in that:

* **They do not attempt to earn a profit** **− and most are exempt from income taxes** − so typical business accounting, income tax accounting, usually is not appropriate.
* They are owned collectively by their constituents; and because ownership is not evidenced by equity shares that can be sold or traded, residents who are dissatisfied with their government must await a change in its elected governing body or move elsewhere.
* **Those contributing financial resources to the organizations do not necessarily** **receive a direct or proportionate share of their services.** For example, homeowners pay property taxes to finance public schools even if they do not have children in school or **the welfare recipient (probably) did not pay the taxes from which welfare benefits are paid.**
* **Their major policy decisions, and perhaps some operating decisions, typically are made by majority vote of an elected or appointed governing body** − for example, a state legislature, a city council, or a hospital board of directors − whose members serve part time, receive modest or no compensation, and have diverse backgrounds, philosophies, capabilities, and interests.
* Decisions usually must be **“in the sunshine”** − is meetings open to the public, including the news media − and most have “open records” laws that make their accounting and other records open to the public.

A G&NP organization exists because a community or society decides to provide certain goods or services to its group as a whole. Often these goods or services are provided regardless of whether costs incurred will be recovered through charges for the goods or services or whether those paying for the goods or services are those benefiting from them. Indeed, many G&NP services could not be provided profitably through private enterprise. In addition, the community or society may consider these services so vital to the public well-being that they should be supervised by its elected or appointed representatives.

**The major types of government and nonprofit organizations may be classified as:**

* 1. **Governmental:** federal, state, county, municipal, township, village, and other local governmental authorities and special districts.
  2. **Educational:** kindergarten, elementary and secondary schools, vocational and technical schools, and colleges and universities.
  3. **Health and welfare:** hospitals, nursing homes, child protection agencies, the American red Cross, and United Service Organizations (USO)
  4. **Religious:** Young Men’s Christian Association (YMCA), Young Women’s Christian Association (YWCA), Salvation Army, and other church-related organizations.
  5. **Charitable:** United Way, Community Chest, and similar fund-raising agencies; related charitable agencies; and other charitable organizations.
  6. **Foundations:** private trusts and corporations organized for educational, religious, or charitable purposes.

This general classification scheme has much overlap among the classifications. Many charitable organizations are operated by churches, for example, and governments are deeply involved in education, health, and welfare activities.

**The G&NP Environment**

**G&NP organizations are similar in many ways to profit-seeking enterprises. For example:**

1. They are **integral parts of the same economic system** and use financial, capital, and human resources to accomplish their purposes.
2. Both must acquire and convert scarce resources into their respective goods and services.
3. Both must have viable information systems, including excellent accounting systems to assure that managers, governing bodies, and others receive relevant and timely information for planning, directing, controlling, and evaluating the sources, uses, and balances of their scarce resources.
4. Because their resources are scarce, **cost analysis and other control and evaluation techniques** are essential to ensure that resources are utilized economically, effectively, and efficiently.
5. **In some cases,** **both produce similar products.** For example, both governments and private enterprises may own and operate transportations systems, sanitation services, and electric or gas utilities.
   * 1. **Distinguishing Characteristics of Governmental and Not-for-Profit Entities**

Governmental and not-for-profit organizations differ in important ways from business organizations. Not surprisingly then, 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.

Broad generalizations about such a diversified group as G&NP organizations are difficult. Nonetheless, the major differences arise from differing:

1. **Organizational Objectives**

**Expectation of income or gain** is the principal factor that motivates investors to provide resources to profit-seeking enterprises. But the objective of most governmental and nonprofit organizations is ***to provide as much service each year as their financial and other resources permit.*** G&NP organizations typically operate on a **year-to-year basis**—that is, each year they raise as many financial resources as necessary and expend them in serving their constituencies. They may seek to increase the amount of resources made available to them each year—and most do—but the purpose is to enable the organization to provide more or better services, not to increase its wealth.

**In sum,** private businesses seek to **increase their wealth for the benefit of their owners; G**&NP organizations **seek to expend their available financial resources for the benefit of their constituency.** Financial management in the G&NP environment thus typically focuses on acquiring and using financial resources—up on sources and uses of expendable financial resources (working capital), budget status, and cash flow—rather than on net income or earnings per share. Even G&NP entities whose external financial reports do not require primary emphasis on acquisition and use of financial resources emphasize this information for internal reporting and management decision-making purposes.

1. **Sources of Financial Resources**

The sources of financial resources differ between business and G&NP organizations, as well as among G&NP organizations. In the absence of a net income objective, no distinction generally is made between invested capital and revenue of G&NP organizations. A dollar is a financial resource whether acquired through donations, user charges, sales of assets, loans, or some other manner.

The typical nondebt sources of financial resources for business enterprises are **investments by owners and sales of goods or services to customers.** These sources of financing usually are not the primary sources of G&NP organization financial resources.

Governments have the unique power to force involuntary financial resource contributions through taxation−of property, sales, and income−and all levels rely heavily on this power. Grants and shared revenues from other governments also are important state and local government revenue sources, as are charges levied for goods or services provided, such as utilities.

Religious groups and charitable organizations usually rely heavily on donations, although they may have other revenue sources. Some colleges and universities rely heavily on donations and income from trust funds; others depend primarily on state appropriations and/or tuition charges for support. Hospitals generally charge their clientele, although few admit their patients solely on the basis of ability to pay. Indeed, many G&NP hospitals serve numerous charity patients and/or have large amounts of uncollectible accounts; and some hospitals rely heavily on gifts and bequests.

There are other, more suitable, differences in sources of G&NP organization financial resources as compared with profit-seeking businesses. For example,

* Many services or goods provided by these organizations are monopolistic in nature, and there is no open market in which their value may be objectively appraised or evaluated.
* User charges, where levied, usually are based on the cost of the goods or services provided rather than on supply-and demand-related pricing policies common to private enterprise.
* Charges levied for goods or services often cover only part of the cots incurred to provide them; for example, tuition generally covers only a fraction of the cost of operating state colleges or universities, and token charges (or no charges) may be made to a hospital’s patients.

1. **Regulation and Control**

The operation of most business enterprise is usually regulated by the **market;** i.e., the interaction of demand and supply. In the business environment, there exist a direct relationship between the financial resources each consumer provides and the goods or services that consumer receives from enterprise essentially dictates the type and quality of goods or services each profit-seeking enterprise will provide. Firms with responsive management will be profitable and will continue in the market. Firms with unresponsive management will be unprofitable and ultimately will be forced out of business. Therefore, the profit motive and profit measurement constitute an automatic allocation and regulating device in the free enterprise segment of our economy.

This profit test/regulator device is not present in the usual G&NP situation, and most G&NP organizations must strive to attain their objectives without its benefits. In addition, as noted earlier, many G&NP organizations provide goods or services having no open market value measurement by which to test consumer satisfaction. This problem exists because the goods or services are unique or are provided to some or all consumers without charge, or at a token charge. Thus, these consumers have no “dollar vote” to cast.

**Evaluating the performance and operating results of most Governmental & Not for Profit organizations is extremely difficult for the several reasons.**

1. There is no open market supply and demand test of the value of the goods or services they provide.
2. The relationship, if any, between the resource contributors and the recipients of the goods and services is remote and indirect.
3. Such organizations are not profit oriented in the usual sense and are not expected to operate profitably; thus, the profit test is neither a valid performance indicator nor an automatic regulating device.
4. Governments can force resource contributions through taxation.

Accordingly, due to the above reasons, other operating results measures and controls must be employed to ensure that G&NP organization resources are used appropriately and to prevent uneconomical or ineffective G&NP organizations from continuing to operate in that manner indefinitely. Governmental and nonprofit organizations, particularly governments, are therefore subject to more stringent legal, regulatory, and other controls than are private businesses.

All facts of a G&NP organization`s operations may be affected by legal or quasi-legal requirements (1) imposed externally, such as by federal or state statue, grant regulations, or judicial decrees, or (2) imposed internally by charter, bylaw, ordinance, trust agreement, donor stipulation, or contract. Furthermore, the need to ensure compliance with such extensive legal and contractual requirements often results in more stringent operational and administrative controls that in private enterprise.

1. **Ownership Interest**

**G and NP organizations are usually owned collectively by their constituents. Ownership is not evidenced by equity shares that can be sold or traded.** Because of this feature, there is no equity interest to be sold or traded. This implies that ownership interest is not clearly defined. **In general, 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 characterizes most G&NFP organization.**

But for-profit seeking enterprises, ownership interest is clearly defined which can be sold or traded or transferred to other parties. A business enterprise might either be owned by a sole proprietor or partners or stockholders who they do have the right to sell or transfer their ownership interest to other parties.

1. **Cost-Benefit Relationship**

***Those contributing resources (donors or taxpayers) do not necessarily receive an equivalent or proportionate share of the government`s or not-for-profit organization`s goods or services.***Someone may contribute more but may receive less or nothing. On the contrary, others may contribute less or nothing but may earn more. For example, welfare recipient (probably) did not pay the taxes from which welfare benefit are paid. However, there exist a direct relationship between costs and benefits in profit-seeking organizations. This implies that those who are capable of afford (incur) more costs are entitled to get a proportionate more benefits. Moreover, resource contributors (creditors and owners) can receive equity interest in the net assets of the organization.

1. **Scope of Operations**

The scope of operation of G&NFP organizations, especially for governmental organizations, is mostly **diversified.** i.e., they are engaged in a wide area of activity. For example, consider the city municipality of Hawassa. Its common operations cover health, security, administration, investments, construction, and others.

Relatively speaking, the operation or area of activity of profit-seeking organizations is more **specific.** Based on their activity, we may categorize a given business entity in a service, a merchandising or a manufacturing classification. Due to the above characteristics, which would be discussed in the subsequent sections, there is a need of complex accounting treatment for G&NFP organizations as compared to profit-seeking organizations.

* 1. **Sources of Financial Reporting Standards**
* ***Dear students what are the responsible bodies for setting standards for state and local government, For profit entities and For Not for profit organization?***

Figure 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.

Authority to establish accounting and reporting standards for not-for-profit organizations split between **the FASB and the GASB** because a sizeable number of not-for-profit organizations are governmentally owned, particularly public colleges and universities and government hospitals. The FASB is responsible for setting accounting and reporting standards for the great majority of not-for-profit organizations, those that are independent of governments. Governmental not-for-profit organizations follow standards established by the GASB.

The GASB and the FASB are parallel bodies under the oversight of the **Financial Accounting Foundation.** The foundation appoints the members of the two boards and supports the boards` operations 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). The federal Sarbanes-Oxley Act greatly enhanced financial support for the FASB by mandating an assessed fee on corporate security offerings. 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.”**

**Figure 1.1: Primary Sources of Accounting and Financial Reporting Standards for Businesses, Governments, and Not-for-Profit Organizations.**  (Source: Statement on Auditing Standards (SAS) 69, amended by SAS 91, April 2000, AICPA Professional Standards, v.1, Au Sec. 411.)

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, the federal government, and 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.”

**Users of Financial Reports**

Users of G&NP entity accounting information as both internal and external. Major external users are:

* Resource providers (tax payers, donors and potential donors, investors and potential investors, bond-rating agencies and grant providing organizations).
* Legislative and oversight bodies (higher-level governments and regulating agencies)
* Service recipients (citizen advocate groups)
  1. **Objectives of Financial Reporting**
* ***Dear students, what are objectives of financial reporting for governmental and not for profit entities?***

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.

Table 1.1 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 **inter period equity.** The concept and its importance are explained as follows:

The Board believes that inter period 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 Table 1.1) focused on evaluating budgetary integrity, operating performance, stewardship, and adequacy of systems and controls.

**Table 1.1: 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** |
| Financial reporting is used in making economic, social, and political decisions and in assessing accountability primarily to:   * Comparing actual financial results with legally adopted budget * Assessing financial condition and results of operations * Assisting in determining compliance with finance-related laws, rules, and regulations * Assisting in evaluating efficiency and effectiveness | Financial reporting should help to achieve accountability and is intended to assist report users in evaluating:   * Budgetary integrity * Operating performance * Stewardship * Adequacy of systems and controls | Financial reporting should provide information useful in:   * 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 |

Unlike the **FASB and the GASB**, which base 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 board 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 Table 1.1 shows, 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.

* 1. **Financial Reporting of State and Local Governments**
* **Dear students, what do you think state and local governments considers when preparing financial statements?**

Like the FASB, the GASB continues to develop concepts statements that communicate the framework within which the Board strives to establish consistent financial reporting standards for entities within its 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.

**Figure 1.2** displays the minimum requirements for general purpose external financial reporting under the governmental financial reporting model specified by GASB Statement No. 34 (**GASBS 34).** Central to the 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.

**The MD&A** should provide an overview of the government’s financial activities and financial highlights for the year. **The MD&A** should provide a narrative explanation of the contents of the CAFR, including the nature of the government-wide and fund financial statements, and the distinctions between those statements. The remainder of the **MD&A** should describe the governments financial condition, financial trends of the government as a whole and of its major funds, budgetary highlights, and activities affecting capital assets and related debt. Finally, the **MD&A** should discuss economic factors and budget and tax rates for the next year.

**GASBS 34** prescribes **two categories of basic financial statements,** **government-wide and fund. Government-wide financial statements** are intended to provide an aggregate overview of a government’s net assets and changes in net assets. 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 of accounting and flow of economic resources measurement focus.

(Note: **Measurement focus**⎯refers the nature of the resources, claims against resources, and flow of resources that are measured and reported by a fund or other entity. For example, governmental funds currently measure and report available financial resources, whereas proprietary and fiduciary funds measure and report economic resources. **Basis of accounting** refers the standards used to determine the point in time when assets, liabilities, revenues, and expenses (expenditures) should be measured and recorded as such in the accounts of an entity.

**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.

The notes to the financial statements are considered integral to the financial statements. In addition, governments are required to disclose certain RSI other than MD&A.

**Figure 1.2. Minimum Requirements for General Purpose External Financial Reporting—GASB Statement No. 34 Reporting Model**

Management's discussion  
and analysis (MD &A)

Government-wide  
financial statements Fund financial statements

Notes to Financial Statements

Required supplementary information  
(other than MD&A)

* 1. **Comprehensive Annual Financial Report (CAFR)**

Serious users of governmental financial information need much more detail than is found in the MD&A, basic financial statements, and RSI (other than MD&A). For state and local governments, much of that detail is found in the governmental reporting entity’s **comprehensive annual financial report (CAFR).** Although governments are not required to prepare a CAFR, most do so as a matter of public record and to provide additional financial details beyond the minimum requirements. As such the GASB provides standards for the content of a CAFR in its annually updated publication Codification of Governmental Accounting and Financial Reporting Standards. A CAFR prepared in conformity with these standards should contain the following sections.

**Introductory section**

The **introductory section** typically includes items such as a title page and contents page, a letter of transmittal, a description of the government, and other items deemed appropriate by management (e.g., list of principal officials, organization chart, location, etc). The letter of transmittal may be literally that – a letter from the chief financial officer addressed to the chief executive and governing body of the governmental unit – or it may be a narrative over the signature of the chief executive. In either event, the letter or narrative material should cite legal and policy requirements for the report. The introductory section may also include a summary discussion of factors relating to the government’s service programs and financial matters. Matters discussed in the introductory section should not duplicate those discussed in the MD&A. because the MD&A is part of the information reviewed (but not audited) by the auditor, it presents information based only on facts known to exist as of the reporting date since the introductory section is generally not covered by the auditor’s report, it may present information of a more subjective nature, including prospective information such as forecasts or expenditures.

**Financial section**

The financial section of comprehensive annual financial report should include **(1) an auditor’s report, (2) management’s discussion and analysis (MD&A), (3) basic financial statements, (4) required supplementary information (other than MD&A), and (5) other supplementary information, such as combining statements and individual fund statements and schedules.** Items (2), (3), and (4) represent minimum requirements for general purpose external financial reporting. So, it should be apparent that a CAFR provides additional supplementary financial information beyond the minimum amount required by generally accepted accounting principles. The financial section should contain sufficient information to disclose fully and present fairly the financial position and results of financial operations during the fiscal year. Laws of higher jurisdictions, actions of the legislative branch of the governmental unit itself, and agreements with creditors and others impose constraints over governments` financial activities and create unique financial accountability requirements Governmental financial reporting has evolved to meet the unique needs of citizens and other financial statement users. It should not be surprising that these financial statements are quite different from those prepared by business organizations. **The basic financial statements, which are reported in the financial section of CAFR, consist of:**

**Government-wide Financial Statements**

1. Statement of net assets
2. Statement of activities

**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
   * 1. **Government-wide Financial Statements**

* The **two government-wide financial statements** are intended to report on the government`s **operational accountability**. As such, the government-wide financial statements are prepared using essentially the same basis of accounting and measurement focus that are used in business accounting−that is, the **accrual basis of accounting and measurement of total economic resources.**
  + 1. **Fund Financial Statements**
* By contrast, governmental fund financial statements report on **fiscal accountability**. Therefore, these statements report only information that is useful in assessing whether financial resources were raised and expended in compliance with budgetary and other legal provisions. Thus, governmental fund statements focus on the **flow of current financial resources**−cash and near cash resources that are available for expenditure. Since long-term obligations do not have to be paid in the current budgetary period, nor do noncurrent assets such as land, buildings, and equipment provide resources to pay current period obligations, **neither** is reported in the governmental funds. Both are reported in the **Governmental Activities column of the government-wide statement of net assets.**
* **Modified accrual** is the basis of accounting that has evolved for governmental funds. Under this basis, **revenues** are recorded only if they are **measurable and available** for paying current period obligations. **Expenditures** are generally recognized when **incurred.**
* The governmental fund statement of revenues, expenditures, and changes in fund balances reports **expenditures,** since outlays to acquire goods or services are more relevant than expenses in measuring the outflow of current financial resources. **Expenses,** however, are more relevant at the government-wide level, as they measure the cost of services provided. Consequently, **expenses,** classified by program or function, are reported for both **governmental and business-type activities.**
* Proprietary fund financial statements present financial information for enterprise funds and internal service funds. Both types of funds operate essentially as self-supporting entities and, therefore, follow accounting and reporting practices similar to those of business organizations. Enterprise funds and internal service funds are distinguished primarily by the kinds of customers they serve. **Enterprise funds** provide goods or services to the **public**, whereas **internal service funds** mainly serve **departments of the same government.** For most governments, the information reported in the Business-type Activities column of the government-wide statements is simply the total of all enterprise funds information. Because internal services funds predominantly serve governmental activities, financial information for internal service funds is typically reported in the **Governmental Activities column** **at the government-wide level.**
* The final two required financial statements are those for the fiduciary funds. By definition, **fiduciary funds** account for resources that the government is holding or managing for an external private party, that is, an individual, organization, or other government. Because these resources may not be used to support the governments own programs, GASB standards require that financial information about fiduciary activities be omitted from the government-wide financial statements; however, the information must be reported in two fund financial statements: **a statement of fiduciary net assets-fiduciary funds and a statement of changes in fiduciary net assets-fiduciary funds.** Both statements are prepared using **accrual accounting** **with the economic resources measurement focus.**

Both governmental funds and proprietary funds financial statements must provide separate columns for **each major fund.** A fund is classified as major if it is significantly large with respect to the whole government. **“A fund is “major” if**

1. Total assets, liabilities, revenues, or expenditures/expenses of the individual governmental or enterprise fund are at least **10 percent** of the corresponding total of assets, liabilities, revenues, expenditures/expenses for all funds of that category or type (total governmental or total enterprise funds), and
2. Total assets, liabilities, revenues, or expenditures/expenses of the individual governmental or enterprise fund are at least **5 percent** of the corresponding total for all governmental and enterprise funds combined.

The aggregate of non-major governmental and enterprise funds is reported in a **single column of the corresponding statements.**

Reporting by major fund meets the information needs of citizens and other report users having a specific interest in the financial condition and operations of a particular fund. To meet the needs of individuals having an interest in particular non-major funds, governments should provide separate combining financial statements for nonmajor governmental and proprietary funds, as well as for discretely presented component units. Combining and individual fund statements are not ordinarily audited unless the engagement letter with the auditor extends the scope of the audit to include these statements. Other supplementary information that may be presented in the financial section of the CAFR includes schedules necessary to demonstrate compliance with finance-related legal and contractual provisions and schedules to present comparative data on items such as tax collections and long-term debt.

**Statistical section**

* In addition to the introductory and financial sections of the CAFR, 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.
* GASB Statement No. 44 indicates that generally the statistical section should present information in five categories to assist the user in understanding and assessing a government`s economic condition. The five categories are:

1. **Financial trends information,** which provides the user with information that is helpful in understanding and assessing how a government`s financial position has changed over time. Schedules in this category are prepared at both the fund level and government-wide level. The focus is on showing the trend in fund balances and net asset categories, including changes in net assets and fund balances.
2. **Revenue capacity information,** which assists the user with understanding and assessing the government’s ability to generate its own revenues (own-source revenues), such as property taxes and user charges. The schedules presented should focus on the governments most significant own-source revenues. Suggested schedules provide information on the revenue base (sources of revenue), revenue rates (including overlapping tax rate information), and property tax levy and collection information.
3. **Debt capacity information,** which is useful in understanding and assessing the governments existing debt burden and its ability to issue additional debt. Four types of debt schedules are recommended−ratios of outstanding debt to total personal income of residents, information about direct and overlapping debt, legal debt limitations and margins, and information about pledged revenues.
4. **Demographic and economic information,** which assists the user in understanding the socioeconomic environment in which the government operates, and provides information that can be compared over time and across governments. Governments should present demographic and economic information that will be most relevant to users, such as information on personal income, unemployment rates, and employers.
5. **Operating information,** which is intended to provide a context in which the governments operations and resources can be better understood. This information is also intended to assist users of financial statements in understanding and assessing the government’s financial condition. At a minimum, three schedules of operating information should be presented-number of government employees, indicators of demand or level of service (operating indicators), and capital asset information.

**MODULE END QUESTIONS**

1. **Brief Discussion Part**

**Instruction:** Give brief description for each of the following questions

1. Describe the principal differences that distinguish governmental and not-for-profit organizations from business organizations.
2. Compare and contrast the Objective of financial reporting of State and local government, Federal Government, and Not for profit entities.
3. Identify the authoritative bodies responsible for setting financial reporting standards for (1) state and local governments, (2) the federal government, and (3) not-for-profit organizations.
4. Explain the minimum requirements for general purpose external financial reporting for state and local governments and how they relate to comprehensive annual financial reports.
5. 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.
6. **Multiple choice Questions**

**Instructions: Choose the best answer from given alternatives**

1. All of the following are characteristics of not-for-profit organizations (NPOs) that distinguish them from business organizations *except*
2. Ability to impose taxes on citizens.
3. Operating purposes other than to earn a profit.
4. Absence of ownership interests.
5. None of the above.
6. Which of the following organizations would least likely meet the criteria to be classified as a governmental not-for-profit organization?
7. Museum C. Public hospital
8. Religion-affiliated university D. Social service agency
9. Government accounting standard board set Standards for;
   1. Business entities C. Governmental entities
   2. Governmental not for profit entities D. All except “A”

C**HAPTER TWO**

PRINCIPLES OF ACCOUNTING AND FINANCIAL REPORTING FOR STATE AND LOCAL GOVERNMENTS

**Unit Objectives**

Dear students After studying this chapter, 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.
* Define fund and principles of fund accounting, Types of funds in each fund category and characteristics of each fund type.
* Discuss the nature of major fund reporting and the criteria used to determine whether a fund should be reported as a major fund.
  1. **Introduction**

Dear students in this unit we will cover different sections starting with activities of state and local government, principles of accounting and financial reporting for state and local government and ends with major fund reporting principles.

* 1. **Activities of Government**

Government may involve in three types of activities:

1. Governmental activities,
2. Business-Type Activities, and
3. Fiduciary Activities
4. **Governmental Activities**

Governmental organizations differ from those of for-profit business organizations in 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 service 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**. Governments must also incur costs for **general administrative support** such as data processing, finance, and personnel. **Core governmental services, together with general administrative support, comprise the major part of what GASB Concepts Statement No. 1 refers to as governmental-type activities.** In its more recent pronouncements, GASB refers to these activities as simply governmental activities.

1. **Business-Type Activities**

Governments also engage in 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 service they receive.** Operating subsidies from general tax revenues are not uncommon, however, particularly for transportation systems.

1. **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 hears to a deceased individuals 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.**

* 1. **Governmental Financial Reporting**
     1. **Defining the Financial Reporting Entity**
* ***Dear students before reading the following notes what do you know about government financial reporting specifically primary government and component units?***

Financial reporting has historically emphasized transactional substance over legal form. That is to say that preparer of financial statements cannot be satisfied with including in their reports only those organizations and activities that are legally defined as being a part of the government being examined. Instead, the preparer of the report must go beyond the legal definition of the entity to include all organizations and activities that may be legally separate but are still a substantive part of the government at hand.

Specific guidelines on defining the financial reporting entity can be found in the GASB’s *Codification of Governmental Accounting and Financial Reporting Standards*, Section 2100. That guidance will be briefly summarized in the paragraphs that follow. A reporting entity consists of the primary government and certain other organizations, identified as component units, for which the primary government is financially accountable.

1. **Primary Government**

The core or nucleus of the financial reporting entity is the “primary government.” All state governments and general-purpose local governments are considered to be primary governments. In addition, special-purpose governments are also considered to be primary governments if they meet **all of** the following criteria:

* The members of the governing body are chosen in a general election;
* The government functions as a separate legal entity; and
* The government is fiscally independent.

A government is considered to function as a separate legal entity if it enjoys the corporate rights typically associated with separate legal status. Examples of such rights include the ability to have its own legal name, the ability to sue or be sued in its own name, and the ability to own property in its own name. If an entity is *not* legally separate, it is considered to be an integral part of whichever government does exercise those powers.

1. **Component Units**

The financial reporting entity includes both the primary government and all of its “component units.” Component units are legally separate entities that meet ***any one* of** the following three tests:

**Test 1:** The primary government appoints the voting majority of the board of the potential component unit; *and i*s able to impose its will on the potential component unit *and/or i*s in a relationship of financial benefit or burden with the potential component unit.

**Test 2:** The potential component unit is fiscally dependent upon the primary government; or

**Test 3:** The financial statements would be misleading if data from the potential component unit were not included.

A primary government is said to be “financially accountable” for a component unit if it meets Test 1 or Test 2. Details on all three of these tests are provided below.

It is important to note that an entity can be the component unit of only one primary government. However, situations may arise when a given entity meets the criteria for inclusion as a component unit of more than one primary government. For example, the state could appoint a local governmental unit board and partially finance its operations (Test 1), while the local governmental unit’s board also may be fiscally dependent upon the county (Test 2). Should such a situation arise, a decision must be made to include the local government district as a component unit of one or the other primary governments.

* 1. **Components of Basic Financial Statements (BFS)**
* *Dear learners, as you remember business organization communicates its financial information through financial statements, the same is true for governmental organization. What are those statements?*

In continuing to pursue the concept of establishing “accountability,” we now arrive at the description of the vehicle most effectively utilized to establish that concept with the end user – the Basic Financial Statements (BFS). These general-purpose reports are the minimum acceptable GAAP presentation of the reporting entity. These statements are designed to be “lifted” from the CAFR and included in official statements for bond offerings and for widespread distribution to those users requiring less detailed financial information than is contained in the CAFR. The Basic Financial Statements provide readers with an overview of both the financial position and the results of financial operations for the reporting entity. The governmental unit issuing the BFS should provide an accompanying transmittal letter to inform users of the availability of the CAFR for those requiring more detailed financial information.

Basic Purpose Financial Statements have three components: Government wide financial statements, fund financial statements and Notes to the financial statements.

* + 1. **Government Wide Financial Statements**

1. **Statement of Net Assets**

The Statement of Net Assets presents the financial position of the reporting entity on the last day of the fiscal year. so, Ethiopian governmental entities statements should be dated Sene 30, of each year. The Statement of Net Assets includes the governmental activities and business type activities of the governmental units in separate columns. A total column representing the total entity wide activity of the unit is then presented. Component unit activities are also shown on this Statement but these are not included in the total for the entity wide activities. The Statement of Net Assets uses the economic resources measurement focus and the accrual basis of accounting.

1. **Statement of Activities**

The Statement of Activities uses the economic resources measurement focus and accrual basis of accounting. The statement provides an accounting of revenues, expenses and other activities that impact on the entity’s net assets.

* + 1. **Fund Financial Statements**

1. **Governmental Funds**

The next set of basic financial statements use the current resources measurement focus and modified accrual basis of accounting. The information on these statements is presented according to fund activity. Each fund is evaluated to determine if it meets the criteria to be a major fund or aggregated with other funds and presented in the non- major fund category.

1. **Balance Sheet**

The balance sheet reports only current assets and current liabilities. Each major fund is presented in a separate column with a separate column for non-major funds. The difference between the assets and liabilities is the fund balance. Fund balance is comprised of two components: reservations and designations. Reservations represent legal obligations of the governmental unit. Designations represent management’s decision to dedicate a portion of the fund balance for future use. A designation is only an intent to spend; this money may be used for another purpose if necessary.

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

This is the operating statement of the governmental unit. Each major fund is presented in a column with a separate column for aggregated non-major funds. Any fund designated as major on the balance sheet must also be displayed as major on this statement.

Revenues are listed first followed by expenditures. A total line for Excess (deficiency) of revenues over expenditures must be included. Other financing sources (uses) and special and extraordinary items are shown after this line. The Net change in Fund balances is the difference between the Excess (deficiency) of Revenues over Expenditures and the Total Other Financing sources (uses) plus the Special and Extraordinary items. This total is added to the beginning fund balance to arrive at an end of the year fund balance. This total must equal the total ending fund balance on the balance sheet.

1. **Reconciliation Statements**

There are two required reconciliation statements. These statements reconcile the information on the fund financial statements that are presented on a modified accrual basis to the entity wide statements presented on full accrual. Some reconciling items include: the impact of acquiring capital assets, long-term liability treatment and revenue recognition.

1. **Proprietary funds**
2. **Statement of Net Assets**

This statement is prepared using the economic resources measurement focus and the accrual basis of accounting. Funds should be presented based on the major fund criteria with a separate column for non-major funds. Internal Service funds are presented on this statement. however, they are not included in the major fund criteria and the information is not included in the total column for Proprietary funds.

Assets and liabilities must be displayed as current and non-current. The difference between total assets and total liabilities is the net assets of the fund.

1. **Statement of Revenues, Expenses and Changes in Fund Net Assets**

This statement is the basic statement of activities for the proprietary funds and must utilize the same major fund categories as the statement of net assets. The revenues and expenses must be distinguished between operating and non-operating.

1. **Combined Statement of Cash Flows**

GASB Statement #9 requires that governmental enterprises prepare a statement of cash flows for each period for which results of operations are reported. This statement is required for all governmental entities that use proprietary fund accounting. Statement #9 requires that the cash flow statement classify cash receipts and payments according to whether they stem from operating, non-capital financing, capital and related financing or investing activities.

The combined statement of cash flows provides the user with information relevant to the cash receipts and cash disbursements of an entity during an accounting period. The statement reports cash receipts, cash disbursements, and net change in cash resulting from operating, investing and financing activities of a governmental entity’s proprietary funds. This statement is generally quite useful to the user who has limited knowledge regarding financial matters. Most people, having experience with at least their own checkbook, can relate to issues concerning cash.

When used in conjunction with the statements described above, the statement of cash flows should help clarify issues related to:

* An entity’s ability to generate future net cash flows;
* An entity’s ability to meet its obligations as they come due;
* An entity’s needs for external financing;
* The reasons for differences between operating income and associated cash receipts and payments; and
* The effects on the entity’s financial position of its cash and non-cash investing, capital and financing transactions during the period.

A statement of cash flows should explain the changes during the reporting period in cash and cash equivalents regardless of whether there are restrictions on their use. The total amounts of cash and cash equivalents at the beginning and end of the period shown in the statement of cash flows should be easily traceable to similarly titled line items or subtotals shown on the Combined Balance Sheet as of those dates. Cash equivalents are defined as short-term, highly liquid investments that are both:

* Readily convertible to known amounts of cash; and
* So, near their maturity that they present an insignificant risk of changes in value because of change in interest rates.

Generally, only investments with original maturities of three months or less meet this definition.

Examples of items commonly considered cash equivalents are Treasury bills, commercial paper, certificates of deposit, money market funds and cash management pools. Cash purchases and sales of these types of investments generally are part of the entity’s cash management activities rather than part of its operating, capital, investment and financing activities, and details of those transactions should not be reported in a statement of cash flows. Not all investments that qualify are required to be treated as cash equivalents. Governmental enterprises should establish a policy concerning which short-term, highly liquid investments it will treat as cash equivalents. The enterprise should then disclose its policy for determining which of those items are treated as cash equivalents. Any change in that policy is a change in accounting principle and should be reported by restating financial statements for earlier years that are presented for comparative purposes. GASB Statement #9 recognized two methods for the preparation of cash flows – the “indirect” method and the “direct” method; however, GASB Statement #34 rescinded the indirect method.

* + 1. **Notes to be Included with the Governmental Units Financial Reports**

Notes are an integral part of a governmental entity’s external financial reporting and are the governmental unit management’s responsibility. Notes are the means by which the entity amplifies or explains the information presented in the main body of the statements. Information that pertains to specific financial statement items can be explained in qualitative terms, and supplementary data of a quantitative nature can be provided to expand the information in the financial statements. Restrictions placed on the state and local governmental units by contractual or financial arrangements are also presented and explained in the notes. Although notes are often written in language that is technical and difficult for the average user to understand, they provide important and meaningful information for the user of financial statements.

* 1. **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.

**Principle 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.***

The above statement implies that a governmental accounting system must provide data both for reporting in conformity with GAAP and for controlling and reporting of finance-related legal compliance matters. Thus, governmental units are required to prepare **two sets of financial statements.** These are:

1. Financial reports in compliance with GAAP **(General purpose financial statements)**
2. Financial reports in compliance with legal requirements. These sets of financial statements are considered as **“special reports” or “supplementary schedules”** and are not the basic general purpose financial statements.

**Principle 2: Fund Accounting System**

Governmental accounting systems should be organized and operated on a fund basis.

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.*

This definition requires that **two conditions** must be met for a fund, in a technical sense to exist:

1. There must be a **fiscal entity**⎯assets set aside for a specific purposes, and
2. There must be a **double entry accounting entity**⎯created to account for the fiscal entity.

In broader terms a single fund accounting entity is somewhat like a business accounting entity. Each **business accounting entity** has a self-balancing set of accounts⎯sufficient to capture all the reported attributes for the whole business and all its transaction. Likewise, **each fund of a government** has a self-balancing set of accounts sufficient to capture all the reported attributes⎯for a government fund of this type⎯of the portion of a government`s activities and resources that is accounted for in each particular fund. A key difference is that one accounting entity is used to account for all the activities and resources of a business, whereas each fund accounting entity is used to account for only a certain subset of a government`s activities and resources.

Likewise, each business accounting entity has its own journals, its own ledger, its own trial balance, and its own financial statements. Similarly, for **each fund of a government** there are separate journals and a separate ledger(s) and trial balance; and separate financial statements are prepared and presented.

**Principle 3: Types of Funds**

Three categories of activities in which governments engage were described early in this chapter: governmental, business-type, and fiduciary. There are **three closely related categories of funds:** governmental, proprietary, and fiduciary. Except for the fact that most internal service funds are treated as part of governmental activities rather than as part of business-type activities for purposes of government-wide financial reporting, the activity and fund categories are the same.

1. **Governmental Funds**

**Governmental funds⎯**are used to account for activities of a government that are carried out primarily to provide services to citizens and that are financed primarily through taxes.

The **governmental funds** category contains five types of funds: the General Fund, special revenue funds, debt service funds, capital projects funds, permanent funds.

1. **The General Fund**: to account for all financial resources except those required to be accounted for in another fund. Every state and local government has **one and only one General Fund,** although it may be called by a different name such as **general revenue fund**, **general operating fund, or current fund.** Other governmental funds will be created as needed. Most departmental operating activities, such as the city manager’s office, finance, personnel, and data processing, are typically accounted for in the General Fund. Unless a financial resource required to be accounted for in a different fund type, it is usually accounted for in the General 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. When tax or grant revenues or private gifts are **legally restricted for particular operating purposes,** such as the operation of a library or maintenance of roads and bridges, a **Special Revenue Fund** is created. The purpose of special revenue fund is to demonstrate that all revenues from that source were used for the special purposes only. For example, a government embarked 25% of current year revenue from value added tax for draught affected people, SRF may be established to account for this revenue. The number of special revenue funds used by state and local governments varies greatly, ranging from a **few too many.** Nevertheless, GASB standards recommend that governments establish only the minimum number of funds needed to comply with legal requirements and to provide sound management. An excessive number of funds creates undue complexity and contributes to inefficient financial administration.
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). Governments often engage in capital projects to accommodate a growing population or to replace existing capital assets. These projects typically involve major construction of items such as buildings, highways or bridges, or parks. To account for tax or grant revenues, or bond proceeds embarked for a capital project, as well as payments to architects, engineers, construction contractors, and suppliers, a **capital projects fund** is typically created. Multiple capital projects may be created if a government has multiple capital projects.
4. **Debt Services Funds** : to account for the accumulation of resources for, and the payment of, general long-term debt principal and interest. Governments that have bond obligations outstanding and certain other types of long-term general liabilities may be required by law or bond covenants to create a **debt service fund.** The purpose ofdebt service fund is to account for financial resources segregated for the purpose of **principal and interest payments on general long-term debt.** Some governments account for all debt service on general long-term debt in their General Fund, but governments ordinarily create one or more debt service funds if they have general long-term debt.
5. **Permanent fund** : is used to account for permanent endowments created when a donor stipulates that the principal amount of a contribution must be invested and preserved but **earnings on amounts** so invested can be used for some public purpose. Public purposes include activities such as maintenance of a cemetery or aesthetic enhancements to public buildings. If the earnings from a permanent fund can be used to benefit only private individuals, organizations, or other governments, rather than supporting a program of the government and its citizenry, **a private-purpose trust fund** is used instead of a permanent fund. In other words, a **permanent fund** is a fund to account for financial resources when an investment`s periodic revenue is used to pay general government expenditures.

Note that the governmental funds distinguished from one another by **the purpose or purposes for which the financial resources accounted for in each fund may or must be used.** Therefore, general government resources that are to be used to pay for construction of a major general government capital project are accounted for in a **Capital Projects Fund.** On the other hand, financial resources to be used to pay principal and interest on general long-term debt are accounted for in a **Debt Service Fund.** The distinguishing factor in the classification is the **purpose for which the resources are to be used.**

Accounting and financial reporting for the governmental category, the five fund types just described, have evolved to meet the budgetary and financial compliance needs of government, to achieve and report on the government’s **fiscal accountability.** Thus, it is hardly surprising that accounting for governmental funds focuses on the inflows and outflows of **current financial resources.** Current financial resources are cash or items such as receivables that will be converted into cash during the current fiscal period or that will be **available** soon enough after the end of the period to pay current-period liabilities. With the lone exception of property tax revenues, which GASB standards require to be collectible within 60 days of the end of the current fiscal year to be deemed available, governments are free to establish their own definition of available and, therefore, which items to recognize in their financial statements as current financial resources and revenues. In practice, the definition of available may range anywhere from 30 days to one year, but generally does not exceed 120 days.

Because governmental funds account for the inflows and outflows of current financial resources, the balance sheet for governmental funds reports only current assets and current liabilities and **fund balances (or fund equity),** the difference between current assets and current liabilities.

Thus, the accounting equation for a simple governmental fund is essentially the **working capital equation.**

**Current Assets ⎯ Current Liabilities = Fund Balance**

Governmental fund accounting measures fund financial position and changes in fund financial position sources, uses, and balances of net financial resources (working capital) rather than net income. The statement of revenues, expenditures, and changes in fund balance is the primary governmental fund operating statement. Indeed, it is more similar to a statement of cash flows than to an income statement.

Note that the governmental funds accounting equation do not provide for fixed assets used in general government activities or long-term debt incurred for those activities. However, significant amounts of fixed assets typically are **used in general government activities and significant amounts of long-term debt are related to those activities.** Accountability for these general government fixed assets and long-term liabilities is maintained in **two separates non-fund accounting entities called account groups.**

Account groups essentially lists the government`s general government fixed assets, are called general fixed assets (General Fixed Assets Account Group) and its general government long-term liabilities, known as general long-term debt (General Long-Term Debt Account Group).Offsetting accounts, counterbalancing the list of general fixed assets of general long-term debt, complete the accounting equation for each account group.

Consequently, the accounting equation for the General Fixed Assets Account Group is:

**Fixed Assets = Investment in General Fixed Assets**

The accounting equation for the General Long-Term Debt Account Group is:

**Amount Available in Debt Service Funds to Retire General Long-Term Debt + Amount to Be Provided in the Future to Retire General Long-Term Debt = Long-Term Liabilities Payable**

**Illustration 2.1**

The city of Hawassa issued a two-year note in the amount of Br 2,000,000 to finance the acquisition of five new fire trucks. The proceeds of the note and the expenditure for the fire trucks are to be accounted for in the General Fund. The city maintains a general journal and general ledger for the General fund and a separate general journal and general ledger to record the effect of certain transactions on governmental activities at the government-wide level.

**Required:**

Record the issuance of Br 2,000,000 note and the subsequent purchase of the fire trucks in the general journals of the general Fund and governmental activities at the government-wide level.

**Solution for illustration 2.1**

The issuance of the two-year note by the city of Hawassa has a very different effect on the General Fund than it does on governmental activities, as shown in journal entries 1a and 1b.

**General Fund:**

**1a.** Cash 2,000,000

Other Financing Sources⎯Proceeds of Two-Year Note 2,000,000

**Governmental Activities, Government-wide:**

**1b.** Cash 2,000,000

Notes Payable 2,000,000

The credit account **Other Financing Sources⎯Proceeds of Two-Year Note** in entry 1a is a temporary account indicating that additional financial resources (cash in this instance) have been added to the fund of the General Fund. Thus, the Br 2,000,000 proceeds of the note have the same effect on the balance sheet of financial resources in the fund that receiving Br 2,000,000 of tax revenues would have. **Other financing sources** are reported in a different section of the statement of revenues, expenditures, and fund balances than are revenues, but beyond that, the distinction is of little importance; the resources in the fund are all available to spend regardless of their source. Note that Entry 1b is identical to journal entry that a business entity would make for this transaction, reinforcing the fact that transactions affect government-wide financial statements in essentially the same manner as they do business accounting. Note also that the two-year liability is recorded only at the government-wide level since only current assets and current liabilities are recorded in governmental funds.

Journal entries 2a and 2b illustrate the dual effects on the integrated reporting model when the fire trucks are purchased:

**General Fund:**

**2a.**Expenditures⎯Capital Outlay 2,000,000

Cash 2,000,000

**Governmental Activities, Government-wide:**

**2b.** Equipment 2,000,000

Cash 2,000,000

Entry 2a shows that long-lived assets, fire trucks in this example, are not accounted for in the General Fund because governmental funds are used only to account for the inflow and outflows (expenditures) of current financial resources used to provide services or purchase equipment and supplies that have been approved in the budget. In the Governmental Activities column of the government-wide statement of net assets, the long-term effects of transactions must be reported, including general capital assets such as fire trucks that will provide service benefits in the future. Entry 2b accomplishes this objective by recording the purchase of the fire trucks in the same manner that a business entity would account for the purchase.

In addition, depreciation expense will be recognized on the fire trucks for the next several years in the government-wide financial statements. Thus, the fire trucks and all other depreciable assets used in carrying out governmental activities will be reported net of accumulated depreciation in the Governmental activities column of the statement of the net assets.

## Proprietary Funds

**Proprietary funds**⎯are used to account for a government`s continuing business-type organizations and activities. Proprietary funds of a government follow accounting and financial reporting principles that are **similar** to those of commercial business entities. As in business, if a government intends to charge users for the goods or services in order to determine appropriate prices or fees. Determining the full cost is also essential in deciding whether the government should continue to produce or provide particular goods or services or to contract for them with an outside vendor. Accrual accounting, including depreciation of capital assets, is essential for governments to determine the full cost of providing business-type services and to report on the extent to which each such activity is covering its full cost of operation.

There are **two types of proprietary funds:** **internal service funds and enterprise funds,** although they may be required by law or contractual provisions such as debt covenants. The two funds differ primarily in terms of their objectives and the way financial information of each type of fund is reported in the fund and government-wide financial statements.

1. **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. Thus, **enterprise funds** may be used to account for activities in which goods or services are provided to the public for a fee that is the principal source of revenue for the fund.

**GASB standards require the use of an enterprise fund if:**

1. The activity is financed with debt that is secured solely by a pledge of the net revenues from fees and charges of the activity.
2. Laws or regulations require that the activity’s costs of providing services, including capital costs (such as depreciation or debt service), be covered with the fees and charges rather than with taxes and similar revenues.
3. The pricing policies of the activity establish fees and charges designed to recover its costs, including capital costs.

**Examples of activities that can be accounted through enterprises funds include:**

* Operating a central data processing facility (information services fund).
* Operations of centralized maintenance facility (fleet services fund)
* Copy service activities (copy service fund)
* Providing several type of insurance programs (insurance revolving fund)
* Operations of centralized supply facility (warehouse revolving fund)

1. **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.** Thus, **internal service funds** are created to improve the management of resources and generally provide goods and services to departments or agencies of the same government and sometimes to other governments on a cost-reimbursement basis. Examples of services typically accounted for by internal service funds include central purchasing and warehousing of supplies, motor pools, centralized data processing, and self-insurance pools.

The primary distinction between the two types of proprietary funds is who the predominant “customers” are⎯that is, typically the **general public for Enterprise Funds** and **other departments or agencies of the government for Internal Service Funds.**

Financial reporting differs for internal service funds and enterprise funds. Major enterprise funds are reported in separate columns of the three proprietary fund financial statements: statement of net assets; statement of revenues, expenses, and changes in fund net assets; and statement of cash flows. Major fund reporting does not apply to internal service funds. Instead, these funds are all reported in a single column of the proprietary fund financial statements.

To reinforce a point made previously, **all internal service fund financial information** is generally reported in the **Governmental Activities column of the government-wide financial statements,** unless an internal service fund predominately serves a proprietary fund, in which case it is reported in the **Business-type Activities column of the government-wide financial statements.** Thus, for most governments the information reported in the business-type activities column of the government-wide financial statements will be the **same as** the enterprise fund totals reported in the propreitry fund financial statements. Furthermore, since the business-type activity financial information is reported using the same measurement focus and basis of accounting in the proprietary fund and government-wide financial statements, there is no need to reconcile any differences between the statements or to use a dual-track approach.

**The proprietary fund accounting equation is:**

**CAs + Noncurrent (including fixed) Assets = CLs +LTLs + Contributed Capital +R/Es**

1. **Fiduciary Funds**

**Fiduciary funds** ⎯are used to account for assets held by a government in a trustee or agency capacity, whether for individuals, private organizations, other governmental units, or other funds of the government.

Fiduciary activities of a government are reported using the same principles as proprietary fund and government-wide financial statements: the **economic resources measurement focus and accrual basis of accounting.** It is worth mentioning again that fiduciary activities are reported only in the fiduciary fund financial statements (statements of fiduciary net assets and statements of changes in fiduciary net assets) and not in the government-wide financial statements.

The fiduciary fund category consists of **agency funds and three types of trust funds;** investment trust funds, pension trust funds, and private-purpose trust funds. **Agency funds** generally are used when the government holds cash on a custodial basis for a private party (individual, organization, or government). Examples are taxes or fees collected by a government on behalf of other governments. There are **no net assets in agency funds,** since for every dollar of assets held there is a dollar of liability to the private party **(total assets in the fund always equal total liabilities).**

Trust funds differ from agency funds primarily in the length of time and the manner in which resources are held and managed. In most cases, trust fund assets include investments whose earnings add to the net assets of the fund and which can be used for a specified purpose. Examples of trust funds are funds that hold assets in trust to provide retirement benefits for employees **(pension trust funds),** **investment trust funds** used to report the equity of external participants (typically other governments) in a sponsoring government`s investment pool (i.e., investment trust funds are funds used to account for the assets, liabilities, net assets, and changes in net assets corresponding to the equity of the external participants), **private-purpose trust funds** created to account to benefit private individuals, such a fund to provide scholarships for the children of firefighters and police officers killed in the line of duty.

Accounting for fiduciary funds is typically much more complex than just accounting for investments. For example, a large, legally separate state pension plan usually has significant capital assets such as land, buildings, and equipment to report in its financial statements. The expenses of the plan include personnel, supplies, utilities, depreciation, and other items, in addition to investment-related expenses.

**Table 2-1 Summary of Government-wide and Fund Characteristics**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Characteristics** | **Government-wide** | **Governmental Funds** | **Proprietary Funds** | **Fiduciary** **Funds** |
| Types of funds | Not Applicable (NA) | General, special revenue, debt service, capital projects, permanent | Enterprise, internal service | Agency, investment trust, pension trust, private−purpose trust |
| Accountability focus | Operational accountability | Fiscal accountability | Operational accountability | Operational accountability |
| Measurement focus | Economic resources | Current financial resources | Economic resources | Economic resources |
| Basis of accounting | Accrual | Modified accrual | Accrual | Accrual |
| Required financial statements | Statement of net assets;  Statement of activities | Balance sheet;  Statement of revenues, expenditures, and changes in fund balances | Statement of net assets;  Statement of revenues, expense, 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 and noncurrent assets, current and noncurrent liabilities, net assets | 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 or change statement accounts | Revenues, expenses | Revenues, expenditures, other financing sources/uses | Revenues, expenses | Additions, deductions |
| Budgetary accounting | Not formally integrated into the accounts | Formally integrated into the accounts of certain funds | Not formally integrated into the accounts | Not formally integrated into the accounts |

**Principle 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.**

**In sum, the government:**

* Must establish and maintain those funds required by law or contractual agreement, just as it must observe other finance-related legal and contractual provisions.
* Should maintain other funds that assist in ensuring effective control over and accountability for its finances.

However, maintaining too many funds may be as detrimental as maintaining too few funds.

Selecting the specific funds a government needs requires professional judgment, and the funds in use should be reviewed from time to time to ensure that all funds needed are in use and that no unneeded funds are in use. In amplifying the fourth principle, the GASB offers the following guidance to the exercise of professional judgment in determining the fund structure of a state or local government:

…some governmental units often need several funds of a single type, such as special revenue or capital projects funds. On the other hand, many governmental units do not need funds of all types at any given time. Some find it necessary to use only a few of the specified types. For example, many small governmental units do not require internal service funds. Moreover, (1) resources restricted to expenditure for purposes normally financed from the general fund may be accounted for through the general fund provided that applicable legal requirements can be appropriately satisfied; and (2) use of special revenue funds is not required unless they are legally mandated. (3) Debt service funds are required if they are legally mandated and/or if financial resources are being accumulated for principal and interest payments maturing in future years.

The general rule is to establish the minimum number of separate funds consistent with legal specifications, operational requirements, and the principles of fund classification. Using too many funds causes inflexibility and undue complexity in budgeting, accounting, and other phases of financial management, and is best avoided in the interests of efficient and economic financial administration.

Principle 5: Reporting Capital (Fixed) 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 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.

**Principle 6: Valuation of Capital (Fixed) Assets**

Capital assets should be reported at historical cost or, if the cost is not practically determinable, at **estimated 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.

Estimated cost (at the time of acquisition) is allowed because some governments have not maintained adequate capital asset records before beginning to report in conformity with generally accepted accounting principles. This principle (1) allows a government to estimate the original cost of both general capital assets and specific fund capital assets for which original costs cannot reasonably be determined but (2) requires that its other capital assets and all capital assets acquired subsequently be recorded at cost (or estimated value, if donated).

**Principle 7: Deprecation 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 set forth in GASBS 34. **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.**

**Principle 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 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.**

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

1. **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, 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 nonexchange transactions should be recognized in accordance with [Codification] Section N50, “Nonexchange Transactions.”

1. **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 for 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.

**The essence of this principle is that, in governmental accounting:**

* The **accrual basis** refers to the basis of accounting under which revenues are recorded when earned and expenditures (expenses) are recorded as soon as they result in liabilities for benefits received, notwithstanding that the receipt of cash or the payment of cash may take place, in whole or in part, in another accounting period.
* **Modified accrual basis**⎯under the modified accrual basis of accounting, required for use by governmental funds, revenues are recognized in the period in which they become available and measurable, and expenditures are recognized at the time a liabilities is incurred pursuant to appropriation authority.

1. **Revenues must be** **“available”** ⎯collectible within the period or soon enough thereafter to pay liabilities incurred for expenditures of the period, as well as levied for the period or earned and measurable⎯or must be deferred (recorded as deferred revenues) and recognized as revenues when “available.” Thus, revenues may be recognized later in governmental-type funds than in proprietary-type funds.
2. **Expenditures (not expenses)⎯**for operations, capital outlays, and debt service⎯are recognized (1) when operating or capital outlay liabilities to be paid from governmental-type funds are incurred and (2) when general government debt service (principal and interest) payments on long-term debt are due.

* **Transfers** of resources among funds (interfund transfers) should be recorded when they occur⎯when the interfund payable or receivable arise⎯even though cash (or noncash assets) has not been remitted from one fund to another fund.

The distinction between **expenditures** and e**xpenses is extremely important in governmental accounting.** ***Expenses −*** the measurement focus of proprietary fund accounting− are costs expired during a period, including depreciation and other allocations, as in business accounting. **Expenditures −** the measurement focus of governmental fund accounting − are financial resources expended during a period for operations, capital outlays, and long-term debt principal retirement and interest. With the exception of long-term debt principal retirement expenditures, expenditures reflect the cost incurred to acquire goods or services, whereas expenses reflect the cost of goods or services used.

**Table 2-2 Expenses versus Expenditures**

|  |  |  |
| --- | --- | --- |
|  | **Expenses (Costs Expired)** | **Expenditures (Financial Resources Expended)** |
| **Operating** (Operating expenses and expenditures often are identical but may differ somewhat because of accrual or allocation differences in expense and expenditure measurement standards) | Salaries, utilities, etc | Salaries, utilities, etc |
| **Capital** (the entire cost of capital assets acquired during the period is accounted for as a capital outlay expenditure, whereas a portion of all exhaustible capital asset costs incurred to date is allocated to each period as depreciation expense) | Depreciation | Capital outlays |
| **Debt Service** (Interest is both an expenditure and an expense, through not necessarily of the same amount. Long-term debt retirement is an expenditure but not an expense) | Interest | Long-Term Debt Retirement |

**Principle 10: Budgeting, Budgetary Control, and Budgetary Reporting**

1. An annual budget(s) should be adopted by every governmental unit. **Budget** is a plan of financial operation embodying an estimate of proposed expenditure s for a given period and the proposed means of financing them.
2. The accounting system should provide the basis for appropriate budgetary control. **Budgetary control ⎯** refers to the control or management of a government or enterprise in accordance with an approved budget for the purpose of keeping expenditures within the limitations of available appropriations and available revenues.
3. Budgetary comparisons schedules should be presented as required supplementary information (RSI) for the General Funds and each major special revenue fund that has a legally adopted annual budget.

**Principle 9 is essentially a bridge between**

* **Principle 1**−which requires that government accounting system make it possible to determine and demonstrate compliance with finance-related legal and contractual provisions−such as the annual operating budget(s)−as well as report in conformity with GAAP; and **Principle 12**−which requires presentation of financial statements on both the budgetary basis and the GAAP basis, as well as an explanation and reconciliation of the differences between the budgetary and GAAP basis.

**Principle 11: Transfer, Revenue, Expenditure, and Expense Account Classification**

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

**Principle 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.

**Principle 13: Interim and Annual Financial Reports**

1. Appropriate interim financial statements and reports of financial position, operating results, and other pertinent information should be prepared to facilitate management control of financial operations, legislative oversight, and where necessary or desired for external reporting purposes.
2. 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 sections.
3. **The** **minimum requirements for MD&A, basic financial statements, and required supplementary information other than MD&A are:**
4. Management`s discussion and analysis
5. Basic financial statements. The basic financial statements should include:
6. Government-wide financial statements
7. Fund financial statements
8. Notes to the financial statements
9. Required supplementary information other than MD&A.
10. **General purpose financial statements [GPFS]** of the reporting entity may be issued separately from the comprehensive annual financial report. Such statements should include the basic financial statements and notes to the financial statements that are essential to fair presentation of financial position and operating results of operations (and cash flows of proprietary fund types and nonexpendable trust funds). These statements are may also be required to be accomplished by required supplementary information….
11. 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 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.
12. The nucleus of a financial reporting entity usually is a **primary government.** However, a governmental organization other than a primary government (such as component unit, joint venture, jointly governed organization, or other stand-alone government) serve as the nucleus for its own reporting entity when it issues separate financial statements.
    1. **Major Fund Reporting**

GASB standards recognize that most financial statement users are unlikely to have a significant interest in all of the many funds that a government may use. Instead, it is likely that their interest will be focused on larger dollar-amount funds. Consequently, GASBS 34 requires that financial statements prepared for governmental funds and enterprise funds include a separate column for each major fund.12 An additional column is provided in each statement for the total amounts for all nonmajor funds of that type—governmental or enterprise, as applicable.

**Determination of Major Funds**

By its nature the General Fund of a government is always a major fund. In addition, any fund that a government considers of significant importance to financial statement users can be reported as major. Otherwise, *GASBS 34* requires that any fund that meets the following size criteria be designated as major:

Both governmental funds and proprietary funds financial statements must provide separate columns for **each major fund.** A fund is classified as major if it is significantly large with respect to the whole government. **“A fund is “major” if**

1. Total assets, liabilities, revenues, or expenditures/expenses of the individual governmental or enterprise fund are at least **10 percent** of the corresponding total of assets, liabilities, revenues, expenditures/expenses for all funds of that category or type (total governmental or total enterprise funds), and
2. Total assets, liabilities, revenues, or expenditures/expenses of the individual governmental or enterprise fund are at least **5 percent** of the corresponding total for all governmental and enterprise funds combined.

The aggregate of non-major governmental and enterprise funds is reported in a **single column of the corresponding statements.**

Reporting by major fund meets the information needs of citizens and other report users having a specific interest in the financial condition and operations of a particular fund. To meet the needs of individuals having an interest in particular non-major funds, governments should provide separate combining financial statements for nonmajor governmental and proprietary funds, as well as for discretely presented component units. Combining and individual fund statements are not ordinarily audited unless the engagement letter with the auditor extends the scope of the audit to include these statements. Other supplementary information that may be presented in the financial section of the CAFR includes schedules necessary to demonstrate compliance with finance-related legal and contractual provisions and schedules to present comparative data on items such as tax collections and long-term debt.

**MODULE END QUESTIONS**

1. **Brief Discussion Questions**

**Instruction:** Give brief description for each of the following questions

1. Briefly describe the three Activities of state and local government using examples?
2. Briefly define Funds, fund accounting system and all types of funds using examples?
3. What are principles of governmental accounting and financial reporting discuss each of them?
4. What is major fund and briefly discuss criteria of classifying funds as major or not using illustrations?
5. **Matching Questions**

**Instructions**: Match the following fund types listed under **column “A”** with their appropriate definitions or examples listed under **Column “B” (0.5 point each).**

**COLUMN “A” COLUMN “B”**

1. General fund **A.** Taxes collected on behalf of another governmental unit.
2. Special revenue fund **B.** account forPrincipal and interest payments on general long-term debt.
3. Capital projects fund **C.** Costs of a central purchasing and warehouse function.
4. Permanent fund **D.** used to Account for Construction of highways, bridges, or parks.
5. Debt service fund          **E.** used to account for financial resources other than those which are required to be accounted for in another fund.
6. Internal service fund **F.** Accounts for any revenue, grant, or gift that is legally restricted for a particular operating purpose.
7. Enterprise fund      **G.** principal and income benefit individuals, private organizations, or other governments.
8. Pension fund **H.** used to account for activities in which goods or services are provided to the public for a fee.
9. Investment trust fund  **I.** Gifts in which the principal must be invested and preserved but the investment earnings can be used for public purposes.
10. Agency fund   **J.** Assets held in trust to provide retirement benefits for municipal workers

**K.** Assets held for external government participants in government’s investment pool for the purpose of earning investment income.

1. **Multiple Choices Questions**

**Instruction:** After reading each of the following question Attentively choose the best answer from a given Alternatives.

1. The government-wide statement of net assets and statement of activities should be prepared using \_\_\_\_\_\_\_\_\_\_\_\_?
2. Economic resources measurement focuses and Accrual basis of accounting
3. Current financial resource measurement focuses and Accrual basis of accounting
4. Fiscal accountability and operational accountability
5. All of the above.
6. In the reporting of governmental activities, fiscal accountability is demonstrated by:
7. Government-wide financial statements.
8. Fund financial statements.
9. Both fund and government-wide financial statements.
10. Neither fund nor government-wide financial statements.
11. The modified accrual basis of accounting is used for which of the following fund categories?
12. Governmental funds C. fiduciary funds
13. proprietary funds D. All of the above
14. Which of the following is not a fiduciary fund type?
15. permanent fund C. investment trust fund
16. private-purpose trust fund D. pension trust fund
17. The town of **Bonga** operates electric and water utilities for its customers. In which of the following funds should the operations of the utilities be accounted for?
18. Special revenue fund. C. Enterprise fund
19. Debt service fund D. Internal service fund.

**CHAPTER THREE**

**ACCOUNTING FOR GENERAL AND SPECIAL REVENUE FUNDS**

**UNIT objectives**

After reading this unit you will be able to;

* Discuss nature and operation of general and special revenue funds
* Distinguish, at the fund level, between Revenues and Other Financing Sources and between Expenditures and Other Financing Uses.
* 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.
* Explain how revenues and expenditures are classified in the General Fund.

**Introduction**

Every state and local government must have a general fund that is used to account for all financial resources, except for those resources that must be accounted for in a different fund. A government may only maintain one general fund. This unit will discuss: The nature and purpose of the general and special revenue funds; Revenues and expenditures recognitions; and Examples of common journal entries.

* 1. **The General Fund** 
     1. **Nature and Purpose**

Every governmental unit must establish a General Fund. The General Fund is used to account for most of the current operating revenues and expenditures of the unit including certain capital outlays and certain debt service expenditures. All tax revenues and other receipts and expenditures not specified by law or contractual agreement to another fund type are accounted for in the General Fund. This includes revenues and expenditures for federal programs. The General Fund is usually the largest and most important of the funds maintained by governmental units.

The General Fund typically has a greater number and variety of revenue sources than other funds and its resources finance a wide range of governmental activities. The General Fund is established at the inception of the governmental units and continues to exist throughout the life of the governmental system.

* + 1. **Number of Funds**

The governmental units will report only one General Fund; however, for practical purposes they may find it convenient to maintain separate and distinct components of the General Fund.

* + 1. **Basis of Accounting and Measurement Focus**

The focus of General Fund accounting is sources and uses of “available spendable resources” rather than upon net income determination. The General Fund uses the modified accrual basis of accounting. Therefore, revenues are recognized when they are both measurable and available. This fund also uses the flow of current financial resources measurement focus.

The General Fund contains only “current” assets and “current” liabilities. “Current,” meaning the asset is expected to be received or the liability paid within one year from the Balance Sheet date. General Fund assets and liabilities having a life greater than one year are reported on the entity wide statements.

Claims against the governmental unit should be recognized as General Fund liabilities when the claims are scheduled or applicable for liquidation with existing resources.

The General Fund has many sources of revenue and many types of expenditures, and hence, a need for numerous general ledger accounts. Excessive general ledger accounts are very inconvenient to work with. The local and state governmental unit may, therefore, use general ledger control accounts and subsidiary ledgers.

* + 1. **Accounts and Transactions**
  1. **Revenues and Other Sources of Financing**

Revenues represent increases in current financial resources. Proceeds from issuance of long-term debt and receipt of interfund transfers are not classified as revenue. Instead, these items are classified as “other sources of financing.” General Fund revenues are susceptible to accrual when they are both measurable and available. Revenues are measurable when they can be reasonably estimated. In order to be available, revenues are estimated to be collected during the current budgetary period or after the end of the period, but in time to pay liabilities outstanding at the close of the budgetary period. When amounts are both determined to be measurable and available, we classify them as “revenue accruals.” Do not record the item as revenue in the General Fund if the “measurable” and “available” conditions are not met. Many general fund revenues are measurable, such as taxes, grants and fees.

* 1. **Classification of Revenues**

The primary classification of government revenues is by fund. Within specific revenues may be classified by sources. Generally, there are seven sources. These are explained under:

* + 1. **Tax revenues**

Tax revenues constitute the large portion of governmental revenues and are compulsory or obligatory. In general, tax revenues may be classified in to three categories. These are direct taxes (personal income tax, business income tax, tax on dividend, rental income tax and miscellaneous income taxes), indirect taxes (turn over tax, value added tax, excise tax) and taxes on foreign trade (custom duty on imported goods and services, etc).

* + 1. **Special assessments**

Special assessments are levied against certain properties to defray part or all of the cost of specific improvements or services, which are presumed to be of particular benefit to the properties against which special assessments are levied. Special assessments are levied when routine services are extended to property owners outside the normal service of the government.

* + 1. **Licenses and permits**

They include those revenues collected by the governmental unit from individuals or business concerns for various rights or privileges granted to them, such as business license, driving license, building permit, etc.

* + 1. **Intergovernmental Revenues**

They include grants, entitlements, and shared revenues. A grant is a contribution or gift of cash or other assets from other governmental unit to be used or expended for specific purpose, activity or facility. There are two types of grants, namely capital grants and operating grants. Capital grants are restricted by the grantor for the acquisition or construction of fixed assets. All other grants are considered operating grants.

* + 1. **Charges for services**

They include revenues collected by the government from the public for the services rendered to them. These include revenue from courts, receipts from parking lots, library use fees, tuition fees etc. Library use fees do not include fines.

* + 1. **Fines and forfeits**

Forfeiture is the automatic loss of cash or other properties as a punishment for not complying with legal provisions and as compensation forms the resulting damages, or losses. Fines and forfeits include; Fines and penalties for commissions of statutory offences; Fines and penalties for neglect of office duties; Library fines; Forfeitures of amounts held as a security against loss or damages and Penalty of any sort. Penalties levied on delinquent taxes (past due taxes) are not considered as fines, rather are considered as tax revenues.

* + 1. **Miscellaneous revenues**

They include all revenues other than the above six categories of revenues, such as: Interest earnings on temporary investments; Rent and royalties; Compensation for loss of fixed assets; Contributions from public enterprises; Contributions from private sources; Contributions from donors, and others.

* 1. **Budgetary Accounts**

Budgetary accounts are those accounts that affect budgetary operations and conditions. Budgetary accounts include:

* **Estimated Revenue-** It is used to record total amount of revenue expected to be recognized (from revenue budget).
* **Appropriations-** which are used to record budgeted expenditures.
* **Encumbrances -** which are used to record estimated amount of purchase orders or contracts.
* **Estimated other financing sources-** are used to record estimated other financing sources.
* **Estimated other financing uses-** which are used to record estimated other financing uses.

In order to facilitate the preparation of financial statement that show budget and actual amounts, the accounting systems of funds which budgets are required by law should incorporate budgetary account.

* 1. **Journal Entries**

1. **Recording the Budget: Budgetary entry:**

Estimated Revenues xxx

Estimated Other Financing Sources xxx

Appropriation xxx

Estimated Other Financing Uses xxx

Fund Balance xxx

**Example 1**: Assume that a given governmental unit has made the following budget estimate for its general fund:

Estimated Revenues (Br.):

Taxes 780,000

Licenses and permits 256,000

Charges for services 184,000

Appropriations (Br):

Estimated Other Financing Sources (Br):

Transfer from other funds 115,000

Bond issue proceed 115,000

Health and Welfare 270,000

General Government 590,000

Public safety 440,000

**Required: Prepare a budgetary entry.**

Estimated Revenue 1,220,000

Estimated Other Financing Sources 230,000

Appropriations 1,300,000

Fund Balance 150,000

**Note that** budgetary surplus is said to exist when budgeted sources exceed budgeted uses. On the other hand, budgetary deficit is said to exist if budgeted uses exceed budgeted sources.

1. **Property Taxes and Uncollectible**

Property Taxes should be recorded in the fiscal year, in which they are levied, assuming they are also classified as available. Property taxes are considered available if they are expected to be collected within the current budgetary period, or within 60 days after the end of the period. In unusual circumstances, NCGA Interpretation-3 allows property taxes to be collected during a period longer than 60 days, but the financial statements must disclose both the length of the period used and the reason for using the longer period.

If taxes levied to finance the next fiscal year were collected in advance during the current period, the revenue should not be recognized. Instead, the amount collected should be recorded as deferred revenue. In the following fiscal year, a journal entry will be recorded to recognize the deferred revenue amount collected.

When property taxes are delinquent but expected to be collected, they should be reported as deferred revenue if it is estimated that the taxes will not be available to pay current obligations (collected within 60 days of the end of the fiscal year).

The governmental unit should disclose the assessment date, levy date, due dates and collection dates of taxes. Additionally, they must disclose their policy for recognizing property taxes.

State and local governmental units usually do not collect the entire tax levy. Accordingly, the amount recorded as revenue receivable from taxes often needs to be offset by an allowance for doubtful accounts. Governmental accounting does not recognize a “bad debt expense,” for these uncollectible, as does private business accounting. Instead, an allowance for doubtful accounts is established in the General Fund by reducing the amount of revenue recognized from taxes.

**Example 2:** Property taxes of Br. 20,000,000 are levied. Five percent of the levy is estimated to be uncollectible. The following entry would be made to record the levy:

Property Taxes Receivable-Current 20,000,000

Revenue—Current Real Estate Taxes 19,000,000

Estimated Uncollectible Taxes-Current 1,000,000

**Example 3:** Assume that Br.16, 000,000 of the tax receivables are collected and Br.750, 000 of the receivables is now deemed uncollectible: the following entry is made to record the collection:

1. Cash 16,000,000

Property Taxes Receivable-Current 16,000,000

1. Estimated Uncollectible Taxes 750,000

Property Taxes Receivable-Current 750,000

**Example 4:** Assume that the remaining receivable balance is considered delinquent; the journal entry used to record is as follow:

* + - 1. Property Taxes Receivable-Delinquent 3,250,000

Property Taxes Receivable -Current 3,250,000

* + - 1. Estimated Uncollectible Taxes-Current 250,000

Estimated Uncollectible-Delinquent 250,000

**Example 5:** Br. 400,000 is levied in property taxes during the current year. There is a history of 7.5 percent being uncollectible. Br. 4,000 receivable will not be collected until 90 days after the fiscal year end.

1. ***Revenue Recognized at the Beginning of the Fiscal Year (Time of Levy)***
   1. Taxes Receivable 400,000

Revenue – Current R/E Taxes 370,000

Estimated Uncollectible Taxes 30,000

(To record property tax levy)

* 1. Revenues – Current Real Estate Taxes 4,000

Deferred Revenue 4,000

*(To record property taxes that does not meet the revenue recognition definition of available)*

1. ***Revenue Recognition upon Receipt***
   1. Taxes Receivable 400,000

Estimated Uncollectible 30,000

Deferred Revenues 370,000

*(To record property tax levy)*

* 1. Cash 350,000

Taxes Receivable 350,000

*(To recognize revenue for current collections.)*

* 1. Deferred Revenue 350,000

Revenue – Current Real Estate Taxes 350,000

*(To record current collections)*

***Please note Common Errors to Avoid:***

* + Remember to record accrued taxes as of the end of the fiscal year properly. DO NOT report them as fund balance reservation. This error would incorrectly inflate your fund balance.
  + Recognize Taxes Receivable to be collected within 60 days after year end as revenue and defer the remaining balance.

**Change in Estimate**

A change in estimate does not require that you restate prior financial statements. Only adjusting entries to the current year are required. Include an appropriate disclosure concerning the change in estimate in the financial statements if the effects of the change in estimate are material.

* A particular governmental unit may discover at the end of the accounting period that the allowance for uncollectible accounts for the current period was overstated or understated. To record the revised estimate, adjust the allowance and revenue accounts.
* An estimated uncollectible rate could be incorrect for several years, resulting in consistently overstating or understating uncollectible amounts.

**Example 6:** The uncollectible account should have been six percent, instead of five percent in ***Example 2***. The entry to record the revision at the end of the year would be:

Revenue – Current Real Estate Taxes 200,000

Estimated Uncollectible Taxes 200,000

(Br. 20,000,000 x 6% = Br. 1,200,000; Br. 1,200,000 – Br. 1,000,000 = Br. 200,000)

**Example 7:** The uncollectible accounts were understated by Br. 120,000 in prior years and by Br. 200,000 for the current year. The change in estimate is recorded as follows in the current period.

Revenue – Current Real Estate Taxes 320,000\*

Estimated Uncollectible Taxes 320,000

(Br. 120,000 + Br. 200,000)

1. **Delinquent Property Taxes**

Taxes not paid by the due date on the bill are **delinquent.** The amount of taxes remaining in “taxes receivable – current year” should be transferred to “taxes receivable – delinquent.” If you maintain separate “allowance for uncollectible taxes” by year, then this account should also be transferred from a current account, to a delinquent account.

Delinquent taxes are usually subject to penalties and interest charges. The cash collection of interest and penalties is similar to the collection of the property taxes.

**Example 8:** To record the receipt of interest and penalties:

Cash XXX

Interest and Penalties Receivable – Delinquent Taxes XXX

1. **Tax Anticipation Notes Payable**

Notes (or warrants) issued in anticipation of the collection of taxes, usually retriable only from tax collections, and frequently only from the proceeds of the tax levy whose collection they anticipate.

Taxes anticipation notes payable is issued by the governmental unit when expenditures are expected to be made before major items of revenues are received. The unit borrows in the anticipation of the collection of taxes in later months and use for the payment of notes. The transaction is recorded as follows:

Cash xxx

Tax Anticipation Notes Payable xxx

The repayment of the note, with interest, is recorded as follows:

Tax Anticipation Notes Payable xxx

Expéditeurs (interest) xxx

Cash xxx

1. **Taxpayer-Assessed Revenues & Income Taxes**

In the past, accounting standards required that these revenues be recognized on a cash basis, although many governmental units chose to record these revenues when they were measurable and available. The Governmental Accounting Standards Board (GASB) Statement No. 22 put an end to this discrepancy between theory and practice by stating that these taxes must be accounted for using *modified accrual accounting*. Therefore, these amounts must meet the definitions of measurable and available in order to be recognized as revenue. Taxes should be reported net of anticipated refunds to taxpayers.

1. **Grants and Entitlements**
   * Grant means a contribution received from another government, which is to be used or expended for a specific purpose or activity.
   * Entitlement is the amount of payment a local government receives from another government as determined by a formula established by law. For example, Basic Education, Special Education, Transportation.

Before revenue can be recognized, you must evaluate the circumstances surrounding the grant or entitlement to determine if the measurable and available criteria have been met.

1. ***State Subsidies***

Recognize current fiscal year state subsidies as current revenue, even though the funds will be received in the subsequent fiscal year.

**Example 9:** Assume that Br. 50,000 of the current year transportation subsidy was not received as of the end of the budget period.

State Subsidies Receivable – Transportation 50,000

Revenue – Transportation 50,000

1. **Donations**

Financial donations are usually recorded on the cash basis because they are not considered measurable until they are received.

The proper treatment of donated fixed assets depends on the governmental unit’s plans for those assets. If the unit intends to retain the fixed assets, they are recorded directly in the government wide statement of net assets, with no effect on the governmental funds. If, however, the unit intends to sell the donated fixed assets, that unit should record the transaction in one of three ways:

* + 1. If the assets are sold by the end of the fiscal year, report revenue in the operating statement.
    2. If the assets are sold after the end of the budget year, but before the financial statements are issued, report the fixed assets on the fund’s balance sheet as “assets held for resale” and report revenue on the operating statement.
    3. If the assets were not sold before the issuance of the financial statements, the assets should be reported only in the statement of net assets. When they are sold, the unit would report the sale.

Donations are valued at the Fair Market Value of the item at the time of the donation.

**Example 10:** Assume that a particular governmental unit receives a cash gift of Br. 1,000 from a private benefactor to be used at the discretion of the higher officials for general operations.

Cash 1,000

Contributions and Donations 1,000

(To record receipt of revenue from a donation)

**Example 11:** Assume that a particular governmental unit receives a gift of land from a donor. An independent appraiser values the land at Br. 50,000 on the current market.

Using the above information, no entries should be completed, to record the general capital asset, on the General Fund; but the Statement of net Assets used to pass the following entry:

Land Br. 50,000

Investment in Capital Assets Br. 50,000

(To record donated land as a general capital asset)

1. **Miscellaneous Revenues**

The state and local governmental units may collect a variety of other revenues such as fines, fees and charges. Since it is not practical to measure a number of these revenues, GASB’s Codification, Section 1600.113 recommends that some miscellaneous revenues should be accounted for on a cash basis unless the measurable and available criteria can be satisfied. Miscellaneous revenues should be accounted for in the General Fund. Use an Enterprise Fund, however, when a fee is charged to users in exchange for a service.

Other accrued revenues such as tuition, interest, etc are recorded as the current fiscal year if it meets the measurable and available criteria.

**Example 12:** The journal entries may look like:

Accounts Receivable – Type XXX

Revenue – Type XXX

1. **Proceeds from Issuance of Long-Term Debt**

When long-term debt is issued and the proceeds are available to the General Fund, you should record the proceeds as part of “other financing sources.” These proceeds are reported in the General Fund on the Statement of Revenues and Expenditures, under the “Other Financing Sources” section of the statement. These proceeds should not be reported under the General Fund’s operating revenues. Although bond proceeds are reported in the General Fund, the long-term debt is reported in the non- current liabilities section on the statement of net assets, not in the General Fund.

If short-term debt is issued by the General Fund, i.e. debt to be paid off in one year or less, the debt liability is recorded in the General Fund because, the payment of the debt will require current resources.

**Example 13:** Assume that $10,000,000 of long-term notes are sold and the proceeds are available to the General Fund: the following entry should be recorded in the general fund;

**GENERAL FUND:**

Cash 10,000,000

Proceeds from Issuance of Long-Term Debt 10,000,000

**B. Expenditures and Other Financing Uses**

Expenditures are decreases in fund financial resources. Inter-fund transfers are not classified as expenditures, but instead are reported as “other financing uses.” Some examples of General Fund expenditures are current operations and repayment of principal and interest on long-term debt. Depreciation and amortization are not expenditures within the General Fund. Expenditures are generally accrued when incurred if the transaction results in a reduction of the General Fund’s current financial resources. However, expenditures for long-term debt principal and related interest are recognized when they are due. Do not record expenditure if there is not a reduction in the fund’s current financial resources. For example, a governmental unit may estimate a liability for compensated absences, but if the actual payments to employees are expected to be made after the current fiscal year, the expenditure would not be reported in the General Fund at year end. Expenditures are generally classified by function and object.

The Basic Entry Format for Expenditure should be:

Expenditure Account XXX

Cash or Accounts Payable XXX

**Examples of Expenditure Items That Can Be Accrued:**

1. **Salaries and Benefits**

**Example 1:** Assume that there are total salaries and benefits of Br.425,000 that were earned but not paid as of Sene 30 of the budget year.

Expenditures – Salaries and Benefits 425,000

Accrued Salaries and Benefits 425,000

**NOTE:** Payroll expenditures under GAAP reporting include those payroll costs incurred within the fiscal year. The actual disbursement of cash or payroll costs does not always occur in the fiscal year the costs were incurred. Payroll costs must include all payroll charges incurred whether or not they are paid during the same fiscal period.

1. **Interest Expenditure Accrual**

Record accrued interest expenditure/expense as a liability as the debt is due.

**Example 2:** Expenditures – Debt Service Interest 30,000

Interest Payable 30,000

Note that the following types of Expenditures may be deferred:

1. **Insurance Premium**

**Example 3:** Annual insurance premium of Br.12,000 paid on SENE 1, 2001.

* 1. Expenditures 12,000

Cash 12,000

(To record payment of premium)

* 1. Prepaid Insurance 11,000**\***

Expenditure 11,000

(\*12,000\*11/12)

*(To record the amount paid in advance as of SENE 30, 2001)*

There are a few transactions, however, that do not conform to the above basic expenditure format. They are:

1. **Inventory**

Governmental accounting requires that amounts spent for the purchase of goods be recorded as expenditures at the time of the purchase. An exception is made for inventory. If the amount of inventory on hand at the end of budget year is significant, the value of such inventory should be recorded on the balance sheet as an asset. This inventory should be disclosed on the balance sheet and the method of accounting for inventory should be disclosed in the footnotes to the financial statements.

Examples of inventory include: Consumable goods, such as office supplies, paper, computer supplies, building and maintenance supplies, science lab supplies, etc.

Generally Accepted Accounting Principles (GAAP) permits two methods of expenditure recognition for inventories: purchase method and consumption method.

The **purchase method** recognizes expenditures for inventory when supplies are purchased. An inventory account and a fund balance reserve must be established at the end of the year.

The **consumption method** first records purchase transactions as supplies, then recognizes expenditures for inventory as supplies are used. The remaining balance in the inventory account at year end is reported as an asset. Since inventories do not finance current or future general fund expenditures, a portion of the fund balance equal to the value of the inventory must be reserved.

**Example 4:** Purchase Method Vs Consumption Method

|  |  |  |
| --- | --- | --- |
| **Transaction** | **Consumption Method (Periodic Inventory System)** | **Purchase Method** |
| Supplies of $75,000 are purchased. | Supplies 75,000  Cash 75,000 | Expenditures–Supplies75,000 Cash 75,000 |
| Based on a year end count, it is determined that $60,000 of the supplies was used during the year. | Expenditures – Supplies 60,000 Supplies 60,000 | No entry |
| Fund balance reserve is established at the end of the year. | Fund Balance 15,000  Fund Balance-Reserved  for Supplies 15,000 | Supplies 15,000  Fund Balance- Reserved  for Supplies 15,000 |

1. **Capital Outlays**

The General Fund may purchase capital assets, such as land, buildings, and equipment. The general entries for these transactions are:

***GENERAL FUND:*** Expenditures – Capital Outlay XXX

Cash XXX

The asset obtained is accounted for in the government wide statement of net assets.

1. **Debt Service Payments**

Debt service payments made from the debt service fund should be recorded in the debt service fund. Debt service transactions are described in detail in the duties addressing debt and debt service funds of this module.

A state and local governmental unit can appropriate and make certain debt payments from their general fund. Debt service payments made from the general fund are recorded in the general fund, not the debt service fund.

Principal and interest payments are recorded when principal and interest payments become due and payable.

**Example 5:** Assume that Br.1,000,000 of 6% bonds are issued on January 1, 2XX1 and pay interest semiannually beginning on July 1, 2XX1. Conditions of this specific bond requires it to be maintained within the general fund. The entry on July 1, 2XX1 in the general fund would be:

Expenditures – Interest 30,000\*

Cash 30,000

(To record semi-annual interest payment \*1,000,000\*6%/2)

**Example 6:** Assume there is no requirement to maintain the bond within the general fund. Funds for the interest payment are transferred from the general fund to the debt service fund on June 30, 2xx8.

GENERAL FUND

Transfer to Debt Service Fund 30,000

Cash 30,000

DEBT SERVICE FUND

* 1. Cash 30,000

Transfer from General Fund 30,000

* 1. Expenditures – Interest 30,000

Interest Payable 30,000

When the payment includes a principal portion, you should make an appropriate reduction of the liability in the statement of net assets – non current liabilities section.

**C. Other Transactions Affecting the General Fund**

1. **Appropriations**

An appropriation is an authorization for administrators to incur liabilities in the amounts specified in the appropriation during the budget period. An appropriation is considered expended when the authorized liabilities have been incurred. When determining the uncommitted balance of appropriations, simply determining unrealized budgetary revenue is not sufficient. It is not enough to compare budgeted expenditures or appropriations against actual expenditures, encumbrances must be considered also.

1. **Encumbrances**

Encumbrance accounts allow for the recording of legal commitments issued against the appropriation of a fund. Legal commitments include items such as purchase orders for goods and/or supplies and contracts with suppliers. Recording encumbrances is essential to keeping expenditures within the approved budget. An encumbrance reserves a part of the appropriation at the time of commitment to ensure that resources will be available to cover the expenditure when the goods are delivered or the services rendered to the governmental unit. It is essential for good management and budgetary control to record expenditure commitments that will be paid later from fund resources. The accounting entry to record a commitment is debit Encumbrances and credit Reserve for Encumbrances.

The encumbrance account does not represent expenditure for the period, only a commitment to expend resources. Likewise, the account *reserve for encumbrances* is not synonymous with a liability account since the liability is recognized only when goods are received or the services are actually performed.

**Encumbrance Liquidation**

An encumbrance may be liquidated in whole or in part or canceled when any of the following situations occur:

* + Satisfactory receipt or legal acceptance of a partial or complete shipment of goods or services;
  + Notice from or failure of the vendor to fulfill terms of the order or contract;
  + Cancellation of the order; and
  + If funds are not available due to lack of funds.

Notice that the issuance of purchase orders and/or contracts has two effects: (1) the encumbrance of the appropriation that gave the governmental unit the authority to order goods and services, and (2) the starting of a chain of events that will result in the governmental unit incurring a liability when the purchase orders are filled and the contracts executed. Both effects should be recorded in order to assist administrators in avoiding over expended appropriations and to plan for the payment of liabilities on a timely basis.

**Example 1:** Assume that a purchase order is written for Br.20, 000 on TIKIMIT 20, 2002. Later, on HIDAR 10, 2002, the actual invoice is received with the delivery in the amount of Br.18, 250. The entry to record this transaction is:

**TIKIMIT 20, 2002:**  Encumbrance 20,000

Reserve for Encumbrances 20,000

*(To record issuance of the purchase order)*

**HIDAR 10, 2002:** Reserve for Encumbrances Br.20, 000

Expenditure Control / Subsidiary Accounts Br.18, 250

Encumbrances Br.20, 000

Vouchers Payable Br.18, 250

*(to record acquisition of the goods order and to offset the encumbrance accounts using combined entries)*

If this should happen, the available balance at the end of the initial accounting period would be overstated.

Expenditures and the liability account must both be recorded in the actual amount due the supplier. The fact that estimated and actual amounts differ causes no accounting difficulties as long as goods or services are received in the same fiscal period.

**Year-End Treatment of Encumbrances**

At the end of the fiscal year, all remaining encumbrances are considered reservation of fund balance not liabilities. They will become a liability when the goods and / or services are received in the following fiscal year. The budgetary estimate should include an estimated Reservation of Fund Balance as part of the funds available in the following fiscal year.

1. **Fund Balance**

The difference between governmental fund assets and liabilities is referred to as the fund balance. Therefore, the fund balance, for a particular governmental unit, is the difference between total assets and total liabilities as shown on the Balance Sheet or the Statement of Revenues, Expenditures, and Changes in Fund Balance in the Annual Financial Report.

1. **Inter-fund Activity**

Transactions may occur between funds. These interfund transactions are classified as revenue, expenditure or expense within the individual funds, but not to the governmental units overall. Interfund transactions are divided into four categories. These categories are (a) quasi-external transactions, (b) reimbursements, (c) inter fund loans, and (d) inter fund transfers. .

* + 1. **Quasi-External Transactions**

Those transactions that would have been recorded as revenues, expenditures or expenses had involved external organizations. The quasi-external transaction suggests the existence of a buyer-seller relationship. For example, charges for utilities or data processing provided by one fund to another fund.

These transactions should be accounted for as revenues and expenditures (or expenses) in the funds involved. Since each fund is an accounting entity, the amounts due to one fund from other funds, as well as the amounts owed to other funds, should be reflected in the fund accounts as **‘*due to’*** and **‘*due from’*** other funds transactions.

***Due to Other Funds*** is a liability account that reflects amounts owed to another fund for goods sold or services rendered. These amounts include only short-term obligations on open accounts, not interfund loans.

***Due from Other Funds*** is an asset account used to indicate amounts owed to a particular fund by another fund for goods sold or services rendered. This account also includes only short-term obligations on open accounts, not interfund loans.

**Example 2:** Internal Service Fund Billings: Assume that in a particular governmental unit the printing center gives a printing service costing Br.5,000 to the general-type activities; the journal entry is:

**General Fund:** Expenditure – Printing Service 5,000

Due to Internal Service Fund 5,000

**Internal Service Fund:**

Due from General Fund 5,000

Revenues - Printing Service 5,000

**Example 3:**  The Enterprise Fund bills the General Fund Br. 6,000 for services rendered, the quasi-external transactions would be recorded as follows:

**General Fund:** Expenditures 6,000

Due To Other Funds – Enterprise Fund 6,000

**Enterprise Fund:** Due From Other Funds – General Fund 6,000

Revenues 6,000

* + 1. **Reimbursements**

A reimbursement is a repayment of expenditure or expense initially made in one fund, but properly accounted for in another fund. One fund (the reimbursed fund) pays the expenditures or expenses of another fund (the reimbursing fund) with the understanding that the reimbursing fund will pay the reimbursed fund at a later date. Do not confuse these transactions with loans, advances or interfund transfers. The proper accounting for reimbursements is to record an expenditure or expense in the reimbursing fund, and a reduction of expenditure or expense in the reimbursed fund.

1. **When the General Fund is the Reimbursed Fund**

Record the initial payment of the expenditure or expense as expenditure in the General Fund. No entry is made in the reimbursing fund. When the reimbursing fund reimburses the General Fund, the General Fund reduces its expenditures by the amount received. The reimbursing fund then recognizes the expenditure or expense.

**Example 4:** The general fund pays a utility bill of Br.20,000 for the cafeteria fund. The initial payment is recorded in the general fund as:

1. Expenditures – Utilities 20,000

Cash 20,000

When the cafeteria fund reimburses the general fund, the general fund reverses its original entry:

1. Cash 20,000

Expenditures – Utilities 20,000

1. **When the General Fund is the Reimbursing Fund**

When the general fund is the reimbursing fund, this initial payment made by the other fund (reimbursed fund) is not recorded in the general fund. When the general fund reimburses the other fund, the expenditure is recorded in the general fund.

**Example 5:** The cafeteria fund made a Br.20,000 utility bill payment on behalf of the general fund. When the General Fund reimburses the cafeteria fund, the following entry would be made in the General Fund:

Expenditures – Utilities 20,000

Cash 20,000

1. **Interfund Loans**

Interfund loans are made from one fund to another. The fund that made the loan expects to be repaid. Loans may be short-term or long- term. Interfund loan amounts are reported as gross. You should not net interfund loan amounts. Loans between funds are treated as balance sheet transactions. The borrowing fund reports a liability and an increase in cash. The lending fund reports a receivable and a decrease in cash.

1. ***Short Term Loans and the Short Term Portion of Long Term Loans***

Short-term loans and the short-term portions of long-term loans are expected to be repaid within twelve months. “Due To” and “Due From” accounts are used for short-term loans. The total of governmental unit’s “Due to Other Funds” account should equal the total of the “Due From Other Funds” account.

**Example:** Assume that general fund provides short term inter-fund loan to fund B for Br 1,000, the necessary journal entry to record the loan would be:

**General Fund:** Due From Fund B 1,000

Cash 1,000

**Fund B:** Cash 1,000

Due To General Fund 1,000

(To record an interfund loan to Fund B)

**Preparing Closing Entries**

The essence of the closing process for the General Fund or special revenue funds of a state or local government is the transfer of the balances of the operating statement accounts and the balances of the budgetary accounts for the year to the Fund Balance account. Note that the first closing entry has the effect of reversing the entry to record the budget and the entry to amend the budget. After the closing entries are posted, the Fund Balance account represents the net amount of resources available for appropriation.

**Example 6: Given the following Closing entries information:**

Estimated Revenues Br. 1,625,000

Appropriations Br.1,620,000

Revenues Br.1,620,000

Expenditures Br.1,610,000

Encumbrances Br.2,000

The closing entries may be made with a budgetary fund balance account as in “A” below or without a budgetary fund balance account as in “B” below:

1. **Closing entries with a budgetary fund balance:** 
   1. Appropriations Control Account 1,620,000

Budgetary Balance 5,000

Estimated Revenues Control Account 1,625,000

(To close budgetary accounts)

* 1. Revenues Control Account 1,620,000

Expenditures Control Account 1,610,000

Encumbrances Control Account 2,000

Budgetary Fund Balance 8,000

*(To close the operating accounts and Encumbrances Control Account to the Budgetary Fund Balance.)*

* 1. Budgetary Fund Balance 8,000

Unreserved Fund Balance 8,000

*(To close the balance of the Budgetary Fund Balance to the Unreserved Fund Balance.)*

1. **Closing entries without a budgetary fund balance account:**
   1. Appropriations Control Account 1,620,000

Unreserved Fund Balance 5,000

Estimated Revenues Control Account 1,625,000

(To close budgetary accounts)

* 1. Revenues Control Account 1,620,000

Expenditures Control Account 1,610,000

Encumbrances Control Account 2,000

Unreserved Fund Balance 8,000

*(To close the operating accounts and Encumbrances Control Account to the Unreserved Fund Balance)*

* 1. **Special Revenue Funds**

The purpose of a special revenue fund is to account for the proceeds of revenue sources that are **legally** restricted for specific purposes. Special Revenue Funds differ from enterprise funds in that the services delivered by a Special Revenue Fund are not financed by user charges. NCGA Statement 1 states that special revenue funds should be used only when legally mandated. Additionally, if resources are used to support expenditures made from the General Fund, these resources should be accounted for in the General fund. This task will discuss: the nature and purpose of Special Revenue Funds; and how Special Revenue Funds are established.

* + 1. **Nature and Purpose**

Special Revenue Funds are used to account for financial resources, which are restricted to expenditures for specified purposes.

* + 1. **Basis of Accounting and Measurement Focus**

As a governmental fund type, the focus of Special Revenue Fund accounting is on sources and uses of “available expendable resources” rather than upon net income determination. Special Revenue Funds are accounted for on a modified accrual basis of accounting as defined in this unit.

The Special Revenue Fund contains only current assets and current liabilities. Current meaning the asset is expected to be received or the liability paid within one year from the Balance Sheet date. Liabilities should be recognized as fund liabilities when the claims are scheduled or applicable for liquidation with existing resources.

**Note** that accounting for Special Revenue Funds are similar to that of the General fund we have illustrated in previous section of this unit.

**MODULE END QUESTIONS:**

1. What is the main difference between General Fund and Special Revenue Fund?
2. What are the possible classifications of governmental units accounting?
3. Distinguish between:
   1. Expenditure and Encumbrances.
   2. Appropriations and Expenditures.
   3. Revenues and Estimated Revenues.
   4. Reserve for Encumbrances and Fund Balance.
4. What is the importance of incorporating budget in accounting records of General Fund and Special Revenue Funds?
5. Are all expenditures made by governmental units required to be encumbered? Why/Why not? Exemplify it.
6. What types of governmental revenues are accrued and which of the others are not accrued?
7. Why Tax Anticipation Notes Payables are issued by the governmental units?
8. Define and distinguish among; Inter-fund Transfers and Quasi-External Transactions and Inter fund Loans.

**Part II: Choose the Best Answer among the Alternatives Given**

1. When supplies ordered by a governmental unit are received at an actual price which is less than the estimated price on the purchase order, the encumbrance account is:
2. Credited for the estimated price on the purchase order.
3. Credited for the actual invoice price
4. Debited for the estimated price on the purchase order.
5. Debited for the actual invoice price.
6. None of the above.
7. Which of the following source of revenues derives from underlying exchange transactions?
8. Property taxes
9. Federal and state grants
10. Fines and forfeits
11. Charges for services
12. Goods for which a Br. 600 purchase order had been placed were received at an actual cost of Br. 590. The journal entry to record the receipt of the goods will include a:
13. Debit to expenditures for Br. 590
14. Credit to Voucher Payable for Br. 590
15. Credit Encumbrances for Br. 600
16. All of the above.
17. Transfers from one fund to another fund which are made for liquidating a fund or establishing a new fund is referred to as:
18. reimbursements
19. operating transfers
20. Equity transfers
21. Quasi External Transactions
22. None of the above.
23. Which one of the following expenditures may not require to be encumbered?
24. Acquisition of equipment on account
25. Acquisition of supplies on account
26. Remuneration of employees
27. None of the above.
28. Which one of the following accounts would not be used in recording the budget of the General Fund?
29. Estimated revenues
30. Other Financing Uses
31. Appropriations
32. Fund Balance
33. None of the above.
34. Government unit purchased equipment using funds from General Fund, which of the following account increased by entry to recorded General Fund?
35. Expenditures
36. Cash
37. Equipment
38. All of the above.

**III. Work out Problem**

The hypothetical balance sheet of **BONGA Town – General Fund** as Sene 30, 2XX0, end of fiscal year, is shown below.

**BONGA Town General Fund**

**Balance Sheet**

**Sene 30, 2XX0**

Assets

Cash 800,000

Taxes Receivable – Delinquent 200,000

Allowance for uncollectible taxes-Delinquent 10,000 190,000

Interest and penalties Receivable on taxes 20,000

Total Br.**1,010,000**

Liabilities and fund Equity:

Vouchers Payable 400,000

Fund Balance 610,000

Total liab. And fund equity Br.**1,010.000**

Transactions occurred in the fiscal year started on Hamle 1, 2XX0 and ended on Sene 30, 2XX1 are summarized below:

1. The budget for the year provided for General Fund estimated Revenues totaling Br. 1.5 million; Estimated other Financing sources of Br, 300,000: Appropriations of Br. 1.2 million and Estimated Other Financing uses fo Br. 100.000
2. The town council authorized a temporary loan of Br, 500,000 in the form of a 90-day tax anticipation notes, at 10 percent interest paid per annum.
3. The property tax of Br. 900,000 with 5 percent estimated uncollectible was levied by the town.
4. The town issued purchase order of Br. 200.000 sent to vendors for supplies
5. Cash collections of Br. 600.000 and Br. 75,000 were made by the town council from current taxes and delinquent taxes respectively. Moreover, interest and penalties of Br. 15, 000 related to the delinquent taxes was collected for the year
6. Cash of Br. 650, 000 was collected as charges for services provided to the general public
7. Supplies order under transaction number four (above) was received at actual cost of Br. 197, 000
8. The Town council made prepayment of Tax anticipation notes payable along with related interest.
9. A total of Br. 570,000 was expended as payroll transaction
10. A purchase order for estimated cost of Br. 40 000 was placed to acquire supplies
11. The town received cash of Br. 100, 000 from licenses and permits
12. Cash payment is made to acquire office equipment for Br. 500, 000 and to pay voucher payable of Br. 150, 000

**Additional information:**

* 1. Supplies on hand, determined with physical count, were Br. 35,000. Assume that consumption method is used by BONGA Town.
  2. A total of Br. 30 000 was accrued as interest and penalties on delinquent taxes
  3. All taxes receivables – current becomes delinquent

***Required:***

* + 1. ***Pass the necessary journal entries to record the above transactions***
    2. ***Pass the necessary adjuring entries***

**Answer Key to Model Exam Questions**

PART II: Multiple choices

* 1. A
  2. D
  3. D
  4. C
  5. D
  6. B
  7. A

**III. Work Out Problem**

1. ***Journal entries*** 
   1. Estimated Revenues ………………………… 1,500,000

Estimated Other Financing Sources …………. 300,000

Appropriations ………………………………….. 1,200,000

Estimated Other Financing Uses ……………… 100,000

Fund Balance…………………………………….. 600,000

* 1. Cash …………………………….……………… 500,000

Tax Anticipation N/P……………………… 500,000

* 1. Taxes receivable – Current ……………………. 900,000

Revenues (Taxes)……………………………..... 855,000

Allowance for uncollectible current taxes …….. 45, 000

* 1. Encumbrances …………………………………. 200,000

Reserve for encumbrance ………………… 200,000

* 1. Cash ………………………………………………690,000

Taxes receivable – Current ……………………………….... 600,000

Taxes receivable – Delinquent …………………………… 75,000

Interest. Pen. Receivable on Taxes …………………………….. 15,000

* 1. Cash …………………………………………… 650,000

Revenues (Charges for Services) ………………………….. 650,000

* 1. Reserve for encumbrances……………………… 200,000

Encumbrances ………………………………………….… 200,000

Expenditures (supplies) ……………………………197,000

Voucher Payable …………………………………… 197,000

* 1. Tax Anticipation N/P ……………………………500,000

Expenditures (interest)………… ……………….12,500

Cash…………………………………………………………..512,500

* 1. Expenditures (wages & salaries) …………………570,000

Cash …………………………………………………….….570,000

* 1. Encumbrances …………………………………… 40,000

Reserve for encumbrances ………………………………….40,000

* 1. Cash …………………………………………… 100,000

Revenues (license &permits) ………………………………100,000

* 1. Expenditures (office equipment )………………….500,000

Voucher Payable ………………………………… 150,000

Cash………………………………………………………. 650.000

**2) Adjusting Entries**

* 1. ***To adjust supplies***

Inventory of supplies 35,000

Fund Balance 35,000

Expenditures (supplies) 35,000

Reserve for inventory of supplies 35,000

* 1. ***To record Accrued Interest and penalties on Taxes***

Interest and penalties Receivable on Taxes 30.000

Revenues – Interest and Penalties 30,000

* 1. ***To reclassify current taxes to delinquent taxes***

Taxes Receivable Delinquent 300,000

Allowance for Uncoll. - Current Taxes 45.000

Taxes Receivable- Current 300.000 Allowance for Uncoll. Delinquent Taxes 45,000

**CHAPTER FOUR**

**CAPITAL PROJECT, DEBT SERVICE AND PERMANENT 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, debt service fund and permanent 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) ………...25,000

Revenues ……………………………………………625,000

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

* 1. **Permanent Funds**

Governments sometimes receive donation or other resources from individuals, states, and private or public organizations. Commonly, these donations take the form of trusts. Trusts may be accounted for in a number of different funds, depending on the nature and terms of the agreement. Trusts that generate income for the benefit of the government or its citizens and require the principal to be maintained are reported in a governmental Permanent fund. An example for permanent fund is a cemetery perpetual care fund which provides resources for the ongoing maintenance of public cemetery. The following example is used to illustrate the accounting for Permanent fund.

**Illustartion-6.3:** Assume that early in 2007, Shek Muhammad Alamudi drove by the town of Bonga and was distressed by the poor maintenance level of the road. He entered in to agreement with the town’s officials on April 1, 2007, to provide Br.300,000 to the town with stipulation that the Br.300,000 is invested, the principal never be expended, and the earnings be used to maintain the village cemetery. Accordingly, the cemetery perpetual care fund was established, and the following entry was made:

1. Cash---------------------------- 300,000

Revenues-additions to permanent fund------------- 300,000

The funds were immediately invested in ABC company bonds, which were selling at par. The bonds carried an annual interest rate of 8% and paid interest on April 1 and October1:

2. Investments-Bond---------------------- 300,000

Cash ------------------------------------- 300,000

On October 1, Br.12, 000 interests was received

3. Cash------------------------------------ 12,000

Revenue-Investment Income –Interest-------------- 12,000

During 2007, Br.11, 000 was expended for cemetery maintenance:

4. Expenditure –cemetery------------- 11,000

Cash------------------------------------ 11,000

Modified accrual accounting permits interest revenue to be accrued at year end. The amount is Br.6, 000 (300,000 \*8%\*1/4)

5. Accrued interest Receivable---------- 6,000

Revenue-Investment income--- interest--- 6,000

GASB statement No.31 requires that investments with determinable fair values be recorded at fair value. On December 31, 2007, it was determined that ABC company bonds had a fair value of Br. 302, 000, excluding accrued interest:

6. Investment- Bond---------------- 2,000

Revenue-net increase in fair value------ 2,000

As of December 31, the books were closed for the cemetery perpetual care fund as follows:

Revenue –addition to permanent endowment---------- 300,000

Revenue-Investment income-interest---------------------- 18,000

Revenue –net increase in fair value of Inv. ------------- 2,000

Expenditure Cemetery --------------------------------------- 11,000

Fund Balance-reserved for other purpose------------------ 309,000

Financial statement for cemetery perpetual care fund are presented as part of the governmental funds balance sheet and the governmental fund statement of revenue, expenditure and changes in fund balances.

**Module End Questions**

1. **Give brief answer**
   1. Explain the characteristics of debt service fund?
   2. Explain the different source for debt service fund?
   3. Explain the different types of long-term debt.
   4. Explain the characteristics of capital project fund.
2. **Multiple choice questions**

1. The resource used to finance capital projects fund may come from

* 1. Private donations C) Intergovernmental revenue
  2. General obligation debt D) All of the above

2. The issuance of bonds to provide resources to construct a new courthouse should be recorded in a capital project fund crediting

* 1. Bonds payable C) Fund payable
  2. Revenue-bond D) Proceeds from bond issue

3. When a construction project continues beyond the end of an accounting period, a special entry must be made at the beginning of the new period when encumbrance accounting is used. This entry includes:

A) a credit to revenue C) a debit to expenditure

B) a debit to cash D) a debit to encumbrance

4. In which of the following types of fund encumbrance system is not used

1. General fund C) Special revenue fund
2. Capital project fund D) Debt service fund

5. The principal amount of bonds issued to finance the cost of new city hall would be recorded as liability in

1. General long-term debt account in government activity
2. General capital asset account in government activity
3. Capital project fund D) Debt service fund

**III. Work out**

1. Assume that AMAHRA Regional Government is planning to construct dam on the river Abbay that will be used for agricultural irrigation with estimated cost of Br. 2,000,000. The regional government is authorized to issue Br 1,800,000 of 5% bond as partial financing of the construction of the dam and the balance of the estimated cost over the bond issue is to be contributed by the ministry of rural development of Ethiopia. Assume that construction is completed with in one accounting period, August 1, 2007 to June 30 2008. The following transactions occurred in association with the dam.

1. On August 10, 2007, Br 90,000 is borrowed from development bank of Ethiopia to cover pre-construction costs. This borrowing was made in expectation of sale of bonds.
2. On September 1, 2007, a bid is issued and Lalibela Constriction Company that bid at Br 2,450,000 is selected and the contract is signed between the two parties.

C. The bond issue is sold on November 4, 2007 for the amount the regional government is authorized to issue.

1. The Balance from ministry of rural development is collected on Jan 1, 2008.
2. On January 28, 2008 when the project is 60% completed, the contractor submits billings to payment of Br 1,470,000 and on February 5, 2008, the first claim of the contractor is paid along with the borrowing from the bank on which interest of Br. 2, 500 is accrued.
3. On May 28, 2008, billing for the balance remaining is received from contactor and then the dam is inspected by the building design enterprise for the perfection and the dam is accepted accordingly.
4. On June 30, 2008 the records are closed and equity transfer is made to the debt service fund.

**Instruction:** Record Journal entries for the above transactions and then prepare the statement of revenue, expenditure and fund balance.

**Answer Key to Model Exam questions**

**I. Give brief answer**

1. Refer to section 4.3.1

2. Refer to section 4.3.2

4. Refer to section 4.3.3

5. Refer to section 4.2.1

**II. Multiple choices**

1. D 2.D 3.D 4.D 5.A

**III. Work out problem**

Journal entries

August 10 Cash -…………………………………………...90,000

Bond anticipation Notes payable …………...90,000

Sept 1 Encumbrance ………………………………. 2,450,000

Reserve for encumbrance …………………………2,450,000

Nov 4 Cash ……………………………………………1,800,000

Proceeds from bond issue ………………………….1, 800,000

Jan 1 Cash (2,600,000-1,800,000)………………………….800,000

Revenue ……………………………………………….800,000

Jan 28 Reserve for encumbrance 60%( 2,450,000)………….1,470,000

Encumbrance ……………………………………………1,470,000

Jan 28 Expenditure………………………………………….1, 470,000

Voucher payable…………………… ………… 1,470,000

Feb 5 Voucher payable ……………………………………..1,470,000

Bond anticipation notes payable ………………….. 90,000

Expenditure (interest) …………………………..….. 2, 500

Cash ……………………………………………………..1,562,500

May 28 Reserve for encumbrance 40 %( 2,450,000)………..980,000

Encumbrance …………………………………………..980,000

May 28 Expenditure …………………………………………. 980,000

Voucher payable ……………….....……………….........980,000

May 28 Voucher payable ………………………….…….....980,000

Cash …………………………………......................980,000

June 30 Revenues ……………………………………………… 800,000

Proceeds from Bonds Issue …………………………...1800,000

Expenditure…………………………………………..2,452,500

Fund balance ………………………………………… 147,500

June 30 Equity transfer out …………………………………..147,500

Cash ………………………………………………………147,500

June30 Fund Balance ……………………………......................147,500

Equity transfer out ………………………………………….147,500

**Amhara Regional State**

**Statement of revenue, Expenditure and Fund balance**

**For the ended June 30, 2008**

Revenues………………………………………………………………….. 800,000

Less expenditure ………………………………………………………. (2,452,500)

Expenditure in excess of revenue………………………………………...1,652,500

Add other financing source

Proceeds from bound issue ………….........................1,800,000

Less other financing uses ……………….. ……………… 0…………… 1,800,000

Revenue and other financing source in

Excess expenditure and other financing used……………………………….. 147,500

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

Ending fund balance ………………………………………………………….147, 500

Equality transfer out ……………………………………………………….. (147,500)

Fund balance after closing ………………………………………………………… 0