

CHAPTER 2: PRINCIPLES OF ACCOUNTING AND FINANCIAL REPORTING FOR STATE AND LOCAL GOVERNMENTS

<u>Number</u>	<u>Topic</u>	OUTLINE	<u>Type/Task</u>	<u>Status (re: 15/e)</u>
Questions:				
2-1	Governmental activities		Describe	Same
2-2	Business-type activities		Describe	Same
2-3	Fiduciary activities		Describe	Same
2-4	Fund categories		Explain	2-6
2-5	Definition of fund		Explain	2-7
2-6	Modified accrual; definition and rules		Distinguish	2-8
2-7	Required reconciliations		Explain	New
2-8	Reporting changes in fiduciary net position		Explain	New
2-9	Distinguishing effects of governmental transactions		Journalize	Same
2-10	Major fund criteria		Explain	Same
Cases:				
2-1	Accounting and reporting principles		Analysis; explanation	2-2
2-2	Evaluation of basic financial statements		Evaluation; explanation	New
2-3	Identification of major funds; application of major fund criteria		Internet; identification; calculation	Same
Exercises/Problems:				
2-1	Examine the CAFR		Examine	Same
2-2	Various		Multiple Choice	Items 1,9, and 10 are new; 2 and 8 revised; Other items are same
2-3	Various		True/False	Mainly new and revised
2-4	Matching fund types with fund categories		Matching	New
2-5	Matching government-wide and fund financial reporting characteristics		Matching	2-4
2-6	Matching transactions with funds		Matching	2-5
2-7	Determination of major funds		Calculation; written report	2-7 revised
2-8	General long-term liability and general capital asset transactions		Journalize and explain	2-6 revised

CHAPTER 2: PRINCIPLES OF ACCOUNTING AND FINANCIAL REPORTING FOR STATE AND LOCAL GOVERNMENTS

Answers to Questions

- 2-1. Certain core services are provided by most general purpose governments—those related to the 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, among others. Governments must also incur costs for general administrative support (such as, data processing, finance, and personnel) of its service departments. Core governmental services, together with general administrative support, comprise the major part of what GASB refers to as *governmental activities*. The measurement focus and basis of accounting for these activities is on the flow of current financial resources on the modified accrual basis in the governmental funds and on the flow of economic resources on the accrual basis in the Governmental Activities column of the government-wide financial statements.
- 2-2. The *business-type activities* of a government include public utilities (such as electric, water, gas, and sewer utilities), transportation systems, toll roads and bridges, hospitals, parking garages and lots, liquor stores, golf courses, airports, and swimming pools, among other activities. Many of these activities are intended to be self-supporting by charging users for the services they receive. Focusing financial reporting on economic resources recognized on the accrual basis of accounting allows the government to determine whether charges for services are sufficient to cover the full cost of the activity. This measurement focus and basis of accounting is the same used for reporting governmental activities in the government-wide financial statements, but quite different from the current financial resources measurement focus and modified accrual basis of accounting used in the governmental funds.
- 2-3. *Fiduciary activities* of a government involve the government's discharge of its fiduciary responsibilities, either as an agent or trustee, for parties outside the government. For example, a government may serve as agent for other governments in the administering and collecting of taxes. Fiduciary activities are accounted for in agency funds, investment trust funds, pension trust funds, and private-purpose trust funds.

Fiduciary activities are reported only in the fund financial statements and not in the government-wide financial statements because these resources belong to external parties, not the government. Fiduciary funds use accrual accounting and focus on economic resources, as do business-type activities. However, reporting for fiduciary activities differs from that for governmental funds since the latter funds focus primarily on the budget and current financial resources.

Ch. 2, Answers (Cont'd)

2-4. The three categories of funds are governmental, proprietary, and fiduciary. The fund types included in each category are shown below:

Governmental	Proprietary	Fiduciary
General Fund	Enterprise funds	Agency funds
Special revenue funds	Internal service funds	Investment trust funds
Debt service funds		Pension (and other employee benefit) trust funds
Capital projects funds		Private-purpose trust funds
Permanent funds		

These categories correspond to the three activity categories with the exception that financial information for internal service funds is generally reported in the Governmental Activities column of the government-wide financial statements. However, if an internal service fund predominantly serves an enterprise fund, its financial information is reported in the Business-type Activities column.

2-5. As a fiscal entity, a fund has its own resources and can incur liabilities to be repaid from the fund resources. As an accounting entity, the fund has its own self-balancing set of accounts.

2-6. Governmental funds, the five fund types listed in Illustration 2-3 of the text, focus on the flow of current financial resources. Consequently, these funds use the modified accrual basis of accounting. Under modified accrual revenues are recognized if the inflow is measurable and available to pay current period obligations. Expenditures are recognized as incurred if they will be paid from available resources.

2-7. Governmental fund balances represent the difference between currently available assets of the governmental funds and liabilities to be repaid from those assets. (Deferred outflows and deferred inflows of resources, if any are reported, also affect fund balance, as discussed in this chapter.) Changes in fund balances reflect revenues and other financing sources inflows and expenditures and other financing uses outflows. Changes in fund balances focus on the flow of current financial resources, recognized on the modified accrual basis of accounting. Net position of governmental activities at the government-wide level reflects the difference between all economic assets and liabilities, both short-term and long-term, recognized on the accrual basis. Changes in net position reflect the difference between revenues and expenses. Because of the different measurement focuses and bases of accounting, GASB standards require that total fund balances be reconciled to total net position of governmental activities and that the change in fund balances be reconciled to the change in governmental activities net position. The reconciliation schedules can be presented on the face of the government-wide statement of net position and statement of activities, respectively, or they can be presented as separate schedules.

Ch. 2, Answers (Cont'd)

2-8. As explained in Chapter 2, fiduciary fund resources belong to external parties, not the government. Reporting increases (decreases) in fiduciary net position as revenues (expenses) would imply the resources can be (were) used at the discretion of the government. To avoid this impression, GASB standards use the terms *additions* (*deductions*) to report increases (decreases) in fiduciary net position.

2-9.	<u>General Fund:</u>	<u>Debits</u>	<u>Credits</u>
	Cash	1,000,000	
	Other Financing Sources— Proceeds of 5-Year Note		1,000,000
	<u>Governmental Activities:</u>		
	Cash	1,000,000	
	Mortgage Note Payable		1,000,000
	<u>General Fund:</u>		
	Expenditures—Capital Outlay	1,000,000	
	Cash		1,000,000
	<u>Governmental Activities:</u>		
	Buildings	1,000,000	
	Cash		1,000,000

2-10. GASBS 34 requires that any fund that meets the following relative size criteria be designated as major:

- a. Total assets, liabilities, revenues or expenditures/expenses of that governmental or enterprise fund are at least 10 percent of the corresponding element total (assets, liabilities, and so forth) for all funds of that category or type (that is, total governmental or total enterprise funds), *and* (emphasis added)
- b. The same element that met the 10 percent criterion in (a) is at least 5 percent of the corresponding element total for all governmental and enterprise funds combined.

In addition to funds that meet these two criteria, the General Fund of a state or local government must always be reported as a major fund. Finally, at its discretion management can report as a major fund any other governmental or enterprise fund that it considers of significant importance to financial statement users.

Solutions to Cases

2-1. A quick look at these financial statements reveals that Ms. Eager has almost no knowledge of GASB reporting requirements. Let's examine these financial statements from the viewpoint of (a) a local CPA who is considering auditing the town's financial statements and (b) a member of the town council or a citizen.

Ch. 2, Solutions (Cont'd)

- a. As a CPA knowledgeable about governmental accounting, you should see many red flags regarding this potential audit engagement. Do the financial statements that Ms. Eager has prepared conform to GAAP? The short answer is no! To the CPA contemplating whether to serve as auditor, these financial statements should set off alarm bells. He or she has only to compare these statements to the variety of government-wide and fund financial statements required by GASB standards (see Illustrations A2-1 through A2-11) to realize that they fall far short of what is required by GAAP. Among the many problems the CPA should detect (although students will probably miss many of these problems at this early point in the course) are the following.
1. The town does not present separate government-wide and fund financial statements, although with a little work the balance sheet could be converted into a government-wide statement of net position.
 2. The statement of activities is not in the cost of services format recommended by GASB.
 3. Because no fund financial statements are prepared, key information such as nonspendable, restricted, committed, assigned, and unassigned fund balances of the General Fund (see Illustration A2-3, for example) and the Road Tax Fund are not presented.
 4. Budget and actual comparison information is not presented as required, either as basic statements or required supplementary information schedules (see Appendix B at the end of chapter 2).
 5. Expense detail is lacking. More functional detail is needed under "Government services," such as general government, public safety, public works, and other relevant functions, so the amounts expended for each service area can be determined. Presumably, this would also reduce the relatively large amount reported as "Miscellaneous."
 6. Why are accounts receivable relating to the Sewer Fund missing from the balance sheet? The presence of sewer fees on the statement of activities suggests that the Sewer Fund is being operated as an enterprise fund. If so, billings that have not been collected at year-end should be reported. In addition, GAAP requires accrual of a receivable and revenue for services provided but unbilled at year-end.
 7. If the Sewer Fund is an enterprise fund, then a statement of cash flows is required for that fund.

Ch. 2, Solutions, 2-1 (Cont'd)

8. Where are the notes to the financial statements? The notes are an integral part of any set of financial statements.
9. Where is the MD&A—also required by GAAP?

Given the serious reporting deficiencies observed, it is likely the CPA would be required to render an adverse opinion, since it appears that the financial statements do not fairly present financial information in conformity with GAAP. Depending on the quality of the town's financial records, it is also possible that the CPA would have to issue a disclaimer report due to missing or insufficient financial information. (Note: You may wish to look at Chapter 11 for the meaning of adverse and disclaimed audit reports.)

- b. A member of the town council or a citizen of the town should be concerned as well about several of the issues raised by the CPA in part *a*. Although the treasurer may still be preparing statements of cash receipts and disbursements for each fund, the lack of information about cost of services for governmental functions and sewer operations should be of concern. Moreover, unless the town budgets on a cash basis, the lack of GAAP-based fund statements results in a lack of full information about available financial resources in the General and Road Tax Funds for budgeting purposes. The lack of budget and actual comparison statements or schedules should also be of concern to a member of the town council or a citizen.
- 2-2. a. Based on the description of this city's financial statements in the MD&A, the statements appear to conform very well to GASB standards. Specifically:

Government-wide Financial Statements

- Include the two required financial statements—statement of net position and statement of activities.
- Use “accounting methods similar to those used by the private sector,” i.e., economic resources measurement focus and the accrual basis of accounting.
- Report governmental and business-type activities in separate columns.

Fund Financial Statements

- Provide detailed information about *major funds*. All nonmajor funds are summarized and presented in a single column.
- Report on three kinds (i.e., categories) of funds—governmental, proprietary, and fiduciary.
- *Governmental funds* are “prepared on a modified accrual basis, which means they measure only current financial resources and uses.” Capital assets and other long-lived assets, along with long-term liabilities, are not presented in the governmental fund statements.

Ch. 2, Solutions, 2-2 (Cont'd)

- *Proprietary funds* include both enterprise and internal service funds, prepared on the accrual basis and include all their assets and liabilities, current and long-term.
 - *Fiduciary funds* include activities that report trust responsibilities of the city. “These assets are restricted in purpose and do not represent discretionary assets of the city. Therefore, these assets are not presented as a part of the government-wide financial statements.”
- b. This is a straightforward way of saying that the governmental fund information focuses only on current financial resources, not all economic resources. As a result, it is necessary to present a reconciliation of the governmental fund total fund balances to the government-wide governmental activities net position and change in fund balances to change in net position, as explained in Chapter 2 and shown in Illustrations A2-4 and A2-6 for the City of Jacksonville, Florida.
- 2-3. Identification of which funds are reported as major funds is readily accomplished by viewing the governmental funds balance sheet and statement of revenues, expenditures, and changes in fund balances. Once a student calculates 10 percent of total governmental fund assets, liabilities, revenues, and expenditures, and 5 percent of governmental and enterprise fund totals for the same elements, it should be relatively simple to compare the totals for these elements for each major fund to the 10 percent and 5 percent amounts. Comparisons for the General Fund are unnecessary since this fund is always reported as a major fund.

Solutions to Exercises and Problems

- 2-1. Each student should have a different governmental annual report, so will have different answers to questions in this exercise. We suggest allowing students to discuss their answers, which will give them an idea of the range of the answers of other students.
- 2-2.
- | | |
|-------|--------|
| 1. a. | 6. b. |
| 2. d. | 7. b. |
| 3. b. | 8. c. |
| 4. a. | 9. c. |
| 5. d. | 10. b. |

Ch. 2, Solutions (Cont'd)

- 2-3. 1. T.
2. F. This statement would be true if permanent funds were listed rather than internal service funds. Internal service funds are proprietary funds.
3. T.
4. F. Fiduciary fund financial information is reported only in the fiduciary fund financial statements.
5. T.
6. F. Internal service fund financial information should be reported in the Governmental Activities column of the government-wide financial statements if, as is typical, the internal service fund predominantly supports governmental activities.
7. T.
8. F. At the time of the purchase, an expenditure is reported in the General Fund operating statement and equipment is reported in the Governmental Activities column of the government-wide statement of net position. Annual depreciation is reported *only* in the government-wide statement of activities, not in the General Fund financial statements.
9. T.
10. T.
- 2-4.
- | | |
|---|----|
| Agency fund | FF |
| Permanent fund | GF |
| Debt service fund | GF |
| Internal service fund | PF |
| Pension (and other employee benefit) trust fund | FF |
| Special revenue fund | GF |
| Enterprise fund | PF |
| General Fund | GF |
| Investment trust fund | FF |
| Capital projects fund | GF |
| Private-purpose trust fund | FF |

Ch. 2, Solutions (Cont'd)

- 2-5.
- | | | |
|----|--|--|
| 1. | Governmental funds | <i>b, e, f, i</i> |
| 2. | Proprietary funds | <i>a, d, g, h, j</i> |
| 3. | Fiduciary funds | <i>a, c, g, k</i> |
| 4. | Governmental activities,
government-wide | <i>a, g, h, j</i> (Note: Internal service fund information is typically reported in governmental activities using the same measurement focus and basis of accounting.) |
| 5. | Business-type activities,
government-wide | <i>a, g, h, j</i> (Note: Internal service fund information may be reported as part of business-type activities if the internal service activity primarily supports an enterprise activity) |

- 2-6.
- | | | | |
|----|-----------|-----|-----------|
| 1. | <i>h.</i> | 7. | <i>e.</i> |
| 2. | <i>a.</i> | 8. | <i>i.</i> |
| 3. | <i>j.</i> | 9. | <i>f.</i> |
| 4. | <i>g.</i> | 10. | <i>c.</i> |
| 5. | <i>d.</i> | 11. | <i>k.</i> |
| 6. | <i>b.</i> | | |

2-7.

DATE:	xxx
MEMO TO:	City Manager, Forest City
FROM:	Independent Auditor
RE:	Major Special Revenue Funds

As shown by the blue shading in the calculations provided below, only the Housing and Urban Development Grant must be reported as a major fund. Neither the Gas Tax Revenue Fund nor the Forest City Library Fund meets the GASB threshold for major fund reporting; that is, none of the four elements of those funds (assets, liabilities, revenues, or expenditures) is at least 10% of the corresponding total of all governmental funds *and* at least 5% of the corresponding total of all governmental and enterprise funds. Both total assets and total revenues of the Housing and Urban Development Grant meet the 10 percent of all governmental funds and 5 percent of all governmental and enterprise funds combined criteria. Although the Gas Tax Revenue Fund did not meet the criteria for major fund reporting, rapidly escalating gas taxes tied to the current high price of gasoline might warrant reporting this fund as a major fund to improve accountability to citizens. GASB standards permit government officials to designate any governmental or enterprise fund as a major fund if, in their judgment, the fund is of sufficient importance to warrant designation as a major fund.

Ch. 2, Solutions, 2-7 (Cont'd)

Calculation of Major Fund Thresholds						
Financial Statement Elements	Gas Tax Revenue Fund		Housing and Urban Development Fund		Forest City Library Fund	
	>10% of Governmental Funds	>5% of Governmental and Enterprise Funds	>10% of Governmental Funds	>5% of Governmental and Enterprise Funds	>10% of Governmental Funds	>5% of Governmental and Enterprise Funds
Assets	Yes-10.3%	No-4.6%	Yes-11.2%	Yes-5.01%	No-6.5%	No-2.9%
Liabilities	No-8.4%	No-4.9%	No-9.8%	Yes-5.7%	No-0.0%	No-0.0%
Revenues	No-9.0%	No-4.6%	Yes-11.1%	Yes-5.7%	No-7.8%	No-4.0%
Expenditures	No-8.3%	No-4.6%	No-8.7%	No-4.9%	No-8.0%	No-4.5%

- 2-8. 1. Record the issuance of \$100,000, 2-year note.

<u>General Fund:</u>		
Cash	100,000	
Other Financing Sources— 2-Year Note Payable		100,000
<u>Governmental Activities:</u>		
Cash	100,000	
Notes Payable		100,000

2. Record purchase of vehicles at a total cost of \$100,000.

<u>General Fund:</u>		
Expenditures—Capital Outlay	100,000	
Cash		100,000
<u>Governmental Activities:</u>		
Equipment	100,000	
Cash		100,000

3. Recording these transactions in this manner is completely consistent with GASB standards. Because the General Fund focuses on current financial resources and uses the modified accrual basis of accounting, it does not record long-term liabilities, but does record the inflow of the proceeds of the loan as an *Other Financing Source*. This is a temporary account that increases fund balance in the General Fund. At the government-wide level, however, the focus is on the flow of economic resources

using the accrual basis of accounting. Consequently, the long-term liability for the \$100,000 3-year note is recorded in the Governmental Activities general journal and
Ch. 2, Solutions, 2-8 (Cont'd)

reported in the Governmental Activities column of the government-wide statement of net position.

Similarly, the General Fund records the outflow of current financial resources as *Expenditures*, a temporary account that reduces fund balance of the General Fund. The general capital assets are recorded as an asset, *Equipment*, in the Governmental Activities general journal at the government-wide level. The police vehicles will be depreciated at the government-wide level each year. Depreciation has no effect on the General Fund.