**UNIT SEVEN**

**Proprietary Funds**

 **Introduction**

 **Give short answer**

1. What are proprietary funds and how are they treated in accounting?

2. Explain the two types of proprietary funds.

3. What are the different financial statements prepared for proprietary funds?

4. Explain the accounting of proprietary funds.

5. What is the difference between internal service fund and enterprise funds?

All of the funds discussed in previous chapters (General, Special revenue, Capital project, Debt service and Permanent funds) are classified as governmental funds and owe their existence to legal constraints placed up on the raising of revenue and/or the use of resources for the provision of services to the public and the acquisition of facilities to aid in the provision of services. Funds discussed in the previous units record only current financial resources and liabilities that will be settled with current financial resources. Fixed assets and long – term debts are not accounted for in governmental funds, but are presented in government – wide statement. Governmental funds recognize revenues and expenditures, not expenses. But there are governmental entities that operate like business organizations. The activities of these organizations will be accounted in a Proprietary fund. This chapter is totally devoted to the discussion of proprietary funds.

 7.1.**Proprietary Funds in General**

A second fund classification, proprietary funds, describes funds that are used to account for activities similar to those often engaged in by profit – seeking businesses. That is, users of goods or services provided by a proprietary fund are charged amounts directly related to the costs of providing the goods or services. Thus, in the pure case, proprietary funds are self – supporting. Proprietary funds use the economic resources measurement focus and the accrual basis of accounting. Because revenues and expenses (not expenditures) are recognized on the accrual basis, financial statements of proprietary funds are similar in many respects to those of business organizations. Fixed assets used in fund operations and long – term debt services from fund revenues are recorded in the accounts of each proprietary fund. Depreciation of fixed assets is recognized as an expense, and other accruals and deferrals common to business accounting are recorded in proprietary fund. Budgets should be prepared for proprietary funds to facilitate management of fund activities, but GASB standards do not require or encourage budget – actual reporting.

The use of accrual accounting permits financial statement users to observe whether proprietary funds are operated at a profit or a loss. The accrual basis of accounting requires revenues to be recognized when earned and expenses to be recognized when incurred.

Two types of funds are classified as proprietary funds: Internal service funds and Enterprise funds. Internal service funds provide, on a user charge basis, services to other government departments. Enterprise funds provide, on a user charge basis, services to the general public. Three financial statements are required for proprietary funds: (1) statement of Revenue, expense and change in fund net asset, (2) statement of net Assets (or balance sheet) and (3) statement of cash flows. As is true for governmental funds, enterprise funds are reported by major fund, with non – major funds presented in a separate column. However, internal service funds are reported in a single column.

  **7.2 Internal Service Fund**

As governments become more complex, efficiency can be improved if services used by several departments of funds or even by several governmental units are combined in a single administrative unit. Purchasing, computer services, garages, janitorial services, and risk management activities are common examples. Activities that produce goods or services to be provided to other departments or other governmental units on a cost – reimbursement basis are accounted for by Internal service funds.

Internal service funds recognize revenues and expenses on the accrual basis. They account for all fixed assets used in their operations and for long term debt to be serviced from revenues generated from their operations, as well as for all current assets and current liabilities. Net assets are to be reported in three categories:

(1) Invested in capital assets, net of related debt

(2) Restricted

 (3) Unrestricted

 **Establishment and Operation of Internal Service Funds**

The establishment of an internal service fund is normally subject to legislative approval. The original allocation of resources to the fund may be derived from a transfer of assets from another fund, such as the General fund or an Enterprise fund, intended as a transfer not to be repaid by the Internal service fund over a period of years.

Because Internal service funds are established to improve the management of resources, they should be operated and accounted for on a business basis. For example, assume that administrators request the establishment of a fund for the purchasing, warehousing, and issuing of supplies used by a number of funds and departments. A budget should be prepared for the internal service fund (but not recorded in the accounts) to demonstrate that fund management has realistic plans to generate sufficient revenues to cover the cost of goods issued and such other expenses, including depreciation, that the governing body intends fund operations to recover. Departments and units expected to purchase goods and services from internal service funds should include in their budgets, the anticipated outlays for goods and services. During the year, as supplies are issued or services are rendered, the internal service fund records operating revenues (Charges for services is an account title commonly used instead of sales). Since the customer is another department of the government, a journal entry to record the purchase is recorded at the same time the internal service fund records revenue. If the other fund is a governmental fund, the purchase is recorded as expenditure. Periodically and at year – end, an operating statement should be prepared for each internal service fund to compare revenues and related expenses: these operating statements, called statement of revenues, expenses, and changes in fund net Assets, are similar to income statements prepared for investor – owned businesses. The following illustration will show the accounting of internal service fund clearly.

**Illustration 7.1**: Assume that the administrators of the town of Burkitu obtain approval from the town council in early 2007 to centralize the purchasing, Storing and issuing functions and to administer and account for these functions in a supplies fund. A payment of Br. 596,000 cash is made from the General fund which is not to be repaid by the supplies fund. Of the Br. 596,000, Br. 290,000 is to finance capital acquisitions and Br. 306,000 is to finance non capital acquisitions. Additionally, a long – term advance of Br.200, 000 is made from the water utility fund for the purpose of acquiring capital assets. The advance is to be repaid in 20 equal annual installments, with no interest. The receipt of the transfer in and the liability to the water utility fund would be recorded in the supplies Fund accounts in the following manner:

1. Cash …………………………………………….. 796,000

 Transfers In ……………………………….. 596,000

 Advance from water utility fund …………… 200,000

 To provide some revenue on funds not needed currently, Br.50,000 is invested in marketable securities:

2. Investment 50,000

 Cash 50,000

Assume that early in 2007, a satisfactory warehouse building is purchased for Br.350,000; Br.80,000 of the purchase price is considered as the cost of the land. Necessary warehouse Machinery and Equipment is purchased for Br.100,000. Delivery Equipment is purchased for Br.40,000. If purchases are made for cash, the acquisition of the assets would be recorded in the books of the supplies fund as follows:

3. Land …………………………………………….. 80,000

 Building ………………………………………… 270,000

 Machinery and Equipment – Warehouse……….. 100,000

 Equipment – Delivery ………………………….. 40,000

 Cash …………………………………… 490,000

Supplies are ordered to maintain inventories at a level commensurate with expected usage. No entry is needed because proprietary funds are not required to record encumbrances. During 2007, it is assumed that supplies are received and related invoices are approved for payment in the amount of Br.523,500; the entry needed to record the asset and the liability is as follows:

4. Inventory of Supplies ………………………………… 523,500

 Accounts Payable………………………………… 523,500

Governmental funds that maintain relatively minor inventories of supplies usually account for them on the physical inventory basis. The supplies fund, however, should account for its inventories on the perpetual inventory basis because the information is needed for proper performance of its primary function. Accordingly, when supplies are issued, the Inventory account must be credited for the cost of the supplies issued. Because the using fund will be charged an amount in excess of the inventory carrying value, the Receivable and Revenue accounts must reflect the selling price. The markup above cost should be determined on the basis of budgeted expenses and other items to be financed from net income. If the budget for the town of Burkitu supplies fund indicates that a markup of 30 percent on cost is needed, issuance to General fund departments of supplies costing Br.290, 000 would be recorded by the following entries:

5a. Operating expenses – cost of sales and services … 290,000

 Inventory of Supplies………………………………. 290,000

5b. Due from General fund (290,000\*130%)………… 377,000

 Operating Revenues – charges for Sales and Services ----- 377,000

During the year, it is assumed that purchasing expenses totaling Br19,000, ware – housing expenses totaling Br.12,000, delivery expenses totaling Br.13,000, and administrative expenses totaling Br.11,000 are incurred. The government has chosen to separate operating expenses into three categories: (1) costs of sales and services, (2) administration, and (3) depreciation. If all liabilities are vouchered before payment, the entry would be as follows:

6. Operating Expenses – costs of Sales and Service ………… 44,000

 Operating Expenses – administration …………………… 11,000

 Accounts Payable …………………………….. 55,000

If collections from the General Fund during 2007 total Br 322,000, the entry would be as follows:

7. Cash …………………………………… 322,000

 Due from General fund …………………………… 322,000

Assuming that payment of vouchers during the year totals Br.567,500, the following entry is made:

8. Accounts payable …………………………………………….. 567,500

 Cash ……………………………………………………… 567,500

The advance from the water utility fund is to be repaid in 20 equal annual installments; repayment of one installment at the end of 2007 is recorded as follows:

9. Advance from water utility fund (200,000/20)…………10,000

 Cash ………………………………………………………. 10,000

At the time depreciable assets are acquired, the warehouse building has an estimated useful life of 20 years; the warehouse machinery and equipment have an estimated useful life of 10 years; the delivery equipment has an estimated useful life of 10 years; and non of the assets is expected to have any salvage value at the expiration of its useful life. Under these assumptions, straight – line depreciation of the building would be Br 13, 500 per year; depreciation of machinery and equipment, Br 10,000 per year; and depreciation of delivery equipment, Br.4, 000 per year. (Since governmental units are not subject to income taxes, there is no incentive to use any depreciation method other than straight – line.)

10. Operating Expenses – depreciation ……………………. 27,500

 Accumulated Depreciation – Building ……………… 13,500

 Accumulated Depreciation – Machinery and equipment ------------ 10,000

 Accumulated Depreciation – Equipment – Delivery …… 4,000

Organizations that keep perpetual inventory records must adjust the records periodically to reflect shortages, overages, and out of condition stock disclosed by physical inventories. Adjustments to the inventory account are also considered to be adjustments to the warehousing expenses of the period. In this illustrative case, it is assumed that no adjustments are found to be necessary at year – end.

Interest income is earned and received in cash on the investments purchased at the beginning of the year:

11. Cash …………………………………………………. 3,000

 Non operating Revenues – interest ………………. 3,000

Assuming that all revenues, expenses, and transfers applicable to 2007 have been properly recorded by the entries illustrated, the nominal accounts should be closed as of December 31, 2007:

12. Operating Revenues – Charges for sales and Services ….377, 000

Non operating Revenues – Interest ………………………. 3, 000

 Transfers In ………………………………………………596,000

 Operating Expenses – costs of sales and Services ……. 334,000

 Operating Expenses – Administration…………………. 11,000

 Operating Expenses – depreciation …………………… 27,500

 Net Assets – invested in Capital Assets – Net of Related Debt ….. 272,500

 Net Assets unrestricted ……………………………………………. 331,000

Note that the account, Net Assets, is separated into two components: (1) invested in Capital Assets net of Related Debt and (2) Unrestricted. The first component of net assets (Br.272,500) is computed by taking the fixed assets (entry 3 – Br. 490,000) less accumulated depreciation (entry 10 – Br.27,500) less the amount due to the enterprise fund (entry 1 – Br.200,000 less (entry 9 – Br.10,000 = Br.190,000). The remaining Br.331, 000 is unrestricted; no restrictions exist on the remaining funds.

The balance sheet, statement of Revenues, Expenses, and changes in Fund net assets; and statement of cash flows for the supplies fund are included in the proprietary funds statements at the end of this chapter.

  **7.3 Enterprise Funds**

Enterprise funds are used by governments to account for services provided to the general public on a user – charge basis. Under GASB Statement No.34, enterprise fund must be used in the following circumstances:

• When debt is backed solely by fees and charges.

• When a legal requirement exists that the cost of providing services for an activity including capital costs be recovered through fees or charges.

• When a government has a policy to establish fees and charges to cover the cost of providing services for an activity.

The most common examples of governmental enterprises are public utilities, notably water and sewer utilities. Electric and gas utilities, transportation systems, airports, ports, hospitals, toll bridges, municipal golf courses, parking lots, parking garages, lotteries, municipal sports stadiums, and public housing projects are examples frequently found.

Enterprise funds are to be reported using the economic resources measurement focus and accrual basis of accounting. Fixed assets and long – term debts are included in the accounts. As indicated earlier in this chapter, enterprise funds use accounting and reporting standards provided for business enterprises issued on or before November 30, 1989 (unless that guidance conflicts with GASB guidance) and may use guidance by the FASB for businesses issued after that date. As a result, the accounting is similar to that for business enterprises and includes depreciation, accrual of interest payable, amortization of discounts and premiums on debt, and so on.

Governmental enterprises often issue debt, called revenue bonds, that is payable solely from the revenues of the enterprise. These bonds are recorded directly in the accounts of the enterprise fund. On the other hand, general obligation bonds are often issued for governmental enterprises, in order to provide greater security by pledging the full faith and credit of the government in addition to enterprise revenues. If payment is to be paid from enterprise revenues, these general obligation bonds would also be reflected in the accounts of enterprise funds.

Budgetary accounts should be used only if required by law. Debt service and construction activities of a governmental enterprise are accounted for within an enterprise fund, rather than by separate debt service and capital project funds. Thus, the reports of enterprise funds are self – contained; and creditors, legislators, or general public can evaluate the performance of a governmental enterprise by the same criteria used to evaluate investor – owned enterprises in the same industry. By far the most numerous and important enterprise services rendered by local governments are public utilities. In this subtopic, water utility fund is used to illustrate accounting for enterprise fund as follows:

 **Illustration 7.2:** It is assumed that the town of Burkitu is located in a state that permits enterprise funds to operate without formal legal approval of their budgets. Accordingly, the budget is not recorded in enterprise accounts. Assume that as of December 31, 2006, the accountant for the town of Burkitu prepared the post-closing trial balance shown below:

**Town of Burkitu**

**Water Utility Fund**

**Post closing Trial Balance**

**December 31, 2006**

|  |  |  |
| --- | --- | --- |
|   | **Debit** | **Credit** |
| Cash | Br 467,130 |  |
| Customer Accounts Receivable |  72,500 |  |
| Accumulated Provision for uncollectible Accounts |  | Br 2,175 |
| Materials and Supplies |  37,500 |  |
| Restricted Assets | 55,000 |  |
| Utility Plant in Service | 4,125,140 |  |
| Accumulated Provision for Depreciation of utility Plant |  | 886,500 |
| Construction work in progress | 468,125 |  |
| Accounts payable |  | 73,700 |
| Revenue Bonds Payable |  | **2,700,000** |
| Net Assets – Invested in Capital Assets, Net of Related Debt |  | 1,006,765 |
| Net Assets – Restricted for Debt Service |  | 55,000 |
| Net Assets – Unrestricted |  | 501,255 |
| Total | **Br.5,225,395** | **Br.5,225,395** |

It is common for governmental enterprises, especially utilities, to report “restricted assets.” In this example, the restricted assets include Br.55, 000 set aside for future debt service payments as required by a revenue bond indenture agreement.

When utility customers are billed during the year, appropriate revenue accounts are credited, assuming that during 2007, the total bills to nongovernmental customers amounted to Br. 975,300, bills to the town of Burkitu General fund amounted to Br.80,000, and all revenue was from sales of water, the following entry summarized the results.

1. Customer Accounts Receivable ………………………. 975,300

 Due from General Fund……………………………….. 80,000

 Operating Revenues – Charges for Sales and Services----- 1,055,300

If collections from non governmental customers totaled Br.968,500 for water billings, the following entry is made:

2. Cash…………………………………………………… 968,500

 Customer Accounts Receivable …………………. 968,500

Customers owing bills totaling Br.1,980 left the town and could not be located. The unpaid balances of their accounts receivable were written off to the accumulated provision for uncollectible accounts as follows:

3. Accumulated provision for uncollectible Accounts ………. 1,980

 Customer Accounts Receivable……………………….. 1,980

Governments commonly impose impact fees on developers or builders to pay for capital improvements, such as increased water and sewer facilities that are necessary to service new developments. Increasingly, governments are using impact fees to limit sprawl and to create incentives for developers to refurbish existing commercial properties rather than create new ones. Assume the town of Burkitu imposes impact fees on commercial developers in the amount of Br.12,500 and that these fees are not associated with specific projects or improvements.

4. Cash ………………………………………………………. 12,500

 Capital contributions…………………………………… 12,500

Note that capital contributions is a nominal account that will increase net assets but is reported separately in the statement of revenues, expenses, and changes in fund net assets. Hook up fees for new customers are not capital contributions but are exchange transactions and are included in operating revenues. If the impact fees had been restricted to a specific project, the cash would have been reported as a restricted asset.

During 2007, the town of Burkitu established a supplies fund, and the Water utility fund advanced Br.200,000 to the supplies fund as a long – term loan. The entry by the supplies fund is illustrated in entry 1 in the “Illustration 7.1 of this unit. The following entry should be made by the Water Utility fund:

5. Long Term Advance to Supplies fund ………………. 200,000

 Cash……………………………………………… 200,000

Materials and supplies in the amount of Br.291, 500 were purchased during the year by the water utility fund, and vouchers in that amount were recorded as a liability:

6. Materialsand Supplies……………………………… 291,500

 Account Payable ………………………………. 291,500

When materials and supplies are issued to the departments of the water utility fund, operating expenses are charged for the cost of materials and supplies. Materials and supplies issued for use for construction projects are capitalized temporarily as construction work in progress (**Numbers are assumed**).

7. Operating Expenses – costs of sales and Services …. 110,400

 Operating expenses – administration …………… 60,000

 Construction work in progress………………….. 27,600

 Materials and supplies …………………… 298,000

Payrolls for the year were chargeable to the accounts in the following entry. Taxes were accrued and withheld in the amount of Br.90,200, and the remainder was paid in cash.

8. Operating expenses – Costs of sales and services …… 253,600

 Operating expenses – Administration…………………. 92,900

 Operating expenses – Selling ………………………… 17,200

 Construction work in progress………………………… 58,900

 Payroll taxes payable ……………………… 90,200

 Cash………………………………………… 332,400

Bond interest in the amount of Br.189, 000 was paid:

9. Non operating expenses – interest……………………. 189,000

 Cash ……………………………………………… 189,000

Included in the amount above was bond interest in the amount of Br.17,800 that was considered to be properly charged to construction:

10. Construction work in progress ………………………. 17,800

 Non operating expenses – interest ………………... 17,800

Construction projects on which costs totaled Br.529,300 were completed and the assets placed in service. Utility plant in service summarizes the investment in fixed assets used for utility purposes.

11. Utility plant in service ………………………………. 529,300

 Construction work in progress …………………… 529,300

Payment of accounts totaled Br.275,600, and payments of payroll taxes amounted to Br.81,200.

12. Accounts payable …………………………………… 275,600

 Payroll Taxes payable ………………………………. 81,200

 Cash ……………………………………………… 356,800

Near the end of 2007, the water utility fund received Br.10,000 cash from the supplies fund as partial payment of the long – term advance.

13. Cash ………………………………………………… 10,000

 Long term advance to supplies fund ……………. 10,000

During the year, the Water utility fund made a transfer of Br.200,000 to the fire station addition capital projects fund.

14. Transfer out ………………………………………… 200,000

 Cash……………………………………………… 200,000

At year – end, several adjustments are necessary. First, depreciation is recorded as an operating expense:

15. Operating Expenses…………………………122,800

 Accumulated provision for depreciation of utility plant…. 122,800

Provision is made for bad debts from utility customers. In accord with guides issued by GASB, the bad debt provision is a revenue deduction, not an expense:

16. Operating Revenues – Charges for sales and services …… 2,200

 Accumulated provision for uncollectible accounts ……. 2,200

In accord with the revenue bond indenture, Br.55,000 was transferred from operating cash to the restricted assets category. The transfer required a reclassification of net assets.

17. a) Restricted Assets ………………………………………….. 55,000

 Cash …………………………………………………… 55,000

17 b) Net Assets – unrestricted ……………………………….. 55,000

 Net Assets – Restricted for Debt service ……………… 55,000

Assuming that the illustrated entries for the transactions have been posted, the following trial balance shows the water utility funds before closing entries:

**The Town of Burkitu**

**Water Utility Fund**

**Pre-closing Trial balance**

**As of December 31, 2007**

|  |  |  |
| --- | --- | --- |
|   | **Debit** | **Credit** |
| Cash | Br 124,930 |  |
| Customer Accounts Receivable |  77,320 |  |
| Accumulated Provision for uncollectible Accounts |  | Br 2,395 |
| Due from general fund | 80,000 |  |
| Materials and Supplies |  31,000 |  |
| Advance to other funds | 190,000 |  |
| Restricted Assets | 110,000 |  |
| Utility Plant in Service | 4,654,440 |  |
| Accumulated Provision for Depreciation of utility Plant |  | 1,009,300 |
| Construction work in progress | 143,125 |  |
| Accounts payable |  | 89,600 |
| Payroll tax payable |  | 9,000 |
| Revenue Bonds Payable |  | 2,700,000 |
| Net Assets – Invested in Capital Assets, Net of Related Debt |  | 1,006,755 |
| Net Assets – Restricted for Debt Service |  | 110,000 |
| Net Assets – Unrestricted |  | 446,255 |
| Operating revenue- changes for sales and service |  | 1,053,100 |
| Capital contribution |  | 12,500 |
| Operating expense-cost of sales and service | 364,000 |  |
| Operating expense-administrative | 152,900 |  |
| Operating expense-selling | 17,200 |  |
| Operating expense-depreciation | 122,800 |  |
| Non operating expense-interest | 171,200 |  |
| Transfer out | 200,000 |  |
| Total | **Br.6,438,915** | **Br.6,438,915** |

Revenues, expenses, transfers, and capital contributions accounts for the year were closed to the unrestricted net Assets account as follows:

18. Operating Revenues – charges for sales and services 1,053,100

 Capital contributions ……………………………………. 12,500

 Operating Expenses – costs of sales and services 364,000

 Operating expenses – Administration …… 152,900

 Operating expenses – selling … 17,200

 Operating Expenses – Depreciation …… 122,800

 Transfers out…………………………… 200,000

 Non operating Expenses – interest … 171,200

 Net Assets – unrestricted ……… 37,500

 **7.4 Financial Statement for Proprietary fund**

* 1. **Statement of Net asset**

While preparing the statement of net asset, GASB requires a classified format where current assets, noncurrent assets, current liability and noncurrent liabilities are presented separately. The statement of net asset for the proprietary funds for the town of Burkitu is presented in the next page.

**2. Statement of Revenue, Expense, and Changes in Fund Net Asset**

The statement of revenues, expenses and changes in fund net asset for the proprietary funds of the town of Burkitu is presented below. GASB requires that operating revenues and operating expense be shown separately from and prior to non operating revenue and expense. Operating revenues should be displayed by source. Operating expense may be reported by function or may be reported by object classification such as personal service, supplies, travel, etc. capital contribution, extraordinary and special items and transfers should be shown separately after non operating revenue and expense

**Town of Burkitu**

**Statement of Net asset**

**Proprietary Fund**

**December 31, 2007**

|  |  |  |
| --- | --- | --- |
|  | Business type activityEnterprise fund –water utility | Government activity-Internal service Fund |
| **Assets** |  |  |
| **Current asset:** |  |  |
| Cash | Br.124,930 | Br.3,500 |
| Investment |  | 50,000 |
| Accounts Receivable (net) | 74,925 |  |
| Due from general fund | 80,000 | 55,000 |
| Materials and supplies | 31,000 | 233,500 |
| **Total current asset** | 310,855 | 342,000 |
| Non current asset: |  |  |
| Restricted assets | 110,000 |  |
| Long term advance to supplies fund | 190,000 |  |
| Capital assets net of acc. depreciation | 3,788,265 | 462,500 |
| **Total Non current assets** | 4,088,265 | 462,500 |
| **Total Asset** | **Br.4,399,120** | **Br.804,500** |
| **Liabilities** |  |  |
| **Current liability:** |  |  |
| Accounts payable | 89,600 | 11,000 |
| Payroll taxes payable | 9,000 |  |
| Total current liability | 98,600 | 11,000 |
| **Non current liability** |  |  |
| Advance from water utility fund |  | 190,000 |
| Revenue bonds payable | 2,700,000 |  |
| Total non current liability | 2,700,000 | 190,000 |
| **Total liability** | **Br.2,798,600** | **Br.201,000** |
| **Net assets** |  |  |
| Invested in capital asset net of debt | 1,088,265 | 272,500 |
| Restricted for debt service | 110,000 |  |
| Unrestricted | 402,255 | 331,000 |
| **Total Net asset** | **Br.1,600,520** | **603,500** |

**Town of Burkitu**

**Statement of Revenue, Expense, and changes in fund net asset**

**Proprietary Fund**

**Decmber31, 2007**

|  |  |  |
| --- | --- | --- |
|  | Business type activityEnterprise fund –water utility | Government activity-Internal service Fund |
| **Operating Income** |  |  |
|  Charges for sales and service | Br.1,053,100 | Br.377,000 |
| **Operating expenses** |  |  |
|  Cost of sales and service | 364,000 | 334,000 |
|  Administration | 152,900 | 11,000 |
|  Selling | 17,200 |  |
|  Depreciation | 122,800 | 27,500 |
| **Total operating expense** | 656,900 | 372,500 |
| **Operating income** | 396,200 | 4,500 |
| **Non operating revenue(Expense**) |  |  |
|  Interest revenue |  | 3,000 |
|  Interest expense | (171,200) |  |
| Total non operating revenue and expense | (171,200) | 3,000 |
| Income before contribution and transfers | 225,000 | 7,500 |
|  Capital contribution | 12,500 |  |
|  Transfer in |  | 596,000 |
|  Transfer out | (200,000) |  |
| Change in net asset | 37,500 | 603,500 |
| Net asset January 1,2007 | 1,563,020 | 0 |
| **Net asset December31,2007** | **Br.1,600,520** | **Br. 603,500** |

 **CHAPTER 8**

 **8.1. FIDUCIARY FUNDS**

Governmental units use fiduciary funds to account for assets held in a trustee or agency capacity on behalf of others external to the governmental entity. Such resources cannot be used for the benefit of the government’s own programs. The fiduciary grouping includes trust funds (private-purpose, investment, and pension) and agency funds, which are similar in the sense that the governmental unit acts in a fiduciary capacity for both types of funds. The accounting emphasis for trust and agency funds lies in demonstrating how the government’s fiduciary responsibilities have been met. The basic difference between the two fund types is that a trust agreement, which mandates the degree of management involvement and the duration of the trust, typically exists for trust fund resources. Furthermore, agency funds are ore temporary in nature.

Accounting for fiduciary funds follows the accrual basis of accounting; however, agency funds do not have revenues or expenses because their operations are of a custodial nature. Governments report fiduciary funds in the fund financial statements on a statement of fiduciary net assets and a statement of changes in fiduciary net assets. Fiduciary funds are not included in the government wide statements.

 **8.1.1. Agency Funds**

*Agency funds* are fiduciary funds used to account for resources that governments hold in a custodial or agency capacity. For example, a local government acts as an agent for the federal government when it withholds income and Social Security taxes, which will later be remitted to other government agencies, from employee payrolls. Also, an agency fund reports the debt service transactions of a special assessment bond issue for which the government is not obligated in any manner in order to reflect the fact that the government’s duties are limited to acting as an agent for the assessed property owners and bondholders. Thus, the government acts as an agent for the property owners in collecting special assessments and remitting the amounts collected to bondholders.

Governments utilize agency funds when their agency responsibilities involve numerous transactions, include several different governmental units, or do not arise from normal and recurring operations of any other fund. For example, if a county unit of government serves as a tax collection agency for all towns and cities located within the county, the county will create an agency fund to demonstrate acceptance of responsibility for collecting and remitting taxes for other governmental units. To use an agency fund, however, the governmental entity should only act as a cash conduit, collecting and dispersing cash. If the governmental entity undertakes any administrative duties, such as determining who will receive the cash or monitoring recipient eligibility, it cannot use an agency fund.

The accounting treatment for agency funds is quite simple, as reflected in the following accounting equation:

 Assets = Liabilities

There is no fund balance or equity. Assets and liabilities are recognized at the time that the government becomes responsible for the assets.

1. **Investment Trust Funds** should be used to report the external portion of investment pools reported by the school district (GASB 34, paragraph 71).
2. **The Pooled Investments Fund** is used to administer the pooling and investing of surplus state funds, and the accumulation and allocation of interest earned among the various accounts and funds from which such investments and investment deposits were made.

 **8.1.2.** **Trust Funds**

Investment trust funds are fiduciary funds used to account for multi government external investment pools sponsored by the governmental entity. For example, a county government may offer to pool the cash available for investment from cities located within its boundaries. Because the cash is not an asset of the county government and cannot be used for its benefit, the resources should be accounted for in a fiduciary fund. Furthermore, if a formal agreement exists and income will be recognized in the fund, it would be appropriate to establish a trust. GASB Statement No. 31 describes the accounting for investment trust funds. Accounting for investment trust funds is beyond the scope of this chapter, so the following discussion focuses on private-purpose and pension trust funds.

1. **Private-purpose trust funds** are fiduciary funds used to account for resources (other than investment pools and employee benefits) that are held for the benefit of parties outside the governmental entity.
2. **Pension trust funds** are fiduciary funds used when a government acts as trustee for defined benefit and defined contribution pension plans of a government or for other employee benefit programs.

 **Accounting for a Private-Purpose Trust Fund**

Assume that on July 2, 2011, Morris County receives a $100,000 contribution from the Hurricane Valley Historical Society. A trust agreement specifying that the income from the contribution must be distributed each May 15 to the three school libraries in Morris County accompanies the contribution. The principal amount is intended to remain intact indefinitely. The county establishes a private-purpose trust fund to account for the contribution and associated activities, because the county itself will not benefit from these resources. The entry is as follows:

 Trust Fund

 Cash…………………………………… 100,000

 Contributions—foundations……………………….. 100,000

 To record a contribution received.

This principal amount is not expendable and will remain in the trust fund. Expendable income amounts may be either accounted for within the same trust fund or transferred to a separate expendable trust fund.

On September 1, the county invests the contribution in bonds, which yield 5 percent annually (payable on March 1 and September 1):

 Trust Fund

 Investments…………………………………………. 100,000

 Cash …………………………………………………………..100,000

 To record an investment in bonds

 On March 1, the county receives the first interest payment:

 Trust Fund

 Cash……………………………………………….. 2,500

 Interest income …………………………………..2,500

 To record the collection of interest

On May 15, Morris County distributes the interest to local school libraries:

 Trust Fund

 Distribution to school libraries …………………………….2, 500

 Cash…………………………………………………… 2,500

 To record the distribution of interest

 On June 30, the county adjusts and closes its accounts:

 **Q U E S T I O N S**

1. How are enterprise and internal service funds similar? How are they different?

2. Cite some governmental operations that might be accounted for through an internal service fund.

3. What fund financial statements are needed for an enterprise fund to meet the requirements for fair presentation in accordance with GAAP? Which government-wide statements include enterprise fund data?

4. Which fund financial statements include internal service fund data? Which government-wide statements include internal service fund data?

5. How does the presentation of an enterprise major fund differ from the presentation of an internal service major fund?

6. Because proprietary funds are accounted for in much the same manner as commercial business organizations, is it appropriate for FASB pronouncements to be used for their accounting?

7. Why is it important for internal service funds to differentiate between revenues generated by inter-fund transactions and transactions with external parties?

8. How does a proprietary fund statement of cash flows differ from a commercial enterprise’s statement of cash flows?

9. What fund types are included in the fiduciary fund category? Where are they reported in the financial statements?

10. How might an internal service fund be financed initially? How will the financing appear in the fund financial statements?