**CHAPTER TWO**

PRINCIPLES OF ACCOUNTING AND FINANCIAL REPORTING FOR STATE AND LOCAL GOVERNMENTS

**Learning Objectives**

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. **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 individual’s 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**

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)**

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 purpose, 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⎯a fiduciary 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.**

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 separate non-fund accounting entities called account groups.** Those are General fixed Asset account group and General long-term debt account group. More detail in the future chapters.

1. **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 proprietary 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,currentliabilities, 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.

**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 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.