PacificCPE

COURSE
21152A

Fund Accounting Fundamentals for Government Entities

Fund accounting is the backbone of governmental financial reporting, and this course breaks it down clearly. You'll explore how governments use separate funds to track resources with specific purposes, the different fund types used in practice, and how they interact within the broader financial reporting structure. If you work with or audit governmental entities and want to strengthen your understanding of how fund-based accounting works, this course gives you the essential foundation you need.

CREDIT HOURS 2 | FIELD OF STUDY ACCOUNTING | EXAM QUESTIONS 10

Start Course ↓ | Final Exam Copy ↓

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recall how funds are used in accounting for governmental activities.

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Chapter 1: FUND ACCOUNTING

Chapter Objective

After completing this chapter, you should be able to:

- Recall how funds are used in accounting for governmental activities.

In Chapter 1 of course 21151F, we set forth some of the key characteristics that distinguish governments and not-for-profit entities from businesses. We also discussed their implications for accounting and financial reporting. In particular, we noted that governments and not-for-profits use fund accounting. In this chapter, we explain the rationale for fund accounting, describe the main types of funds maintained, and examine the relationships among funds.

As noted in Chapter 1 of course 21151F, in June 1999, the Governmental Accounting Standards Board (GASB) established the financial reporting model for state and local governments. In this chapter, we highlight the key features of this model. We begin by defining and explaining some common elements of fund and government-wide financial statements, and also focus on more recent concepts and standards that enhance the reporting model. In addition, we present the main attributes of the Financial Accounting Standards Board (FASB)'s model for not-for-profit entities and show how it differs from the government model. A key purpose of our discussion is to emphasize that funds can be combined and reported in a variety of ways for purposes of external reporting.

WHAT IS A FUND?

Government and not-for-profit organizations establish their accounting systems on a fund basis. In governmental and not-for-profit accounting, the term fund has a different meaning than it does in business accounting. In business accounting, funds typically refer either to working capital (current assets less *current liabilities*) or to selected elements of working capital (such as cash and investments), and only a single consolidated accounting entity is used to account for all the activities of a business. The crux of nonbusiness accounting is fund accounting, and it forms the basic building block of governmental accounting and financial reporting. It is an accounting device that an entity uses to keep track of specific sources and uses of funds. In governmental and not-for-profit accounting, a fund is a fiscal and an accounting entity. Each fund has its own self-balancing set of accounts from which financial statements can be prepared.

Thus, governmental and not-for-profit entities customarily use several funds—that is, funds used for internal accounting purposes and funds used for reporting purposes. Thus, there are several fiscal and accounting entities—to account for the various resources and activities. A government's fund

structure rarely mirrors its organizational structure. The number and types of funds reported in a government's financial statements is based on types of revenue sources, types of services provided, and finance- related laws and regulations and is not dependent upon its size but rather upon how the government is organized. For example, City of Chicago, Illinois, has 36 governmental funds, whereas Boston, Massachusetts, has only 18. A not-for-profit organization—for example, a church—may use one fund to account for its general operating revenues and expenses, another to account for resources set aside to construct a new building, and a *third* to account for its religious school.

WHAT ARE THE KEY ELEMENTS OF GOVERNMENT FINANCIAL STATEMENTS?

In its Concepts Statement, Elements of Financial Statements by providing definitions and explanations of seven key elements that comprise basic financial statements—five relating to financial positions and two relating to resource flows[21].

The GASB defines the elements relating to financial position as follows:

- **Assets** *are resources with present service capacity that the government presently controls.* Present service capacity of an asset is the characteristic that enables the government to provide services. Control is the ability of the government to use a resource's present service capacity and to determine the nature and manner of its use. Examples of assets include cash, receivables, investments, buildings and equipment, and intangibles such as right-to-use *lease* assets.
- **Liabilities** *are present obligations to sacrifice resources that the government has little or no discretion to avoid.* They can result from legally enforceable obligations as well as from social, moral, or economic expectations. Thus, a promise to provide vacation benefits to employees may be a liability, even if it is not legally enforceable.
- **A deferred outflow of resources** is the consumption of net assets by the government that is applicable to a future reporting period. Governments may use net assets in one period to provide benefits clearly applicable to future periods. For example, a government may give cash to a grantee to provide services in a future year. The cash payment reduces the cash of the government but does not increase any other asset or decrease any liability. Moreover, because the services must be provided in a future year, rather than the current year, it makes sense that the government delay recognizing a grant expense until the future year. Hence, the decrease in cash (a credit) would be offset by a deferred outflow of resources (a debit)—an item that, such as assets, would be reported on a balance sheet or comparable statement that reports financial position.
- **A deferred inflow of resources** is the acquisition of net assets by the government that is applicable to a future reporting period. Suppose that a government receives property taxes in the year prior to which they are due and in which they are intended to be spent. The net assets of the government increase inasmuch as the cash is received, but are

not offset by a decrease in any other asset or an increase in a liability. Although the government is expected to use the cash to provide future services, no liability is created because an obligation to carry out the broad mission of government is not considered a liability. Further, it would be premature to recognize revenue in a year prior to that in which the taxes are budgeted. Hence, the increase in cash (a debit) would be offset by a deferred inflow of resources (a credit).

- **Net position** *is the residual of all other elements presented in a statement of financial position, that is the assets and deferred outflows less the liabilities and deferred inflows*. In a balance sheet (the statement that shows the financial position of governmental funds—those prepared on a modified accrual basis), the residual difference is presented under the heading "fund balance."

Financial statement elements with the characteristics of deferred inflows and deferred outflows of resources are not unique to governmental accounting. Businesses also report items such as revenues and costs related to future periods. However, they report them among the liabilities and assets, respectively. GASB Statement 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, requires that governments, unlike businesses, must now report the deferred items in a separate category[3]. Thus, a statement of net position might be in a format comparable to the following:

Assets	$100
+ Deferred outflow of resources	50
− Liabilities	(75)
− Deferred inflows of resources	(60)
= Net position	$ 15

Reporting deferrals in separate categories (i.e., deferred inflows of resources or deferred outflows of resources) arguably makes more sense than including them among the liabilities and assets. A deferred inflow, such as grant money received in the current year that is restricted for use in the next year, is a decidedly different economic element than a traditional liability. In the usual course of operations, the entity will not have to return a cash payment to the grantor; it only must wait until a future period when it is allowed to spend the grant. Hence, reporting such sums apart from conventional liabilities clearly distinguishes them from other obligations that will require an outlay of cash or other resources.

The GASB defines the elements of financial reporting relating to resources flows as follows:

- "An **outflow of resources** is a consumption of net assets by the government that is applicable to the reporting period." This element embraces familiar items such as expenses and expenditures but may also include others such as *loss*es and "other

financing uses." It can result from a decrease in assets, an increase in liabilities, or a decrease in a previously recognized deferred outflow of resources.

- "An **inflow of resources** is an acquisition of net assets by the government that is applicable to the reporting period." Inflows of resources include revenues as well as other items such as gains and "other financing sources." An inflow of resources can result from an increase in assets, a decrease in liabilities, or a decrease in a previously recognized deferred inflow of resources.

WHAT CHARACTERIZES FUNDS?

Each fund of a government or not-for-profit entity can be represented by a variation of the accounting equation that describes a business entity. Instead of

Assets = liabilities + owners' equity

fund accounting uses the equation

Assets + deferred outflows = liabilities + deferred inflows + fund balance

or its equivalent

Assets + deferred outflows − liabilities − deferred inflows = fund balance

This form recognizes that governmental accounting, but not business accounting, distinguishes between assets and deferred outflows and between liabilities and deferred inflows. It also rearranges the elements to focus on fund balance. Funds of a not-for-profit entity would use the equation

Assets − liabilities = fund balance

Governments and not-for-profits do not have owners, so the term owners' equity is replaced by the terms **fund balance, net position**, or—for not-for-profits—net assets. Fund balance, net position, and net assets, like owners' equity, are residuals—the difference between assets (and deferred outflows in the case of governments) and liabilities (and deferred inflows for governments). According to GASB Statement 54, *Fund Balance Reporting and Governmental Fund Type Definitions* (Codification Section 1800, paragraphs 166–183), the fund balance (the residual in modified accrual-based governmental funds) is reported in a hierarchy of classifications based primarily on the extent to which the government is bound to observe restrictions on how the amounts in those funds can be spent. Fund balance is the amount left to the parties with rights to the assets after all other claims have been liquidated.

Because funds can be represented by the basic accounting equation (with the slight modification for governments to distinguish between the assets and liabilities and the deferrals) that is used by businesses, they can also be accounted for by the same double-entry system of bookkeeping. Their current status and past performance can be summarized by financial statements similar to those of businesses. For example, the balance sheet of a fund can detail the specific assets, liabilities, deferrals, and elements of fund balance that underlie the accounting equation as of any point in time. A statement of revenues, expenditures, and other changes in fund balance can explain the reasons for changes in fund balance during a specified period of $time_4$. A statement of cash flows can reconcile the changes in cash between the end and the beginning of a period. Fund balance information is important in identifying the available liquid resources to repay long-term debt, reduce property taxes, add new governmental programs, expand existing ones, or enhance the financial position of the government. GASB Statement 54 affects only the fund balance reported on the balance sheet of governmental funds. It does not affect the reporting of net position by proprietary or fiduciary funds. It also does not affect the reporting of net position of governmental activities in the government-wide financial statements.

Under GASB Statement 54, governmental fund balance information is reported in five different classifications. Certain items are classified as nonspendable because the money has already been spent (e.g., inventory, prepaid insurance) or because it cannot be spent (e.g., endowment gifts, bequests to be held in perpetuity). For the spendable amounts, the constraints lessen as the classification proceeds from restricted to committed, assigned, and unassigned (in that order).

- **Nonspendable** fund balance includes amounts that are not in spendable form or are legally or contractually required to be maintained intact.
- **Restricted** fund balance includes amounts constrained for specific purposes by external parties, through constitutional provisions or by enabling legislation.
- **Committed** fund balance includes amounts constrained for specific purposes determined and adopted by a formal action by the highest decision-making authority of the government itself.
- **Assigned** fund balance includes amounts a government explicitly intends to use for specific purposes.
- **Unassigned** fund balance is the residual classification for the general fund and comprises all amounts not included in the other classifications.

Nonspendable Fund Balance

Nonspendable fund balance includes amounts that cannot be spent because they are either not in spendable form or legally or contractually required to remain intact. “Not in spendable form” items include those that are not *expected to be converted to cash*, such as inventory, prepaid amounts, the long-term portion of loans and notes receivable, and property acquired for resale. However, if the

use of proceeds collected from any receivables or sales is restricted, committed, or assigned, then they should be included in the appropriate fund balance classification rather than the nonspendable fund balance. An example of an amount that is legally or contractually required to be maintained intact is the principal of an endowment fund (an investment fund in which only investment income, not the principal, can be spent).

Restricted Fund Balance

Restricted fund balance includes amounts constrained to specific purposes by their providers, through constitutional provisions, or by enabling legislation. Constraints can be externally *imposed* by creditors, bondholders, grant providers, contributors, or laws and regulations of other governments. Enabling legislation *authorize*s the government to assess, levy, charge, or mandate payments of resources and includes a legally enforceable requirement that those resources be used only for the specific purpose stipulated in the legislation. Restrictions placed on resources may be changed or lifted only with the consent of the providers.

Committed Fund Balance

Committed fund balance includes amounts that can only be used for specific purposes pursuant to constraints imposed by formal action of the government's highest level of decision-making authority. Commitments cannot be lifted *unless* the government removes or changes the specified use by taking the same formal action that originally imposed the constraint. Committed funds include contractual obligations for which existing resources in the fund have been specifically committed for use. The funds may also include fund balance saved for a "rainy day" or "stabilization," if the limitations on using those resources have the legal constraints of a commitment.

Assigned Fund Balance

Assigned fund balance includes amounts that are neither restricted nor committed but which the government intends to use for specific purposes. Intent can be expressed by either a governing body or an official, such as the budget director, who has been delegated the authority to assign amounts to be used for specific purposes. Unlike the committed fund balance, the authority for making an assignment does not have to be made by the government's highest level of decision-making authority. Thus, constraints imposed on assigned amounts can be more easily removed or modified than those that are imposed on committed amounts.

Fund balance in **governmental funds** other than the **general fund** is, at a minimum, assigned. Because the other funds report on specific sources and uses of funds, such as the proceeds from borrowing to finance highway and bridge construction, the fund balance of those funds is at least intended to be used for the fund's purpose and may be restricted or committed.

Unassigned Fund Balance

Unassigned fund balance is the residual classification for the general fund and includes amounts that have not been assigned to other funds and have not been restricted, committed, or assigned to specific purposes within the general fund. Thus, positive unassigned balances should be reported only in the general fund. For the other governmental funds, the only unassigned fund balance would be negative, which would indicate expenditures were greater than the resources available for specific purposes.

Fund Balance Disclosures

Fund balance classification policies and procedures should be reported in the notes to the financial statements. The government's highest level of decision-making authority and the formal action that is required to establish a fund balance commitment should be indicated. For the assigned fund balance, the government should disclose the body or official authorized to assign amounts to a specific purpose and its policy for assigning fund balance. The government should also report the order in which restricted, committed, assigned, and unassigned amounts are spent when amounts in more than one classification are available for a particular purpose.

USE OF MULTIPLE FUNDS TO ACCOUNT FOR AN ENTITY

Governments and not-for-profits separate resources into funds for reasons that differ considerably from those for which businesses establish subsidiaries. Businesses generally establish subsidiaries to account for their activities by product or region, to isolate certain business risks, and to minimize their tax obligations. Governments and not-for-profits, on the other hand, most commonly separate resources into funds to ensure that they adhere to restrictions placed on them by legislators, grantors, donors, or other outside parties. For example, if a university were to receive a donation that may be used only for scholarships, it would account for the resources received in a separate scholarship fund. Fund accounting promotes both control and accountability over restricted resources. To a lesser extent, governments and not-for-profits establish funds to account for certain activities—often those of a business type— that are different in nature from their usual activities. For example, a government might account for its golf course, which operates similarly to a privately-owned course, in a fund separate from that used to account for its general operations. By accounting for these types of activities in their own accounting and fiscal entities, the entities are better able to control the activities' revenues and expenditures and to assess their overall performance.

To appreciate the relationship between the two or more funds used to account for a single entity, one must remember that each fund is a separate accounting entity. Thus, every transaction that affects a fund must be recorded by at least one debit and one credit. Any transaction that affects two or more funds must be accounted for as if it affected two or more independent businesses and must be recorded individually in each fund. Suppose that a city maintains two funds: a general fund accounts for its unassigned resources and general operations, and a utility fund accounts for its