PacificCPE

COURSE
21159A

Business-Type Activities and Enterprise Fund in Government Accounting

Not everything a government does fits the governmental fund model—enterprise activities like utilities, transit systems, and public universities follow business-type accounting. This course explores how governments account for these activities using proprietary funds and GASB standards, addresses whether public colleges may actually be insolvent compared to private peers, and examines public-private partnerships and their pitfalls. A great fit for CPAs who work with governmental entities that operate in a commercial or quasi-commercial capacity.

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LEARNING ASSIGNMENTS AND OBJECTIVES

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 the proper accounting treatment for various business-type activities.

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Chapter 1: BUSINESS-TYPE ACTIVITIES

Chapter Objective

After completing this chapter, you should be able to:

- Recall the proper accounting treatment for various business-type activities.

Governments and not-for-profits engage in a variety of functions that are similar to those carried out by businesses. They range in size from the small gift shops of churches to multibillion-dollar regional power authorities.

Thus, in this chapter we look at accounting principles applicable to business-type accounting. As shall soon be evident, the business-type activities of governments and not-for-profits are accounted for similar to corresponding enterprises in the private sector. Their financial statements are on a full accrual rather than a modified accrual basis, and their measurement focus is on all economic resources, not just current financial resources. It should be noted from the start that the discussion of reporting of business-type activities in enterprise funds is equally applicable to reporting in separately issued financial statements of businesses enterprises—and vice versa—even if not reiterated throughout the chapter.

We direct relatively little attention, therefore, to the general principles of full accrual accounting, which are similar to those of businesses and are covered in other courses on financial accounting. Instead, our objectives are more specific:

- To consider criteria for distinguishing between business-type and governmental activities and to raise pertinent questions as to whether and why these activities should be accounted for differently
- To address several selected accounting issues that are unique to government business enterprises
- To set forth the purposes and assess the consequences of using internal service funds to account for goods and services provided by one government department to another
- To show how business-type activities can be incorporated into government-wide financial statements
- To present examples of the information needed to assess revenue bonds—the type of debt associated with both a government's business-type activities and not-for-profit organizations.

WHAT TYPES OF FUNDS INVOLVE BUSINESS-TYPE ACTIVITIES?

In addition to the government-wide financial statements, a governments' business-type activities are reported in greater detail in enterprise funds. Enterprise funds are one of two types of funds reported in proprietary funds financial statements, the other being internal service funds. These funds are said to be nonexpendable (or revolving) and thus focus on determining operating net income, changes in net position (or cost recovery), financial position, and cash flows.

- Enterprise funds account for operations in which goods or services are provided to the general public at large (users external to the governmental unit) on a user-charge basis.
- Internal service funds account for operations in which goods or services are provided by one government department to other funds, departments, or agencies within the same governmental unit (or occasionally to other governments) on a user-charge or cost-reimbursement basis.

Some of the accounting and reporting issues pertaining to business-type activities are common to enterprise funds and internal service funds. However, each fund has unique features, so at the risk of repetition, we shall devote separate sections to each of the fund types.

Governments account for proprietary funds—both enterprise and internal service—on a full accrual basis. They recognize exchange revenues when earned and expenses (rather than expenditures) as incurred, irrespective of when cash is received or paid. They accord balance sheet recognition to both capital assets and long-term debt, depreciating the capital assets and amortizing any premiums or discounts on long-term debt.

Not-for-profits, in contrast to governments, account for their business-type activities—both internal and external—within their current operating funds. However, the current operating funds of not-for-profits, unlike those of governments, are on a full accrual rather than a modified accrual basis. Therefore, not-for-profits, like governments, also account for their business-type operations on a full accrual basis, giving balance sheet recognition to long-lived assets and long-term debt. The resources associated with these activities are generally donor-unrestricted, and hence are so classified per the guidelines of the Financial Accounting Standards Board (FASB) Accounting Standards Update (ASU) No. 2016-14, Financial Statements of Not-for-Profit Organizations.

WHY DO GOVERNMENTS AND NOT-FOR-PROFITS ENGAGE IN BUSINESS-TYPE ACTIVITIES?

Governments and not-for-profits engage in a wide variety of activities that are also carried out by for-profit businesses. For example:

- Governments collect and dispose of trash; supply electric and other utility services; maintain hospitals (often in competition with not-for-profit and stockholder-owned hospitals); and operate swimming pools, tennis courts, and golf courses.

- Universities sell computers, books, and clothing; sponsor professional-like sports teams; operate cafeterias and restaurants; and maintain dormitories.
- Churches, synagogues, hospitals, museums, and zoos sell religious items, gifts, posters, and books.
- Girl Scouts sell cookies; Boy Scouts sell candy.

In the United States, prevailing political and economic doctrine dictates that goods and services be provided mainly by the private business sector. Why, then, do governments and not-for-profits engage in activities similar to those carried out by private enterprise? Several reasons can be cited:

- The activities provide resources that would otherwise have to be raised through taxes, contributions, tuition, or other means. Gift shops, for example, may be major sources of revenue for museums; government-owned utilities may generate excess cash as well as electricity and are thereby a substitute for taxes and other forms of revenue.
- The activities complement and support the main mission of the entity. Thus, for example, college cafeterias, bookstores, and sports programs are an integral part of a university environment.
- The entity wants control over the activity. Thus, universities operate dormitories not necessarily because they can do so at lower cost than private contractors, but to maintain authority over them. Similarly, some cities and counties have rejected proposals to sell their hospitals to private firms so as to keep them entirely within their command.
- The entity can provide the services more cheaply or efficiently than a private firm can. This may be especially true if the government or not-for-profit is not subject to the income, property, or sales taxes that would be charged to private businesses. Public housing authorities, for example, have an inherent cost advantage over private landlords in providing apartments to low-income families in that their operations are not subject to state and federal income taxes.
- The entity wants either to subsidize the activity or to ensure that the goods or services are available at lower-than-market rates. Thus, a city might maintain a bus service or a public golf course even though it is unprofitable to do so.
- The activities, because of their nature, are believed to be inherently governmental rather than those of the private sector. Thus, police and fire services are almost always provided by governments even though there are examples of both being provided by businesses. In recent years, some governments have even outsourced the operation of their prisons, but whether this is an appropriate function for **privatization** is open to controversy.

Both governments and not-for-profits have come under attack of late for operating programs and services that critics believe should be carried out in the private sector. Opponents of "big government" have urged the privatization of services, claiming that, lacking the profit motive,

governments are inherently inefficient. Merchants have accused *tax-exempt* universities and museums with unfair competition in selling books, computers, and other items at below-market prices.

The issue of whether business-type activities should be carried out by governments and not-for-profits is beyond the scope of this text. But the reasons they carry them out are directly pertinent to questions of both how to distinguish business-type from governmental activities and how to account for them.

SHOULD BUSINESS-TYPE ACTIVITIES BE ACCOUNTED FOR DIFFERENTLY FROM GOVERNMENTAL ACTIVITIES?

A fundamental question pertaining to business-type activities is whether and why they should be accounted for differently than governmental activities—those that are financed predominantly through taxes and intergovernmental grants—when they are reported in the fund-level financial statements. The question that arises in particular is why business-type activities should be accounted for on a full accrual rather than a modified accrual basis of accounting.

Key reasons cited for using business-type accounting to account for proprietary-fund activities include:

- The full accrual basis of accounting (i.e., the measurement focus on all economic resources) captures all the resources and obligations, including capital assets and long-term obligations, associated with an activity. It thereby provides a more complete picture of the entity's fiscal status and operating results.
- The measurement focus on all economic resources is more consistent with the objectives of the GASB that financial reporting should provide information to determine whether current-year revenues were sufficient to pay for current-year services and to assist users in assessing service efforts, costs, and accomplishments.
- Full accrual accounting provides information on depreciation, which is an essential cost of operations[1].
- Business-type accounting facilitates comparisons with similar private enterprises.

At the same time, there are cogent arguments against separate accounting principles for proprietary activities:

- Two separate measurement focuses and bases of accounting within the same set of financial statements are confusing and add comp*exity* to the reporting process.
- As suggested earlier, there are no clear-cut distinctions between business and nonbusiness activities. Despite many similarities, governmental activities cannot—and should not—be compared to activities carried out in the private sector. A government should have sound political and economic reasons—other than merely earning a profit— for conducting a

particular activity in the public sector. If it does not, then the activity should be privatized. These reasons by themselves should suggest that the activities be assessed by criteria other than profits—the *bottom line* of corporate financial reports.

- Surveys of statement users indicate that information on depreciation is not of high priority to governmental decision makers. They are concerned mainly with the ability of revenues to cover debt service and other obligations rather than with depreciation. This applies especially to users interested in infrastructure-intensive services such as toll roads, tunnels, and bridges; water supply and wastewater treatment; and electricity supply.

Closely tied to the issue of whether proprietary activities should be accounted for using separate accounting principles is whether they should be accounted for and reported in separate funds. A key rationale for fund accounting and reporting in general is that legally restricted resources should be reported apart from those that are unrestricted. To be sure, the resources of some proprietary funds may be contractually dedicated to servicing revenue bonds. The resources of others, especially those accounted for in internal service funds, however, are not usually legally restricted. They often can be used for all purposes of government and may be subject to the claims of general creditors. As is discussed later in this chapter, governments must present restricted proprietary fund assets (usually owing to revenue bond covenants) separately from those that are unrestricted. Both, however, may be presented within the same fund.

There are compelling reasons to account *internally* for each of a government's business-type activities in separate funds. Separate funds facilitate budgeting, planning, and control. However, when resources that are not legally restricted are reported apart from unrestricted resources, statement users may have difficulty determining the total resources available for future appropriation or payment to creditors. They may be misled into thinking that unrestricted resources are, in fact, restricted.

In contrast to governments, not-for-profits prepare financial reports that are guided by the underlying principle that unrestricted resources, even if used to carry out business-type activities, should be reported in a common fund. Not-for-profits have traditionally reported on their business-type activities within their current unrestricted funds, even though they may have maintained separate sets of books for each separate enterprise. This practice has been officially sanctioned since FASB Statement No. 117, Financial Statements of Not-for-Profit Organizations, which required not-for-profits, for purposes of external reporting, to intermingle all resources, irrespective of whether they are associated with business or nonbusiness activities, unless they are donor restricted$_2$.

Nevertheless, the arguments in favor of reporting on proprietary activities apart from governmental activities are also compelling. Up to the point of "information overload," more information is better than less. If managers need separate reports to assess the performance and fiscal status of business-type activities, so too do citizens, investors, and other statement users. Insofar as statement users

are concerned with the total amount of unrestricted resources, they can readily add the resources in unrestricted proprietary funds together with those in the general fund and other unrestricted funds.

WHAT ARE THE THREE BASIC STATEMENTS OF PROPRIETARY FUND ACCOUNTING?

Similar to businesses, governments are required to prepare three basic proprietary fund statements:

- A statement of net position (balance sheet)
- A statement of revenues, expenses, and changes in fund net position (income statement)
- A statement of cash flows Whereas the amounts reported in the financial statements of governmental funds are significantly different from those incorporated in the government-wide statements, those of proprietary funds are generally exactly the same. As emphasized previously, the proprietary funds statements, like the government-wide statements, are on a full accrual basis of accounting.

The Statement of Net Position (Balance Sheet)

Governments generally present the statement of net position in a format that displays *assets plus deferred outflows of resources less liabilities less deferred inflows of resources equals net position*. As with the government-wide statements, the GASB grants governments an option to employ a more traditional balance sheet format (assets plus deferred outflows of resources equals liabilities plus deferred inflows of resources plus net position). In either case, net position should be displayed in three broad components:

- *Net* investment in capital assets (the total historical cost of capital assets less accumulated depreciation, minus the outstanding debt used to acquire, construct, or improve these assets)
- Restricted net position
- Unrestricted net position

To the extent a government's proprietary funds contain assets that are restricted such that only earnings on those assets can be spent, not the assets themselves—such as the principal of an endowment— restricted net position should be further divided between expendable and nonexpendable restricted net position.

Governments should also segregate the restricted assets from other assets. Suppose that a government holds in a separate bank account cash that is restricted for debt service. To classify that cash as a current asset would suggest that it is available for general use. Therefore, the government should report that cash as a **restricted asset**, apart from its other current assets.

The distinctions between restricted and unrestricted assets, as well as other issues relating to restrictions, are addressed in a subsequent section. It should be noted that GASB Codification Section 1800— Classification and Terminology, which requires the fund balances to be classified as

nonspendable, restricted, *committed*, assigned, and *unassigned*, applies only to the fund balances of governmental funds, not the net position of proprietary funds.

The Statement of Revenues, Expenses, and Changes in Fund Net Position (Income Statement)

The statement of revenues, expenses, and changes in fund net position is comparable to the income statement of a business. It differs, however, in that it is all-inclusive. That is, it reports not only operating revenues and expenses, but also nonoperating resource flows such as capital contributions.

In 2024, the GASB made significant changes to the arrangement of this financial statement. Those changes and the other provisions of Statement No. 103, *Financial Reporting Model Improvements*, are required to be applied to financial statements for fiscal years beginning after June 15, 2025 (i.e., for fiscal years ending June 30, 2026), and all reporting periods thereafter. A key reason for the new format has to do with the comparability—or lack thereof—of this financial statement of business-type activities with the income statement of their not-for-profit and for-profit counterparts, as discussed in the following "In Practice." The following summarizes the key elements as required by Statement 103: