Solutions Manual for Accounting for Governmental and Nonprofit Organizations 1st Patton

Chapter 2

The Use of Funds in Governmental Accounting

QUESTIONS

Q2-1. A fund is 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.

Q2-2. The basic purpose of fund accounting is to help ensure compliance with legal restrictions on the use of governmental resources. Funds are generally established pursuant to law. They serve as a control mechanism to ensure budgetary compliance and help ensure resources are spent for the specific purposes intended.

Q2-3. The three categories of funds are: governmental-type (to account for the basic day-to-day-services provided by government; proprietary-type (to account for governmental activities that operate in a manner similar to private sector enterprises in the sense that they charge fees for services); and fiduciary-type (to account for resources held in a trust or custodial capacity for others).

Q2-4. Measurement focus relates to what is being expressed in the financial statements and which resources are being measured. The economic resources measurement focus is used in measuring whether revenues exceeded expenses. It takes account of transactions and events that affect all the resources available to the activity – financial and capital. Proprietary-type and fiduciary-type funds use the economic resources measurement focus.

The current financial resources measurement focus is concerned with flows of cash and near-cash items. It takes account of current financial resources only. Acquisitions of capital assets are reported as outflows of financial resources, rather than as exchanges of financial resources for capital resources. Proceeds of long-term debt are reported as inflows of financial resources rather than as long-term liabilities. Governmental-type funds use the current financial resources measurement focus,

Q 2-5. The governmental budget process is one of estimating the yield from taxes and other sources and authorizing the expenditure of those resources. The revenue aspect of the budget focuses on the availability of resources for spending. When budgets provide authority to spend, the authority relates to current outflows of budgetary resources. Thus, the budget and budgetary measurements focus on the short run. For example, once resources are used to acquire capital assets, the resources are no longer available for spending. Governmental accounting systems have historically provided information to help manage budget execution. As a result, accounting measurements *within the funds* have tended to be similar to budgetary measurements.

Q2-6. Under the full accrual basis of accounting, revenues are recognized in the period in which they are earned, and expenses are recognized when resources are consumed or liabilities are incurred.

Under the modified accrual basis of accounting, revenues are recognized in the period in which they are measurable and available, the term "available" meaning that the revenues must be collected either within the current period or soon enough thereafter to be used to pay the bills of the current period. Expenditures under modified accrual accounting are generally recognized in the period in which services and goods are received and a liability is incurred, but there are specific exceptions to this rule so certain items are not recognized until the liabilities come due for payment.

Governmental-type funds use the modified accrual basis of accounting. Proprietary-type and fiduciary-type funds use the accrual basis of accounting.

Q2-7. The governmental-type funds and their purposes are:

General – to account for all financial resources not accounted for in some other fund; or more generally, the day-to-day general activities of government.

Special Revenue – to account for the proceeds of specific revenue sources that are restricted or otherwise limited to spending for specified purposes other than debt service and capital projects.

Debt Service – to account for financial resources restricted or otherwise limited to spending for principal and interest on general long-term debt.

Capital Projects – to account for financial resources restricted or otherwise limited to spending for capital outlays, including facilities and other capital assets.

Permanent – to account for resources legally restricted so that only earnings from the resources (and not
the principal itself) may be used to support governmental programs.

Q2-8. There are no capital assets in governmental-type funds because those funds account only for inflows and outflows of financial resources. Governmental-type funds can be used and indeed are used to acquire capital assets. When that happens, however, the accounting within the funds is such that there is an expenditure of financial resources, rather than an exchange of a financial resource for a capital asset. Capital assets are reported in government-wide financial statements, but not in fund financial statements.

Q2-9. The proprietary funds and their uses are as follows:

Enterprise – to account for resources used to supply goods and services, for a fee, to users primarily external to the government itself, such as the general citizenry.

Internal Service – to account for resources used to supply goods or services, on a cost-reimbursement basis, within the government unit and other governments. (The government unit is the predominant user.)

Both funds are used to account for activities involved in providing goods or services. The difference lies in the fact that Enterprise funds sell primarily to nongovernmental users (e.g., citizens who use a toll road or toll bridge), whereas Internal service funds sell to users within the governmental unit and to other governments (but the government unit must be the predominant user).

Q2-10. Enterprise funds and internal service funds use full accrual accounting in order to determine full cost – that is both operating costs and capital costs. Having full costs enables managers of these entities to have appropriate data for determining user charges.

Q2-11. The fiduciary-type funds and their uses are as follows:

Pension Trust – to account for resources held in trust for employee retirement plans and other employee benefit plans

Investment Trust – to account for resources of external investment pools managed by a sponsoring government, and investment accounts managed for individual governmental entities

Private-Purpose Trust – to account for resources of all other trust arrangements maintained by a governmental unit for the benefit of individuals, other governments, and private organizations

Custodial – to account for resources held in a custodial capacity for some other organization and that must be disbursed according to law or contractual agreement

MULTIPLE CHOICE QUESTIONS

MC2-12. b

MC2-13. c

MC2-14. c

MC2-15. d

MC2-16. a

MC2-17. d

MC2-18. c

MC2-19. a

MC2-20. b

MC2-21. b

MC2-22. c

MC2-23. d

MC2-24. d

MC2-25. b

MC2-26. c

MC2-27. d

MC2-28. d Long-term liabilities are not reported in governmental funds.

MC2-29. d

MC2-30. b

EXERCISES

E2-31. *(5 minutes)*

1. Governmental-type
2. Governmental-type
3. Fiduciary-type
4. Fiduciary-type
5. Proprietary-type

E2-32. *(5 minutes)*

1. Capital Projects Fund – Current financial resources (CFR); Modified accrual basis (MA)
2. General Fund – CFR; MA
3. Pension Trust Fund – Economic resources (ER); Accrual basis (A)
4. Custodial Fund – ER; A
5. Internal Service Fund – ER; A

E2-33. *(5 minutes)*

1. Capital Projects Fund
2. Debt Service Fund
3. Special Revenue Fund
4. General Fund

E2-34. *(10 minutes)*

1. Enterprise Fund, General Fund
2. Enterprise Fund, General Fund
3. General Fund
4. Capital Projects Fund
5. General Fund
6. Debt Service Fund
7. Internal Service Fund, General Fund
8. Special Revenue Fund

E2-35. *(5 minutes)*

1. General Fund
2. Capital Projects Fund
3. Debt Service Fund
4. Pension Trust Fund

E2-36. *(15 minutes)*

1. False. Capital Projects Funds are not required to be used if, say, smaller items of equipment are acquired with general tax revenues and paid for directly from the General Fund.
2. True
3. False. Governments may supplement specific sources of revenue for Special Revenue Funds with transfers from the General Fund. However, the proceeds of specific sources of revenue should comprise a substantial portion of the resource inflows to the Special Revenue Fund.
4. False. Capital assets financed by Proprietary Fund resources are accounted for in a Proprietary Fund, not in a Capital Projects Fund.
5. False. Debt Service Funds are used to accumulate resources for paying debt service coming due both in the current and future years. In fact, such funds must be used if the government is accumulating resources for debt service coming due in future years.

E2-37. *(10 minutes)*

1. False. The acquisition or construction of capital assets in governmental-type funds is recorded as an expenditure and is not capitalized and depreciated.
2. True
3. True
4. False. Property tax revenues are recognized to the extent they are measurable and available. Available means collected in the current period or soon enough thereafter to be used to pay the bills of the current period, generally 60 days after the accounting period ends.

E2-38. *(10 minutes)*

1. True
2. False. Enterprise Funds may (and often do) received subsidies from the General Fund.
3. False. Enterprise Funds report expenses. Capital outlays result in assets, which are depreciated. To ascertain the capital assets acquired during the year, read the statement of cash flows.
4. False. Expenses are accrued if applicable to the current year, regardless of when they are expected to be paid.
5. True

E2-39. *(10 minutes)*

1. False. By definition, Fiduciary Funds are used to account for assets held by a government in a trust or agency capacity for others (individuals, other governments or private organizations).
2. True

E2-40. *(15 minutes)*

1. Governmental-type Fund - $605,000; Enterprise Fund - $605,000
   (Accruals of the "stub period" salary are made both under the modified accrual and accrual basis of accounting.)

2. Governmental-type Fund - $100,000; Enterprise Fund - $5,000
   (Governmental-type fund reports the entire capital outlay as expenditures. Enterprise Fund reports only depreciation for six months as expenses. ($100,000/10 = $10,000; $10,000/2 = $5,000)

3. Governmental-type Fund - $13,000; Enterprise Fund - $3,000
   (Governmental-type fund reports entire debt service payment as expenditures. Enterprise Fund reports principal repayment as reduction of liability and interest payment as expense.

E2-41. *(15 minutes)*

1. Governmental-type - $26,000; Enterprise Fund - $26,000
   (Governmental-type fund accrues utility expenditures because they are normally payable from financial resources shortly after end of period. Enterprise fund uses accrual accounting.)

2. Governmental-type - $0; Enterprise Fund - $45,000
   (Governmental-type fund recognizes compensated absences expenditures and liabilities when the liabilities mature; i.e., when employees separate. Enterprise fund uses accrual accounting.)

3. Governmental-type - $0; Enterprise Fund - $63,000
   (Governmental-type fund recognizes interest on long-term debt as an expenditure when the interest is due for payment; hence, no accrual is made. Enterprise fund uses accrual accounting.)

E2-42. *(10 minutes)*

1. EF
2. DSF
3. GF
4. ISF
5. SRF
6. GF
7. EF, ISF

PROBLEMS

P2-43. *(Moderate – 20 minutes)*

1. This municipal clinic probably would be set up as an Enterprise Fund because it charges fees for its services and bills to recover costs for services provided to Medicaid-eligible patients. It therefore needs to have full cost information (including depreciation on buildings and equipment) on an accrual basis to help establish the fees and bills for costs of services.
2. A centralized printing operation should be set up as an Internal Service Fund. This will allow for the accumulation of full costs on an accrual basis of accounting so that appropriate charges for services can be made to the departments requiring printing services.
3. A regional airport could be established as a separate governmental corporation or as a unit of one of the governments. In either event, it would use Enterprise Fund accounting. This will allow for the accumulation of full costs on the accrual basis of accounting, so that each government's share of the net assets and changes in net assets can be computed accurately.
4. A Special Revenue Fund would be established to accumulate the taxes dedicated to spending for the purpose of improving the downtown business area. Creating a special fund helps provide accountability for the resources to ensure they are used for the intended purposes.

P2-44. *(Moderate – 25 minutes)*

1. DSF
2. SRF
3. GF
4. CPF
5. CPF
6. CPF
7. GF
8. GF
9. SRF
10. GF
11. GF
12. DSF
13. CPF
14. PF
15. SRF (transfer from PF)

P2-45. *(Moderate – 25 minutes)*

1. EF
2. GF, ISF
3. EF, GF
4. SRF
5. GF
6. EF, GF
7. DSF
8. GF, DSF
9. CPF
10. ISF, GF
11. SRF
12. PF, SRF
13. EF
14. PF and SRF or EF

P2-46. (*Moderate – 10 minutes)*

1. GF, PTF
2. EF, ISF
3. ISF, GF
4. CPF, DSF
5. GF, CPF
6. SRF, GF

P2-47. *(Moderate – 20 minutes)*

Jasmin City
General Fund
Statement of Revenues, Expenditures, and Changes in Fund Balance
For the Year Ended December 31, 2019

Revenues:		
Property taxes	$7,000,000	
Licenses and permits	1,000,000	
State and federal grants	2,000,000	
Miscellaneous	180,000	
Total revenues		$10,180,000
Expenditures:		
Education	2,000,000	
Parks	750,000	
Public safety	4,000,000	
Highways	900,000	
Total expenditures		7,650,000
Excess of revenues over expenditures		2,530,000
Other financing sources (uses):		
Transfers in	700,000	
Transfers out	(1,500,000)	
Total other financing (uses)		(800,000)
Net change in fund balance		1,730,000
Fund balance, beginning of year		1,500,000
Fund balance, end of year		$ 3,230,000

P2-48. *(Moderate – 15 minutes)*

Item	(a) Expenditures	(b) Expenses
Salaries paid in 2019	3,000,000	3,000,000
Salaries, accrued	20,000	20,000
Utility bill, accrued	10,000	10,000
Equipment acquired / depreciation	200,000	20,000
Principal paid	100,000	0
Interest paid	40,000	40,000
Totals	3,370,000	3,090,000

CASE STUDY

The factors affecting the size of the fund balances of the General Fund and the Sewage Special Revenue Fund are different, so the two funds need to be discussed separately.

General Fund – The fund balance of the General Fund is not a “slush fund.” State and local governments experience economic expansions and contractions. They may also experience emergency expenditure needs, suffer from unexpected cutbacks in aid from higher level governments, and fall victim to so-called “unfunded mandates” (laws passed by higher level governments that impose costs on lower level governments without any financial assistance.) A reasonable fund balance in the General Fund helps the government cope with these problems. The fund balance of the General Fund is essentially a “rainy day” fund. In addition, credit-rating agencies look to the size of the General Fund fund balance as a factor in determining the entity’s credit-rating. In short, well-run governments need to maintain a reasonable level of General Fund fund balance to cope with future problems.

The size of the fund balance, however, is a matter of judgment and reasonable people might not agree as to how large it should be. In the past, credit-rating agencies have suggested rates in the 5-10% range. The GFOA’s Best Practice guidelines recommend that, at a minimum, general-purpose governments, regardless of size, should maintain “unrestricted” General Fund fund balances of “no less than two months or regular general fund operating revenues or regular general fund operating expenditures.” (The GFOA’s definition of “unrestricted” covers what Mt. Lebanon classifies as the total of unassigned and assigned; two months is equivalent to 16.7% of revenues / expenditures.)

The Mt. Lebanon Letter of Transmittal (p. 5) takes note of recent “fiscal challenges.” On page 8, the Letter notes that, before 2015, the Commission’s fund balance goal was 10% of expenditures and that, in 2015, it adopted an ordinance increasing the goal to 12% with the intention of reaching 15%. The letter also states that, at the end of 2016, the unassigned fund balance was 14.9% of General Fund expenditures. Analysis of the fund balance (page 37 of the MD&A) shows that part of the total fund balance is nonspendable and part has been assigned to help balance the 2017 budget. Considering all the factors, the Commission’s policies are generally in line with the GFOA Best Practice guidelines. Thus, Peachum’s promise to use the ”slush fund” to make a substantial cut in the property tax rate is not appropriate.

Sewage Special Revenue Fund – Based on the data in pages 6 and 37, Peacham’s recommendation is not only unsound; it is probably illegal. The Sewage Fund service charge is based on a legal agreement that mandates that the funds be used only for sanitary sewer purposes. Hence, the fund balance is categorized as Restricted. Further, there is a comment on page 6 to the effect that required improvements to the sewage system are so great that the existing sewer fee will need to be raised in the future.