Chapter 7
Accounting for Business-Type Activities of State and Local Governments

Dr. Chula King
The University of West Florida

Student Learning Outcomes

- Distinguish between the purposes of internal service funds and enterprise funds.
- Describe the characteristics of proprietary funds.
- Explain the financial reporting requirements, including the differences between reporting of enterprise funds and internal service funds in the government-wide and fund financial statements.

Student Learning Outcomes

- Explain the characteristics, accounting procedures, and termination of internal service funds.
- Prepare journal entries and describe financial reporting requirements for an internal service fund.
- Describe the characteristics and specialized accounting procedures for enterprise funds.
- Prepare journal entries and financial statements for an enterprise fund.
Proprietary Funds

- Reasons for use
  - To compare benefits and costs of the business-type activities of a government
  - Enhances management of activities in which goods or services are provided on a cost-reimbursement basis to departments of the same government or to the general public on a user charge basis

Accounting Characteristics

- Full Accrual basis
- Capital assets and long-term liabilities accounted for within the funds
- Flexible rather than fixed budgets recommended; generally budgetary accounts need not be integrated into the general ledger
- Depreciation expense and accumulated depreciation are recorded and reported
- For accounting guidance look to accounting procedures used by private enterprises of the similar type

Required Financial Statements

- Similar to those for a for-profit entity:
  - Statement of Net Assets (or Balance Sheet)
  - Statement of Revenues, Expenses, and Changes in Net Assets
  - Statement of Cash Flows
Accounting Equation

\[ \text{Assets} - \text{Liabilities} = \text{Net Assets} \]

- Unrestricted
- Restricted (e.g., for payment of debt service)
- Invested in Capital Assets, Net of Related Debt

Internal Service Funds

When and Why
- authorized by legislative approval
- to account for activities in which goods and services are provided to departments of the same government on a cost reimbursement basis

Reasons for use
- Improve management of common resources by placing them under centralized management and control

Common Types of Internal Service Funds

- Motor pools
- Central purchasing
- Storage
- Issuance of supplies
- Self-insurance pools
- Central data processing
- Printing
Pricing Policies for Internal Service Funds

- Pricing is set by local management or by legislative policy.
- Pricing objectives vary; can cover full costs (direct and indirect), direct costs only, or whatever management desires.
- Legislative bodies are sometimes reluctant to establish ISFs because they do not wish to let purchasing occur outside the budget.

Internal Service Funds

Q: Is legislative loss of pricing control a real concern?
A: Even if an ISF is created for central purchasing and sales of supplies, the legislative body still maintains budgetary control over the expenditures made by most departments and programs via the General Fund and special revenues funds budgets.

Illustration 7-1

[Diagram showing the flow of appropriations and expenditures between Legislative Body, General and other budgetary funds, Departments/programs, Internal Expenditures, Proprietary funds, and External Expenditures to Employees, External Suppliers, Contractors, etc.]
Generally should use the same accounting procedures that a similar for-profit entity would use. (Review illustrative transactions for a supply fund on pp. 233-242 and compare to business accounting)

Billings to Departments is the revenue account that is similar to Sales of a for-profit entity.

Revenues and expenses are closed at year-end to Excess of Net Billings to Departments over Costs (or Excess of Costs over Net Billings to Departments) rather than to Income Summary.

Other than the slight difference in terminology, the financial statements are essentially the same as those of a comparable for-profit entity.

- Statement of Net Assets (see Ill. 7-2)
- Statement of Revenues, Expenses, and Changes in Net Assets (see Ill. 7-3)
- Statement of Cash Flows (see Ill. 7-4)—prepared in conformity with GASB standards rather than FASB standards.

Similarities between GASB and FASB standards:
- Cash Flows Statement shows cash inflows/outflows relating to operating, financing, and investing activities
- Both sets of standards define cash flows as cash and cash equivalents (i.e., time deposits, marketable securities, and other items readily convertible to cash)
Differences between GASB and FASB standards:
- GASB cash flow statement divides financing activities into noncapital and capital and related financing activities.
- Acquisition of capital assets is a capital and related financing transaction in the GASB Cash Flows Statement rather than an investing activity.
- Interest expense on long-term debt is a capital and related financing activity in the GASB cash flow statement rather than an operating activity.
- Cash flows from operating activities must be shown using the direct method (GASB 34).

Terminating an Internal Service Fund
- Transfer ISF's assets to another fund which will continue same activity.
- Terminate activity and distribute assets in-kind to another fund or funds.
- Convert ISF's assets to cash and distribute cash to another fund or funds.

Enterprise Funds
- Reasons for use:
  - account for services provided to the general public on a user charge basis, or
  - where the governing body has determined 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.
### Common Types of Enterprise Funds
- Water and sewer
- Gas and electric utilities
- Transportation systems
- Airports
- Ports
- Toll roads and bridges
- Parking garages and lots
- Golf courses
- Hospitals
- Liquor stores.

### Accounting for Enterprise Funds
- GASB 34 provides guidance on business-type activities.
- GASB standards also require that proprietary funds:
  - Follow pronouncements of the FASB and its predecessors issued before November 30, 1989, unless they conflict with a GASB standard.
  - Additionally, they may opt to follow all FASB and predecessor standards that pertain to businesses, both those issued before and after November 30, 1989, unless they conflict with a GASB standard.
- Note that GASB standards always take priority.

### Enterprise Funds-Restricted Assets
- Assets whose use is restricted by contractual agreements or legal requirements.
- Typical examples:
  - Customer deposits of utilities, assets set aside for repayment of revenue bond principal, reserves for maintenance of plant, and funding of depreciation.
- Ideally, liabilities to be paid from restricted assets should be reported separately from liabilities to be paid from unrestricted assets, but not required by GAAP.
- Net Assets - Restricted should be reported in the Equity section of the Statement of Net Assets.
Enterprise Funds-Restricted Assets

\[
\begin{align*}
\text{Restricted Assets} & = \text{Liabilities Payable from Restricted Assets} + \text{Net Assets, Restricted for payment of debt service} \\
& = 562,600 + 23,700 + 538,900
\end{align*}
\]

Enterprise Funds Utility Plant Construction in Progress

Q: Should interest incurred on debt during construction be capitalized?
A: Yes, see discussion on pp. 248-249 of text

Q: Should an imputed amount equivalent to interest be capitalized if a utility’s own funds are used for construction?

A: Capitalizing an “equity” component of Allowance for Funds Used During Construction (AFUDC) is permitted both by utility regulators and the FASB
Enterprise Funds – Special Current Liabilities

- In addition to the usual Accounts Payable and Accrued Expenses, use two special current liability accounts:
  - Customers Advances for Construction
    - Usually up-front deposits required to be made by builders to provide all or part of the cost of connecting new structures to utility lines. May or may not be refunded in part upon completion.
  - Customer Deposits
    - Usually reported under the caption “Liabilities Payable from Restricted Assets”
    - Even if not refundable until service is terminated, AICPA guidance defines this as a current liability.

Enterprise Funds – Long-term Liabilities

- Bonds or other debt that will be repaid from proprietary fund resources is reported as long-term debt of the fund.
- Bonds whose interest and principal are to be repaid from the revenues of a proprietary fund are called “revenue bonds”
- If bonds primarily or secondarily have general obligation backing, but are being serviced by a proprietary fund, they are treated as revenue bonds. The general obligation contingency is disclosed in the notes to the financial statements.

Illustrative Transactions

- As indicated previously, there are many types of enterprise funds, thus accounting procedures will vary greatly.
- Illustrative transactions and related financial statements for a Water Utility Fund are illustrated on pp. 250-259
  - Uses same account titles recommended by the utility regulatory body
  - Accounting is essentially business accounting. Note, however, the capitalization of AFUDC (Entry 8) and entries to restricted assets (Entries 10, 11, 12, and 17).
In a few states, municipally-owned utilities are subject to rate regulation by a state regulatory agency, which also regulates investor-owned utilities that operate in the state. Those states may require government owned utilities to follow the regulatory accounting principles specified by organizations such as NARUC and FERC. If so, financial statements may appear quite different from those shown in Ill. 7-6 through 7-8.

Financial statement differences
- Plant assets and long-term liabilities are often reported above current assets and current liabilities, respectively.
- Plant assets may be reported at depreciated original cost. Subsequent transfers of ownership require new owners to report assets at depreciated original cost; any excess of purchase price above the net book value of the assets on the old owner's books is reported as "Utility Plant Acquisition Adjustment" in the new owner’s accounts. Regulators may require this account to be amortized at a different rate than used for depreciation.

Q: Why are plant assets and long-term debt reported above current assets and current liabilities under RAP?
A: This is because in regulated utilities, the magnitude of plant assets and long-term debt is great in relation to current assets and liabilities. Current assets and liabilities tend to be comparatively immaterial.
Key RAP definitions:

- **Original cost**: The (depreciated) cost to the first owner to place the utility plant into public use.
- **Utility Plant Acquisition Adjustment**: The difference between the purchase price of a utility plant less the net original cost of the plant on the seller’s books.

An EPA rule requires all municipal landfills to meet stringent location, design, and operating requirements to minimize the potential for environmental damage.

Operators must also provide financial assurance they can properly close landfills when full and provide post-closure groundwater monitoring for 30 years after closure.

These stringent rules are designed to protect the environment from irresponsible handling of hazardous materials.

Estimate the current cost of hiring a qualified third-party to close the MSWLF and care for it for 30 years after closure.

Recognize a portion of this cost proportionate to the ratio of estimated capacity utilized during a year over the total capacity of the landfill as an expense of the enterprise fund and as a liability.

Annual adjustments are made as estimates change from year to year. Several required note disclosures are described at the end of CH 7.
Enterprise Funds – Segment Information

- When there are multiple enterprise funds, summary operating data, including extent of intra-governmental subsidies, should be disclosed in the notes for “major non-homogeneous enterprise funds.”
- Page 262 for required disclosure.

Concluding Comments

- Proprietary funds (internal service and enterprise) are used to account for the business-type activities of a government.
- Accrual accounting is used for proprietary funds and the required financial statements are the same as those for a for-profit entity, except that GASB standards must be used where they apply.
- ISF are reported as governmental activities on the government-wide statements.
- Regulatory accounting terminology and principles are used by some government owned utilities.

The Next Step

- Chapter 7 City of Smithville simulation. Due no later than midnight CDT, June 26.
- Chapter 7 CAFR assignment. Due no later than midnight, CDT, June 26.
- Problems 7-2, 7-5, and 7-7.