# APPENDIX B
# PRINCIPLES OF ACCOUNTING

This chapter presents a detailed discussion of generally accepted accounting principles under the revised uniform system of accounting in Massachusetts. As has been noted in previous chapters, GAAP in municipal government accounting is principally encompassed by the body of principles promulgated by the National Council on Governmental Accounting in its publication, *Governmental Accounting, Auditing and Financial Reporting.* As a result, substantially all of the material presented in this chapter was extracted from that publication with the express permission of the Municipal Finance Officers Association. The most important differences between GAAP and the revised uniform system in Massachusetts have already been presented in Chapter 2. This chapter has been included to give the reader a more in-depth understanding of the 12 basic accounting principles. Where certain principles applied only in part to the revised Massachusetts system, the discussion presented in the NCGA publication has been eliminated or revised as considered appropriate.

## Generally Accepted Accounting Principles and Legal Compliance

### *Principle #1 - Accounting and Reporting*

The accounting system must make it possible to:

- Present fairly and with full disclosure the financial position and results of financial operations of the government unit in conformity with generally accepted accounting principles
- Determine and demonstrate compliance with finance-related legal and contractual provisions

**Generally Accepted Accounting Principles.** Generally accepted accounting principles (GAAP) are uniform minimum standards of and guidelines to financial accounting and reporting. Adherence to GAAP assures that financial reports of all state and local governments -regardless of jurisdictional legal provisions and customs - contain the same types of financial statements and disclosures, for the same categories and types of funds and account groups, based on the same measurement and classification criteria.

Adherence to GAAP is essential to ensuring a reasonable degree of comparability among the financial reports of local governmental units in Massachusetts. Governmental accounting systems thus must provide data that permits reporting on the financial status and operations of each unit in conformity with GAAP.

An important aspect of GAAP as interpreted for Massachusetts is the recognition of the variety of legal and contractual considerations typical of the government environment. These considerations underlie and are reflected in the fund structure, basis of accounting, and other principles and methods set forth here, and are a major factor distinguishing governmental accounting from commercial accounting. Governmental accounting systems designed in conformity with these principles can readily satisfy most management control and accountability information needs with respect to both GAAP and legal compliance reporting.

**Compliance with Legal Provisions.** Government financial operations evolve from and are regulated by various kinds of legal provisions. For example, various statutes spell out in detail such things as tax limits, methods of collection, discounts, and delinquency dates. The annual operating budget is one of the most important of all legal documents governing financial transactions. The expenditure requests in the budget become binding appropriations, which may not legally be exceeded.

An important function of governmental accounting systems is to enable administrators to ensure, and report upon, compliance with finance-related local provisions. This means that the accounting system - its terminology, fund structure, and procedures - must take cognizance of and be adapted to satisfy finance-related legal requirements.

**Conflicts Between Legal Provisions and GAAP.** Legal provisions may conflict with GAAP. Where such conflicts do occur, it is essential that the basic financial statements be prepared in conformity with GAAP, nonetheless. Additional schedules and narrative explanations should be provided as needed to support legal requirements. Conflicts between legal provisions and GAAP should not require maintaining two accounting systems. Rather, the accounting system may be maintained on a legal compliance basis, but should include sufficient additional records to permit GAAP-based reporting.

# Fund Accounting

## *Principle #2 - Fund Accounting Systems*

The accounting systems must be organized and operated on a fund basis. A fund is 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.

The diverse nature of governmental operations and the necessity of assuring legal compliance preclude recording and summarizing all governmental financial transactions and balances in a single accounting entity. Unlike a private business, which is accounted for as a single entity, a governmental unit is accounted for through several separate fund and account group entities, each accounting for designated assets, liabilities, and equity or other balances. Thus, from an accounting and financial management viewpoint, a governmental unit is a combination of several distinctly different fiscal and accounting entities, each having a separate set of accounts and functioning independently of other funds and account groups.

**Separate Fund Records Required.** Each fund must be accounted for in a separate self-balancing set of accounts for its assets, liabilities, equity, revenues, expenditures or expenses (as appropriate) and transfers. This requirement of a complete set of accounts for each fund refers to identification of accounts in the accounting records, and does not necessarily extend to physical segregation of assets or liabilities. For example, it is not always necessary to have a separate bank account for each fund. Likewise, governmental units utilizing system computerization and account coding techniques may treat these separate accounting entities as independent subcomponents of a unified government accounting system.

**Interfund Receivables and Payables.** Each fund of a governmental unit may have financial transactions and debtor-creditor relationships with other funds of the governmental unit. Interfund receivables and payables may result from services rendered by a department financed from one fund to a department financed from another fund, or from interfund loans. Since each fund is a fiscal and accounting entity, the amounts due to one fund from other funds, as well as the amounts owed to other funds, should be reflected in the fund accounts and in fund financial statements.

## *Principle #3 - Types of Funds*

There are three major categories of funds - governmental, proprietary, and fiduciary.

Governmental funds under the revised system will include:

**The General Fund** - to account for all financial resources except those required to be accounted for in another fund.

**Special Revenue Funds** - to account for the proceeds of specific revenue sources (other than special assessments, expendable trusts, or major capital projects) that are legally restricted to expenditure for specified purposes.

**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, special assessment funds, and trust funds).

**Special Assessment Funds** - to account for the financing of public improvements or services deemed to benefit the properties against which special assessments are levied.

Proprietary funds include:

**Enterprise Funds** - to account for operations:

- 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

- 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.

Fiduciary funds include:

**Trust and Agency Funds**

- To account for assets held by the governmental unit in a trustee capacity or as an agent for individuals, private organizations, other governmental units, and/or other funds. These include:

    - Expendable Trust Funds
    - Nonexpendable Trust Funds
    - Agency Funds

**Governmental Funds** - often called "source and disposition," "expendable," or "government-type" funds are those through which most governmental functions typically are financed. The acquisition, use, and balances of the government's expendable financial resources and the related current liabilities (except those accounted for in proprietary funds) are accounted for through governmental funds.

Governmental funds are, in essence, accounting segregations of financial resources. Expendable assets are assigned to the various governmental funds according to the purposes for which they may or must be used; current liabilities are assigned to the fund from which they are to be paid; and the difference between governmental fund assets and liabilities, the fund equity, is referred to as "Fund Balance."

The governmental fund measurement focus is upon determination of financial position and changes in financial position (sources, uses, and balances of financial resources), rather than upon net income determination. The statement of revenues, expenditures, and changes in fund balance is the primary governmental fund operating statement. It may be supported or supplemented by more detailed schedules of revenues, expenditures, transfers, and other changes in fund balance.

**Proprietary Funds** - sometimes referred to as 'income-determination," "nonexpendable," or "commercial-type" funds - are used to account for a government's ongoing organizations and activities which are similar to those often found in the private sector. All assets, liabilities, equities, revenues, expenses, and transfers relating to the government's business and quasi-business activities (where net income and capital maintenance are measured) are accounted for through proprietary funds. The generally accepted accounting principles here are those applicable to similar businesses in the private sector; and the measurement focus is upon determination of net income, financial position, and changes in financial position.

**Fiduciary Funds** - the Trust and Agency Funds - are used to account for assets held by a governmental unit in a trustee capacity or as an agent for individuals, private organizations, other governmental units, and/or other funds. Each trust fund is classified for accounting measurement purposes as either a governmental fund or a proprietary fund. Expendable Trust Funds are accounted for in essentially the same manner as governmental funds. Nonexpendable Trust Funds are accounted for in essentially the same manner as proprietary funds. Agency Funds are purely custodial (assets equal liabilities) and thus do not involve measurement of results of operations.

## *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, since unnecessary funds result in inflexibility, undue complexity, and inefficient financial administration.

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, a local unit which does not finance improvements or services by special assessments obviously does not need Special Assessment Funds.

The general rule is to establish the minimum number of separate funds consistent with legal specifications, operational requirements, the requirements of the Massachusetts system and the principles of fund classification discussed above. Using too many funds inflexibility and undue complexity in budgeting, accounting, and other phases of financial management, and is best avoided in the interests of efficient and economical financial administration.

## *Principle #5 - Accounting for Fixed Assets and Long-term Liabilities*

A clear distinction should be made between (a) fund fixed assets and general fixed assets and. (b) fund long-term liabilities and general long-term debt.

- Fixed assets related to specific proprietary funds or Trust Funds should be accounted for through those funds. All other fixed assets of a governmental unit should, where recorded, be accounted for through a General Fixed Assets Account Group.
- Long-term liabilities of proprietary funds, Special Assessment Funds, and Trust Funds should be accounted for through those funds. All other unmatured general long-term liabilities of the governmental unit should be accounted for through the General Long-term Debt Account Group.

Although the present Massachusetts system does not require accounting for fixed assets, some municipalities have in fact maintained fixed asset records. This generally occurred for those municipal enterprise activities where rate setting regulations required the calculation of the total cost of services, (i.e., electric, gas, hospital enterprises). In order to promote compliance with GAAP without causing operational difficulties for the municipalities, Massachusetts GAAP addresses fixed asset accounting on a fund-by-fund basis as described below.

The revised accounting system will phase in fixed asset accounting in enterprise funds. Thus, additions to the fixed assets of an enterprise activity after the date of implementation of the system will be capitalized and accounted for as a fixed asset. For capital assets acquired prior to the date of implementation, municipalities are encouraged to implement GAAP accounting as soon as it can reasonably be accomplished.

There will be no specific fixed asset accounting requirements for the other funds. Municipalities may, however, where records are available, choose to establish a fixed asset group. The revised system does require that suitable memoranda records be maintained for future capital additions in order to facilitate the ultimate implementation of GAAP requirements for general fixed assets, should that requirement be considered necessary at some time in the future.

Because of the distinctive nature of governmental financial operations and fund accounting requirements, some fixed assets and long-term liabilities are accounted for in fund accounts while others are accounted for through account groups.

**Fund Fixed Assets.** Fixed assets utilized in proprietary fund activities or in Trust Funds are accounted for in the appropriate fund.

Enterprise Fund fixed assets are capitalized in the fund accounts because the fixed assets are used in the production of the goods or services provided or sold. Depreciation of these fixed assets must be recorded to determine total expenses, net income, and changes in fund equity. Moreover, Enterprise Fund fixed assets may serve as security for debt issued to establish, acquire, or improve a public enterprise.

Fixed assets associated with Trust Funds are accounted for through those funds. For example, the principal of a nonexpendable trust may include fixed assets. In such cases, the fixed assets should be accounted for in the appropriate Nonexpendable Trust Fund. This assists in assuring compliance with terms of the trust instrument, provides a deterrent to mismanagement of trust assets, and facilitates accounting for depreciation where the trust principal must be maintained intact.

**General Fixed Assets.** Fixed assets other than those accounted for in the proprietary funds or Trust Funds are general fixed assets. General fixed assets would be accounted for in the General Fixed Assets Account Group rather than in the governmental funds. Although, as has been pointed out previously, the revised accounting system does not require that the general fixed assets of a government be accounted for in accordance with GAAP, such accounting is encouraged. The information presented below in regard to the general fixed assets account group is included for informational purposes only.

General fixed assets do not represent financial resources available for expenditure, but are items for which financial resources have been used and for which accountability should be maintained. They are not assets of any fund but of the governmental unit as an instrumentality. Their inclusion in the financial statements of a governmental fund would increase the fund balance, which could mislead users of the fund balance sheet. The primary purposes for a governmental fund accounting are to reflect its revenues and expenditures - the sources and uses of its financial resources - and its assets, related liabilities, and net financial resources available for subsequent appropriation and expenditure. These objectives can most readily be achieved by excluding general fixed assets from the governmental fund accounts and recording them in a separate General Fixed Assets Account Group.

It should be emphasized that the General Fixed Assets Account Group is an "account group" rather than a "fund." In essence, the General Fixed Assets Account Group is a management control and accountability listing of a government's general fixed assets those not employed in commercial-type activities or held in trust balanced by accounts showing the sources by which such assets were financed.

**Fund Long-term Liabilities.** Bonds, notes, and other long-term liabilities directly related to and expected to be paid from proprietary funds, Special Assessment Funds, and Trust Funds should be included in the accounts of such funds. These are specific fund liabilities, even though the full faith and credit of the governmental unit may be pledged as further assurance that the liabilities will be paid. Also, such liabilities may constitute a mortgage or lien on specific fund properties or receivables.

**General Long-term Debt.** All other unmatured long-term indebtedness of the government is general long-term debt and should be accounted for in the General Long-term Debt Account Group. General long-term debt is the unmatured principal of bonds, warrants, notes, or other forms of non-current or long-term general obligation indebtedness that is not a specific liability of any proprietary fund, Special Assessment Fund, or Trust Fund. General long-term debt is not limited to liabilities arising from debt issuances per se, but may also include other commitments that are not current liabilities properly recorded in governmental funds. Material vested amounts of employee benefits (such as vacation and sick leave) arising from activities financed through governmental funds should be disclosed in the notes to the financial statements if the total amount exceeds a normal year' s accumulation and is not presented in the financial statements.

The general long-term debt of a local government is secured by the general credit and revenue-raising powers of the government rather than by the assets acquired or specific fund resources. Further, just as general fixed assets do not represent financial resources available for appropriation and expenditure, the unmatured principal of general long-term debt does not require current appropriation and expenditure of governmental fund financial resources. To include it as a governmental fund liability would be misleading and dysfunctional to the current period management control (e.g., budgeting) and accountability functions.

Contingent liabilities not requiring accrual should be disclosed in the notes to the financial statements. This includes situations where the governmental unit is contingently liable for proprietary fund, special assessment fund, or trust fund indebtedness. In the event that fund liabilities for which the unit is contingently liable are in default - or where for other reasons it appears probable that they will not be paid on a timely basis from the resources of these funds and default is imminent - these liabilities should be reported separately from other liabilities in the fund balance sheet. All significant facts with respect to the situation should be disclosed.

## *Principle #6 - Valuation of Fixed Assets*

Fixed assets should be accounted for at cost or, if the cost is not practicably determinable, at estimated cost. Donated fixed assets should be recorded at their estimated fair value at the time received.

**Cost.** Fixed assets should be recorded at cost, consideration given or received, whichever is more objectively determinable. The cost of a fixed asset includes not only its purchase price or construction cost, but also ancillary charges necessary to place the asset in its intended location and condition for use. Ancillary charges include costs such as freight and transportation charges, site preparation expenditures, professional fees, and legal claims directly attributable to asset acquisition. The accounting policy with respect to capitalization of interest costs incurred during construction should be disclosed and consistently applied.

**Estimated Cost.** Initial costs of fixed assets usually are normally ascertainable from contracts, purchase vouchers, and other transaction documents at the time of acquisition or construction. When such records are not available, or an inordinate expenditure of resources would be required to establish original asset costs accurately, it is acceptable to estimate the original cost of such assets on the basis of such documentary evidence as may be available, including price levels at the time of acquisition, and to record these estimated costs in the appropriate fixed asset accounts. This practice introduces some margin of error into the fixed asset accounts as compared with proper recording at time of acquisition. However, such errors will have only short-run significance because, as older assets are retired and replaced, estimated costs are replaced by properly recorded actual cost amounts. The extent to which fixed asset costs have been estimated, and the methods of estimation, should be disclosed in the notes to the financial statements.

**Acquisition by Gift.** Governments may acquire properties by gift. Donated fixed assets should be recorded in the fund to which they relate or in the General Fixed Assets Account Group, as appropriate, at their estimated fair value at time of acquisition.

## *Principle #7 - Depreciation of Fixed Assets*

Depreciation of general fixed assets should not be recorded in the accounts of governmental funds. Depreciation of general fixed assets may be recorded in cost finding analyses; and accumulated depreciation may be recorded in the General Fixed Assets Account Group.

Depreciation of fixed assets accounted for in a proprietary fund should be recorded in the accounts of that fund. Depreciation is also recognized in those Trust Funds where expenses, net income, and/or capital maintenance are measured.

Depreciation is an element of expense resulting from the use of long-lived assets. It is conventionally measured by allocating the expected net cost of using the asset (original cost less estimated salvage value) over its estimated useful life in a systematic and rational manner.

Depreciation accounting is an important element of the income determination process. Accordingly, it is recognized in the proprietary funds and in those Trust Funds where expenses, net income, and/or capital maintenance are measured.

Expenditures, not expenses, are measured in governmental fund accounting. To record depreciation expense in governmental funds would inappropriately mix two fundamentally different measurements, expenses and expenditures. General fixed assets acquisitions require the use of governmental fund financial resources and are recorded as expenditures. General fixed asset sale proceeds provide governmental fund financial resources. Depreciation expense is neither a source nor a use of governmental fund financial resources, and thus is not properly recorded in the accounts of such funds.

The recommendation that depreciation not be recorded in the governmental fund accounts neither denies its existence nor precludes calculating depreciation to determine total and/or unit costs (expenses) of all or certain governmental activities and/or programs. The Department of Revenue encourages use of cost accounting systems or cost-finding analyses for such activities (e.g., vehicle operation, garbage collection, and data processing services) either routinely, in the process of "make or buy" or "do or contract for" decision analyses, or for such purposes as determining reimbursable costs under grant provisions, establishing fee schedules, or analyzing activity or program cost. Maintaining governmental fund and account group records in the manner recommended facilitates such calculations.

# Basis of Accounting

### *Principle #8 - Accrual Basis in Governmental Accounting*

The modified accrual or accrual basis of accounting, as appropriate, should be utilized in measuring financial position and operating results. Under the revised system, the books of account will be maintained during the fiscal year essentially on a cash basis. At the end of the fiscal year, adjustments will be made to convert the accounting for the particular funds to the appropriate basis, as follows:

- Governmental fund revenues and expenditures should be recognized on the modified accrual basis.
  - 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 debt and on special assessment indebtedness secured by interest-bearing special assessment levies, which should be recognized when due.
- Proprietary fund revenues and expenses should be recognized on the accrual basis.
  - Revenues should be recognized in the accounting period in which they are earned and become measurable.
  - Expenses should be recognized in the period incurred, if measurable.
- Fiduciary fund revenues and expenses or expenditures (as appropriate) should be recognized on the basis consistent with the fund's accounting measurement objective.

- Nonexpendable trust and pension trust funds should be accounted for on the accrual basis.

- Expendable trust funds should be accounted for on the mo,&ifieO eccrual basis.

- Agency funds assets and liabilities should be accounted for on the modified accrual basis.

• Transfers should be recognized in the accounting period in which the interfund receivable and payable arise.

"Basis of accounting" refers to when revenues, expenditures, expenses, and transfers - and the related assets and liabilities - are recognized in the accounts and reported in the financial statements. Specifically, it relates to the timing of the measurements made, regardless of the nature of the measurement, on either the cash or the accrual method. For example, whether depreciation is recognized depends on whether expenses or expenditures are being measured rather than on whether the cash or accrual basis is used.

Under the cash basis of accounting, revenues and transfers in are not recorded in the accounts until cash is received, and expenditures or expenses (as appropriate) and transfers out are recorded only when cash is disbursed. Under the accrual basis of accounting, most transactions are recorded when they occur, regardless of when cash is received or disbursed. Items not practicably measurable until cash is received or disbursed are accounted for at that time in both commercial and governmental accounting, as may be items whose measurement would be approximately the same under either basis or those which are immaterial.

The accrual basis is the superior method of accounting for the economic resources of any organization. It results in accounting measurements based on the substance of transactions and events, rather than merely when cash is received or disbursed, and thus enhances their relevance, neutrality, timeliness, completeness, and comparability. Accordingly, the accrual basis should be used to the fullest extent practicable. However, there are certain differences in the environment and in the accounting measurement objectives of governmental fund accounting as opposed to proprietary fund or commercial accounting. Some modifications and adaptations are necessary to implement accrual accounting appropriately. Therefore, the procedures outlined below should be referred to as the "modified accrual basis."

**Revenue Recognition.** Revenues and other governmental fund financial resource increments (e.g., bond issue proceeds) are recognized in the accounting period in which they become susceptible to accrual; that is, when they become both measurable and available to finance expenditures of the fiscal period. "Available" means collectible within the current period or soon enough thereafter to be used to pay liabilities of the current period. Application of the "susceptibility to accrual" criteria requires judgment, consideration of the materiality of the item in question, and due regard for the practicality of accrual, as well as consistency in application. Since all revenues, other than real estate and personal property taxes, will be accounted for on the cash basis during the fiscal year, it will be necessary to make year-end adjustments to recognize income on a modified accrual basis.

The guidelines for recording revenues on a modified accrual basis in the governmental funds follows:

- Where a revenue is measurable, it should be recorded as an account receivable. Where the amount of a revenue is not measurable, it should not be recorded.

- Where a revenue is measurable, but is not available in accordance with the guidelines described below, it should be recorded as a deferred revenue and not transferred to revenue until the period in which it does become available.

- Where a revenue is both measurable and available, it should be recorded as a revenue of the period. Thus, for the major revenue sources, any receivable amounts outstanding at the end of the year will be taken into revenue in accordance with the following guidelines:

  - <u>Motor vehicle excise receivables</u> - amounts received during the first 15 days of the following fiscal year

  - <u>Departmental receivables</u> - amounts received during the first 15 days of the following fiscal year

  - <u>State and federal receivables</u> - entire amount

  - <u>Accrued interest receivable</u> - entire amount

**Expenditure Recognition.** As noted earlier, the measurement focus of governmental fund accounting is upon expenditures (decreases in net financial resources) rather than expenses. Most expenditures and transfers out are measurable and should be recorded when the related liability is incurred.

The major exception to the general rule of expenditure accrual relates to unmatured principal and interest on general obligation long-term debt. Financial resources usually are appropriated in the period in which maturing debt principal and interest must be paid. Thus, disclosure of subsequent year debt service requirements is appropriate, but they usually are appropriately accounted for as expenditures in the year of payment.

**Accrual Basis in Proprietary Funds.** Revenues earned and expenses incurred are recognized in a government's proprietary funds in essentially the same manner as in commercial accounting. Only minor adaptations are involved in applying the revenue realization and expense recognition principles in the government environment.

**Transfers.** Transfers of financial resources **among funds** should be recognized in all funds affected in the period in which the interfund receivable(s) and payables arise. Transfers are discussed further below.

# The Budget and Budgetary Accounting

### *Principle #9 - Budgeting, Budgetary Control, and Budgetary Reporting*

An annual budget(s) should be adopted by every governmental unit.

The accounting system should provide the basis for appropriate budgetary control.

Budgetary comparisons should be included in the appropriate financial statements and schedules for governmental funds for which an annual budget has been adopted.

Budgeting is an essential element of the financial planning, control, and evaluation processes of governments. Every governmental unit should prepare a comprehensive budget covering all governmental, proprietary, and fiduciary funds for each annual fiscal period.

Ideally, the basis upon which the budget is prepared should be consistent with the basis of accounting utilized, and thus will differ as between proprietary (accrual) and governmental (modified accrual) funds.

**Integration with Accounting.** The extent to which budgetary accounts should be integrated in the formal accounting system varies among governmental fund types and according to the nature of fund transactions. Integration is essential in General, Special Revenue, and other annually budgeted governmental funds which have numerous types of revenues, expenditures, and transfers. Judgment should be used in other circumstances. For example, full or partial budgetary account integration would be essential where numerous construction projects are being financed through a Capital Projects or Special Assessment Fund or where such projects are being constructed by the government's labor force. On the other hand, where such funds are used to finance one or a few "turnkey" projects adequately controlled by contracts with independent contractors, formal budgetary account integration might not serve a useful purpose.

**Encumbrances.** Encumbrances - commitments related to unperformed (executory) contracts for goods or services - should be recorded for budgetary control purposes. Encumbrances outstanding at year end should not be reported as expenditures. The method by which encumbrances are accounted for and reported should be consistently applied and should be disclosed in the Summary of Significant Accounting Policies.

# Classification and Terminology

### *Principle #10 - Transfer, Revenue, Expenditure, and Expense Account Classification*

Interfund transfers and proceeds of general long-term debt issues should be classified separately from fund revenues and expenditures or expenses.

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.

Proprietary fund revenues and expenses should be classified in essentially the same manner as those of similar business organizations, functions, or activities.

**Interfund Transactions.** Certain interfund and similar transactions constitute fund revenues, expenditures, or expenses in a strict fund accounting context, but are not revenues, expenditures, or expenses of the governmental unit. This often proves confusing to statement users and complicates the preparation of aggregate data for the government, its functions (or programs) or activities, or its organizational components. The interfund transaction classification principles set forth here provide guidance to proper recording of interfund and similar transactions.

The following types of interfund transactions do not constitute transfers, but are appropriately accounted for as fund revenues, expenditures or expenses (as appropriate), or adjustments thereto:

**Quasi-external Transactions.**

Transactions that would be treated as revenues, expenditures, or expenses if they involved organizations external to the governmental unit (e.g., payments in lieu of taxes from an Enterprise Fund to the General Fund; Internal Service Fund billings to departments; routine employer contributions from the General Fund to a Pension Trust Fund; and routine service charges for inspection, engineering, utilities, or similar services provided by a department financed from another fund) should be accounted for as revenues, expenditures, or expenses in the funds involved.

**Reimbursements**.

Transactions which constitute reimbursements of a fund for expenditures or expenses initially made from it which are properly applicable to another fund (e.g., an expenditure properly chargeable to a Special Revenue Fund was initially made from the General Fund, which is subsequently reimbursed) should be recorded as expenditures or expenses (as appropriate) in the reimbursing fund and as reductions of the expenditure or expense in the fund that is reimbursed.

All interfund transactions (except loans or advances, quasi-external transactions, and reimbursements) are transfers. The two major categories of interfund transfers are:

**Residual Equity Transfers.**

Nonrecurring or non-routine transfers of equity between funds (e.g., contribution of Enterprise Fund or Internal Service Fund capital by the General Fund, subsequent return of all or part of such contribution to the General Fund, and transfers of residual balances of discontinued funds to the General Fund or a Debt Service Fund).

**Operating Transfers.**

All. other interfund transfers (e.g., legally authorized transfers from a fund receiving revenue to the fund through which the resources are to be expended, transfers from the General Fund to a Special Revenue or Capital Projects Fund, operating subsidy transfers from the General or a Special Revenue Fund to an Enterprise Fund, and transfers from an Enterprise Fund other than payments in lieu of taxes to finance General Fund expenditures).

Interfund transactions not covered explicitly above should be reflected according to their substance and with due regard for adequate disclosure.

Interfund transfers should be distinguished from revenues, expenses, or expenditures in financial statements. Residual equity transfers should be reported as additions to or deductions from the beginning fund balance of governmental funds. Residual equity transfers to proprietary funds should be reported as additions to contributed capital; those from proprietary funds should be reported as reductions of retained earnings or contributed capital, as appropriate in the circumstances. Operating transfers should be reported in the "Other Financing Sources (Uses)" section in the statement of revenues, expenditures, and changes in fund balance (governmental funds) and in the "Operating Transfers" section in the statement of revenues, expenses, and changes in retained earnings (proprietary funds). Operating transfers thus affect the results of operations in both governmental and proprietary funds.

**Long and Short-term Debt Issue Proceeds.** Short-term and long-term liabilities of proprietary funds and Trust Funds are recorded as fund liabilities. in addition, long-term liabilities incurred by the Special Assessment Fund are recorded as fund liabilities. All other long-term liabilities are recorded in the General Long-term Debt Account Group.

Proceeds of long-term debt issues not recorded as fund liabilities (e.g., proceeds of bonds or notes expended through Capital Projects) normally should be reflected as "Other Financing Sources" in the. operating statement of the recipient fund. In addition, the proceeds of short-term indebtedness issued in anticipation of a bond issue or grant reimbursement in the Special Assessment Fund, the Highway Improvements Fund, or the Capital Projects Fund will also be reflected as "Other Financing Source." Such proceeds should be reported in captions such as "Bond Issue Proceeds," "Proceeds of Short-term Notes," or "Proceeds of Long-term Notes."

**Account Classification.** This topic is covered in Part II, Chart of Accounts, and so will not be discussed here. The treatment of account classifications separately from the other accounting principles should not, however, be taken to mean that it is any less an integral part of the principles.

## *Principle #11 - 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.

The budget, the accounts, and the financial reports are inseparable elements in the financial administration process. Terminology and classification consistency among them is essential to achieving viable accounting systems and comparable, unambiguous financial reporting.

**Governmental Funds and Account Groups.** The budget determines the nature and scope of most governmental fund financial operations by setting the amounts and sources of estimated revenues and transfers in, on one hand, and the amounts and purposes of authorized expenditures and transfers out, on the other. The accounts of several types of governmental funds record, in summary and detail, both the planned revenues, expenditures, and transfers and the actual transactions. In the absence of significant conflicts between legal provisions and generally accepted accounting principles, the financial statements summarize the results of financial operations and financial position as reflected in the accounts. Where legal provisions conflict with GAAP, legal-basis data typically are reflected in the accounts and are used as the starting point for deriving statements prepared in conformity with GAAP.

Effective management control and accountability for governmental funds can best be achieved by utilizing a common language and uniform classification system in financial planning, management, and reporting. The terminology and classifications discussed above provide such a common language. To the maximum extent practicable, they should be used in all phases of budgeting, accounting, and reporting.

**Proprietary Funds.** The terminology and classifications of the budgets prepared to assist in planning and evaluating activities of proprietary funds should be consistent with those used in interim and annual financial reports. Further, as noted earlier, the accounts and financial reports of proprietary funds should be maintained and prepared in essentially the same manner as those of similar business enterprises, especially where similar activities or functions are carried on in both the public and private sectors.

# Financial Reporting

## *Principle #12 - Interim and Annual Financial Reports*

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.

A comprehensive annual financial report covering all funds and account groups (including appropriate combined, combining, and individual fund statements; notes to the financial statements; schedules, narrative explanations; and statistical tables) should be prepared and published.

General purpose financial statements 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 (and changes in financial position of proprietary funds and similar trust funds).

**Reporting Terminology.** Generally speaking, financial reporting includes three types of data presentation:

**Financial Statements**

Derived from the accounting and related records and are generally summarized by major classifications (e.g., expenditures by function or program). Interim financial statements cover periods of less than one year (e.g., a month or quarter) and traditionally have been prepared primarily for internal use. Annual financial statements are prepared for each fiscal year to serve information needs of both internal and external users.

**Schedules**

Set forth financial statement data in greater detail. Schedules are also used to present data on a legally or contractually prescribed basis different from GAAP, and to present other data that management wants to include that is not required by GAAP. Schedules are considered "supplemental" unless referenced in the financial statements or the notes to the financial statements.

**Statistical Tables**

Present comparative data for several periods of time (often ten years or more) or contain data from sources other than the accounting records. Examples of such non-accounting information are assessed valuations and tax rates, economic and population data, and the legal debt margin.

**Interim Financial Reports.** Interim financial reports are comprised principally of statements that reflect current financial position at the end of a month or quarter and compare actual financial results with budgetary estimates and limitations. Interim reports typically are prepared primarily for internal use. Thus, they often do not include statements reporting general long-term debt. Further, they may properly contain budgetary or cash flow projections and other information deemed pertinent to effective management control during the year.

The key criteria by which internal interim reports are evaluated are their relevance and usefulness for purposes of management control. This includes planning future operations as well as evaluating current financial status and results to date. Although management styles and perceived information needs vary widely, the title of sample interim reports has nonetheless been provided in Section III for use as a guideline. Whether these or others are used, local management should continually evaluate their interim reports to ensure that this information properly serves management's needs.

**Annual Financial Reports.** It is recommended that every governmental unit prepare and publish, as a matter of public record, a comprehensive annual financial report (CAFR) that encompasses all funds and account groups. The CAFR should contain both:

- General Purpose Financial Statements (GPFS) by fund type and account group

- Combined statements by fund type and individual fund statements.

The CAFR is the governmental unit's official annual report and should also contain introductory information, schedules necessary to demonstrate compliance with finance-related legal and contractual provisions, and statistical data.

The CAFR should also include notes to the financial statements that are essential to fair presentation, including disclosures of material violations of finance-related legal and contractual provisions and other important matters that are not apparent from the face of the financial statements.

**Statutory Reporting.** The accounting system must also support the information requirements of those State and federal agencies which have administrative or statutory authority to request accounting information. The procedures documented in this manual have been designed to support such reporting requirements.