CHAPTER 2
SUMMARY OF ACCOUNTING PRINCIPLES

This chapter provides a conceptual framework for understanding the accounting principles which have been utilized or adopted in the revised accounting system. A more in depth discussion of accounting principles is presented in Appendix B. Although all key concepts are covered here, users are cautioned not to make operational or procedural decisions without first consulting the detail material in the remainder of this manual.

Introduction

As discussed in Chapter 1, a principal objective of the modifications to UMAS was to bring the system more in tune with generally accepted accounting principles (GAAP) applicable to governmental accounting. These principles have recently been refined and revised by the National Council on Governmental Accounting in its publication:

"Governmental Accounting, Auditing and Financial Reporting" (GAAFR) issued in November 1980

There are several-special conditions which preclude the immediate implementation of full GAAP in Massachusetts at this time, thus:

- The State has never required accounting for fixed assets.
- Pension costs are funded at the present time on a pay-as-you-go basis.
- Wholesale adoption of GAAP in the accounting records should be integrated with revisions in both the budgetary and tax setting process, not only at the municipal level, but at the State level as well.

The design of the improved UMAS has, therefore, adopted as much of the GAAP *accounting principles* as was considered reasonable at this time given the present constraints. Among the principles which have been incorporated into the revised system are:

- Use of a multi-fund accounting system
- Use of enterprise funds to account for those activities which are intended to be self-supporting
- Implementation of fixed asset accounting in enterprise funds
- Procedures to facilitate the preparation of GAAP financial statements

The principal areas where the revised system still differs from GAAP are in the requirements for fixed asset accounting, other than that related to enterprise funds and in the accounting for pension costs.

The paragraphs below set forth the 12 basic accounting principles applicable to municipal accounting presented in the GAAFR and highlight some of the similarities and differences between these principles and those which have been adopted in the revised system for Massachusetts. The twelve principles have been grouped into seven general categories, as follows:

1. Generally accepted accounting principles and legal compliance
2. Fund accounting
3. Fixed assets and long-term liabilities
4. Basis of accounting
5. Budget and budgetary accounting
6. Classification and terminology
7. Financial reporting

CATEGORY 1 - 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.

UMAS: The revised accounting system has been modified to accommodate most of the requirements of GAAP as defined by GAAFR. It will permit statutory reporting directly from the books of account, while at the same time facilitate the preparation of financial statements in accordance with GAAP. The principal areas where the revised system still differs from GAAP are in the accounting for fixed assets as discussed in conjunction with Principle #5 below and in the accounting for pension costs.

CATEGORY 2 - 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.

UMAS: The revised accounting system mandates the use of fund accounting.

Principle #3 - Types of Funds

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

Governmental funds 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 for 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).

Debt Service Funds - to account for the accumulation of resources for, and the payment of, general long-term debt, principal and interest.

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 appropriated ' for capital maintenance, public policy, management control, accountability, or other purposes.

Internal Service Funds - to account for the financing of goods or services provided by one department or agency to other departments or agencies of the governmental unit, or to other governmental units, on a cost-reimbursement basis.

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 a) expendable trust funds, b) nonexpendable trust funds, c) pension trust funds, and d) agency funds.

UMAS: The revised accounting system incorporates the following funds:

- General Fund
- Special Revenue Funds
- Capital Projects Funds
- Special Assessment Funds
- Enterprise Funds
- Trust and Agency Funds

The other funds recommended by GAAFR will not be mandated for implementation at this time in Massachusetts. These include:

Debt Service Funds - debt service (principal and interest) is appropriated and paid annually by Massachusetts governmental units and is not accumulated over time. Debt service funds are more appropriately used for sinking funds, which have been prohibited from use in Massachusetts since 1913 (Sec 47, Ch 44, MGL). Amounts appropriated for debt service will, therefore, be accounted for directly in the General Fund for debt carried in the long-term debt account group, or in Special Assessment or Enterprise Funds for debt related to those funds.

Internal Service Funds - at the present time, very few Massachusetts municipalities have organized central service types of departments and, as a result, this type of fund would not ordinarily be necessary; accordingly it is not required.

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.

UMAS: The revised system utilizes those funds considered necessary to comply with the law and the tenets of sound administration.

CATEGORY 3 - Fixed Assets and Long-Term Liabilities

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 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.

UMAS: 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, as in electric, gas, and hospital enterprises. In order to promote compliance with GAAP without causing operational difficulties for the municipalities, the revised accounting system 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. 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 ate encouraged to implement GAAP accounting as soon as it can reasonably be accomplished. The accounting for fixed assets is discussed in Chapter 18.

There will be no specific fixed asset accounting requirements for the other funds. Municipalities may choose to establish a fixed asset group, however, where records are available. 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.

Long-term liabilities related to special assessment, proprietary and trust funds will be accounted for in those funds. All other general long-term liabilities of the municipality should be accounted for in the General Long-term Debt Account Group.

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.

UMAS: Where municipalities do maintain fixed assets records, the fixed assets will be valued as described above in Principle 6.

Principle #7 - Depreciation of Fixed Assets

a. 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 accounting systems or calculated for cost finding analyses; and accumulated depreciation may be recorded in the General Fixed Assets Account Group.

b. 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.

UMAS - Under the revised system, the only specific fixed asset accounting requirements relate to enterprise activities. Accordingly, the depreciation of fixed assets accounted for in an enterprise fund will be recorded in the accounts of that fund. Should a municipality establish a fixed asset group of accounts, as referred to above, and should depreciation be calculated on those assets, such amounts would be accounted for in the fixed asset group of accounts.

CATEGORY 4 - 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 to the maximum extent possible. The preferred basis of accounting is 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 modified accrual basis.

  - Agency fund 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.

UMAS – Basis of Accounting

The basis of accounting used in an accounting system deter mines when revenues, expenditures, expenses, transfers, and the related assets and liabilities are recognized in the accounts and reported in the financial statements. Historically, Massachusetts municipalities have used the "cash basis" under which accounting transactions are recorded and reported only when cash changes hands. There were, however, two significant exceptions. The first related to revenues from real estate and personal property taxes, which were recorded on an accrual basis, and the second to expenditures made against current appropriations by a municipality during the period after year-end, July 1-15, which were required to be re ported with expenditures as of June 30 (Sec 56 and 56A, Ch 44, MGL). While simplifying the bookkeeping, cash basis accounting has the potential to distort a municipality's financial reports. In order to address this issue, the revised system makes an important distinction between when transactions are "recognized in the ac counts" and when they are "reported in the financial statements."

Transactions will be recorded in the accounts on essentially the same basis as that utilized currently.

At the year-end, appropriate adjustments will be made to the accounts of each fund to convert the accounting for the fund to the correct basis and permit year-end reporting in Accordance with GAAP.

The paragraphs below provide a summary of the basis of accounting which will be utilized by each fund under the revised system.

Governmental Funds

- Recording transactions:
  - Revenue - real estate and personal property taxes will continue to be recorded on an accrual basis. During the year other revenue will be recorded on a cash basis.

  - Expenses/Expenditures - amounts disbursed for expenditures will, in most municipalities, be recorded on a cash basis. Where a municipality has the capacity to identify that a liability has been incurred (e.g., through an encumbrance or vouchering system), expenses will be recorded on an accrual basis. All municipalities will be encouraged to develop such systems.

- Reporting transactions:
  - Revenue - year-end adjustments will be made to convert the accounting for revenue accounts to a modified accrual basis.

  - Expenses/Expenditures - where a municipality has recorded expenses/expenditures on a cash basis during the year, year-end adjustments will be made to convert the accounting for expenses/expenditures to an accrual basis.

Proprietary Funds

- Recording transactions:
  - Revenue - amounts billed to customers for services will be recorded when billed and fully reserved. Such amounts will be recorded as revenue when received.

  - Expenses/Expenditures - same as governmental funds.

- Reporting transactions:
  - Revenue - year-end adjustments will be made to convert the accounting for appropriate revenues to an accrual basis.

  - Expenses/Expenditures - same as governmental funds.

Fiduciary Funds

- Recording transactions:

  - Revenue - will be recorded on a cash basis.

  - Expenses/Expenditures - will be recorded on a Cash basis.

- Reporting transactions:

  - Revenue - year-end adjustments will be made to convert the *accounting for* appropriate revenue accounts to a modified accrual basis for Expendable Trust Funds and Agency Funds, and to a full accrual basis for Nonexpendable Trust Funds.

  - Expenses/Expenditures - year-end adjustments will be made to convert the accounting for expenses/expenditures to the accrual basis.

Under the revised system, amounts paid by the treasurer on previous year's bills during the period July 1-15 will be required to be classified as warrants payable as of June 30 in the fund to which the expenditures pertain.

Revenue Accounting Principles

The process of converting the accounting for revenue in the governmental funds to a modified accrual basis at the end of the year necessarily involves the interpretation of the terms "reasonable" and "available." (See Appendix B.) The term "available" is one which can be subject to many different interpretations, such as likely to be received within 60 days, or within one year. The revised system adopts a conservative interpretation of the "available" criteria. The guidelines for recording revenues on a modified accrual basis in the governmental funds follow:

- 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:

  - motor vehicle excise receivables - amounts received during the first 15 days of the following fiscal year.
  - departmental receivables - amounts received during the first 15 days of the following fiscal year.

  - state and federal receivables - entire amount.

  - accrued interest receivable - entire amount.

CATEGORY 5 - The Budget and Budgetary Accounting

Principle #9 - Budgeting, Budgetary_Control, and Budgetary Reporting

a. An annual budget should be adopted by every governmental unit.

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

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

UMAS: The revised system, like the current system, has been designed to provide full compliance with this principle:

Municipalities will be required to adopt an annual budget, as in the past, in accordance with applicable State law (Sec 59, Ch 41, MGL; Sec 32-34, Ch 44, MGL; Ch 580, Acts of 1980 and local levy limits).

UMAS will enhance budgetary control through more extensive use of funds.

Budgetary comparisons will be included in the financial statements and reports.

Additionally, the new system will provide strong budgetary control over revenues, as well as expenses.

CATEGORY 6 - Classification and Terminology

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

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

b. 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.

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

UMAS: The revised system provides support for this principle by incorporating several significant changes in the method of classifying certain interfund transactions. So-called "quasi-external" transactions (See Appendix C) will be accounted for as fund revenue or expenditures. Loans, advances, and reimbursements will be accounted for separately, while all other interfund transactions will be accounted for as operating transfers with specific reporting requirements.

The chart of accounts described in this manual has been designed to meet the special needs of Massachusetts municipalities while at the same time complying with Principle #10. The structure of the chart is sufficiently flexible to meet the most demanding requirements of the larger municipalities without overtaxing the capacity of the smaller ones.

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.

UMAS: The revised system utilizes a terminology and classification that is consistent with that utilized outside of Massachusetts. The prior system included many terms unique to Massachusetts for accounts widely used elsewhere. For the most part, these terms have been changed to their more commonly used equivalent; for example:

Prior name	**New name** (Reference to chart of accounts)
Overlay Reserve (and overlay deficit)	Provision for Abatements and Exemption (Account 1230)
Tax Title	Tax Liens (Account 1240
Tax Possessions	Tax Foreclosures (Account 1750)
Estimated Receipts (as a budget account)	Estimated Revenue (Account 1910)
Estimated Receipts (as an actual revenue account)	Revenue (Account 1920)
Appropriation (as a budget account)	Appropriation (Account 2910)
Appropriation (as an expenditure account)	Expenditures (Account 2920)
Excess and Deficiency	Unreserved Fund Balance (Account 3151)
Revenue (as a budgetary control)	Budgetary Control (Account 3199)
Revenue (as a reserve)	"Reserve for uncollected" accounts (i.e., Account 1310)

Where unique terminology was the result of legal requirements of the Commonwealth, the existing terminology has been maintained as in the case of "Revolving Funds."

CATEGORY 7 - Financial Reporting

Principle #12 - Interim and Annual Financial Reports

a. 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.

b. 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.

c. 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).

UMAS: The revised system incorporates all of the reporting standards encompassed by Principle #12. Statutory reporting requirements have been simplified and designed to be taken directly from the accounting records after final adjustment. Minimum levels of detailed information have been established for reporting purposes, to permit comparisons between municipalities, both inside the Commonwealth and outside. Information included in the statutory reports will be input to the Municipal Data Bank, discussed in Chapter 10.

Each municipality will be encouraged to prepare a comprehensive annual financial report (CAFR) at the close of the fiscal year. The general purpose financial statements, which are an integral part of the CAFR, will be "liftable" and may be used by municipalities in connection with bond issues and other purposes.

Other Unique Aspects of UMAS

Memoranda Journal Entries - The revised system permits the use of memoranda journal entries in order to facilitate the control over projects accounted for in the special assessment fund, the capital project fund and in the highway improvement special revenue fund. Memoranda entries may be prepared to record the following:

Authorized Project Costs - If used, a memorandum entry will be made in the fund involved to record the total authorized cost of the project. At the end of the fiscal year, or more frequently if appropriate an adjusting entry will be made to reverse out of the authorization accounts the total amount expended on the project during the year. When the project is completed, any balance re*maining in* the account will be reversed.

State and Federal Grants Recorded - If used, a memorandum entry will be made in the fund involved to record the total amount of grants awarded in connection with the project. At the end of the fiscal year, or more frequently if appropriate, an adjusting entry will be made to reverse out of the award authorization accounts the total amount billed under the grants during the year.

Bonds Authorized - If used, a memorandum entry will be made to record authorized long-term debt. Debt authorized for special assessment fund and enterprise fund projects will be recorded in those funds. All other long-term debt authorizations will be accounted for in the long-term debt group of accounts. At the end of the fiscal year, or more frequently if appropriate, an adjusting entry will be made to reverse out of the authorization account the total long-term debt issued during the year.

Although the use of memoranda accounts and journal entries is not mandatory under the revised system, their use is encouraged. Where such accounts are used, they would be included in internal trial balances prepared by a municipality. Balances pertaining to memoranda entries would not, however, be included in the external financial statements.