# CHAPTER 3
# ACCOUNTING BASICS

This chapter provides a brief review of fundamental accounting procedures and accounting system requirements. Accountants, auditors, and other municipal financial officers who desire a fuller discussion should consult one or more of the references listed at the end of this chapter.

## The Accounting Process

The flowchart on page 3-4 illustrates the basic accounting process. The steps depicted there are described below.

1. Recognize that a transaction has occurred
   Usually this step is self-evident; however, the responsible financial official must be alert to subtle changes in accounts. For example, the accrual of interest on savings accounts must be recorded.

2. Prepare adequate source documents
   Accounting trails" (documentation of a transaction from its inception through completion, including means for reporting of the transaction in the financial statement) must be provided. original source documents are important objective evidence that each transaction has occurred. They are of equal importance in a computerized accounting system. Typical source documents include receiving reports, cancelled checks, vendor invoices, time cards, and correspondence of all types.

3. Validate the transaction
   Verification that the transaction was appropriately recorded from the source document is a basic audit function for the financial official.

4. Record the transaction and file the source document
   The transaction should be entered in the appropriate journal (or "book of original entry"). Generally, transactions are recorded chronologically, listing their debit and credit entries simultaneously. In more sophisticated accounting systems, there may be several journals to post (or equivalent computerized files posted) before the source document is properly filed to provide an accounting trail.

5. Post the general and subsidiary ledgers
   The posting process transfers data from journals into the ledgers. In the general ledger, transactions are classified according to accounts. The "cash" account, for example, summarizes

   all changes in cash. In order to limit the number of accounts in a general ledger, it is sometimes simpler to maintain a "control account" only, in which case a subsidiary ledger would be prepared in order to permit the classification and accumulation of more detailed information. The revenue control account is an example of a general ledger account for which there would be a supporting subsidiary ledger. "Personal property taxes" would be a particular revenue source which would be separately accounted for in the revenue subsidiary ledger. Ledgers are the final place where transactions are recorded.

6. Prepare a general ledger trial balance
   This step ensures that the total of the debit balances in the ,ledger equals the total of the credit balances. The formal preparation of a general ledger trial balance is done by listing each account on a work paper and entering the balance of the account in the debit or credit column as appropriate. When each account has been recorded, the total of the debits should be equal to the total of the credits. If this is not the case, the accounts are "out of balance" and it will be necessary to investigate and identify the source of the misposting. Normally, a formal trial balance is prepared on a monthly basis for each fund which has had transactions recorded in it during that month.

   The preparation of a formal trial balance at the close of each month prior to the preparation of financial reports should be required of the accounting department. Thus, before current appropriation balances are reported to various department heads or other financial information is disseminated, a trial balance should be taken to provide assurance that figures are accurate.

7. Close books monthly and annually
   After all of the transactions for a period have been recorded, it will be necessary to record period-end adjustments before financial reports are prepared. The financial official identifies necessary adjustments by reviewing records and supporting documents. Unpaid vendor invoices, or the accrual of interest income, are examples of possible adjustments. Since adjustments invariably occur, recording them before preparing a financial statement is similar to Step 1 above. If these adjustments are not recorded, the reporting will be incorrect.

8. Prepare timely financial reports
   The objective of the accounting process is to produce a single set of related reports to accurately summarize the financial position and operations of the local government unit. If this is not done promptly, the usefulness of the reports is lessened.

## "THE ACCOUNTING PROCESS"

**STEP 1**

RECOGNIZE THAT A TRANSACTION HAS OCCURRED

**STEP 2**

PREPARE A SOURCE DOCUMENT, RECEIPT, VOUCHER MEMORANDUM, ETC.

**STEP 3**

VALIDATE THE TRANSACTION

**STEP 4**

RECORD THE TRANSACTION to FILE

**STEP 5**

POST TO THE GENERAL AND SUBSIDIARY LEDGERS (if used0

POST TRANSACTION TO THE APPROPRIATE UBSIDIARY LEDGER

**STEP 6**

PREPARE TRIAL BALANCE OF GENERAL AND SUBSIDIARY LEDGERS (IF USED)

**STEP 7**

CLOSE BOOKS MONTHLY AND ANNUALLY

**STEP 8**

PREPARE FINANCIAL REPORTS

Daily or Weekly Cycle

## Accounting System Records

This section describes the components of a "model" financial accounting system recommended for normal financial management needs. Theoretically, only a general journal is needed to record all financial transactions. In reality, special journals and subsidiary ledgers are needed to reflect the growing complexity of local finances and show increasingly detailed, useful levels of information.

Every accounting system has limitations and each unit of local government must-therefore adopt a system which best meets ' its own needs and capabilities. The paragraphs below describe the most commonly used accounting records. The chart on the following page illustrates how the various records interrelate.

### *General Journal*

The General Journal is the primary medium used for all original entries. It indicates the amounts to be debited or credited to the various accounts. This journal is often used to summarize transactions from other specialized journals. The following accounting entries are examples of those normally made in the general journal:

- Opening the books and setting up the beginning trial balance
- Recording the annual budget
- Recording adjusting entries or corrections
- Recording transfers between accounts or between funds
- Recording closing entries at year-end

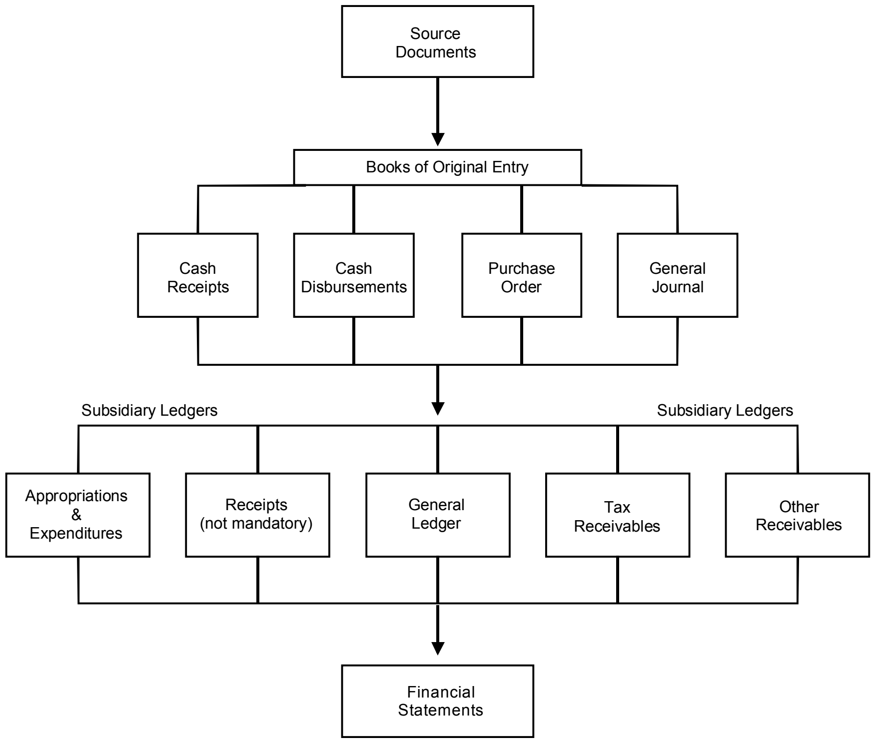
### *Cash Receipts Journal*

The Cash Receipts Journal is used to record all cash received. For each cash receipt, a properly authorized written receipt should be provided to the individual making the payment by the employee who accepts the cash.

### *Cash Disbursements Journal*

The Cash Disbursements Journal is used to record all cash disbursed for such purposes as acquisition of an asset, liquidation of a liability, refund of previously collected revenues, retirement of debt, and expenditures in the current year. All cash disbursements should be made by issuing properly approved warrants drawn on specific funds.

**Overview of Accounting System**



## *General Ledger*

The general ledger is the major component Of most accounting systems. It permits recording transactions on a double-entry basis, either in detail or at a summary level. This record is generally supplemented with journals and subsidiary ledgers; however, the final record of assets, liabilities, revenues, and expenditures will be found in the general ledger.

Separate general ledgers are maintained for each fund. General ledger accounts often include control accounts with related subsidiary ledgers available for recording the individual detail transactions. For this reason, the general ledger control accounts must also be balanced to the totals of the various subsidiary accounts at month end.

A general ledger trial balance should be prepared for each fund after monthly postings are completed and before financial statements are prepared. A trial balance is a list of all the balances in the ledger accounts at the end of an accounting period. It is a check on the mathematical accuracy of the ledger balances. Since the debit and credit double entry accounting structure requires balancing debits and credits for each transaction, the sum of all debit balances must equal the sum of all credit balances.

Just as separate general ledgers should be maintained for each fund, separate trial balances should be completed at the end of each accounting period for each general ledger. A trial balance does not indicate the accuracy of the postings, only that account totals are in balance; therefore, periodic testing and verification routines should be performed.

## *Purchase Order Register*

A purchase order register may also be referred to as an "encumbrance journal" and is generally used by all municipalities employing a purchase order system as a part of their purchasing procedures. A purchase order is written evidence of an order placed with vendors or contractors by the local unit. The submission of a properly authorized and approved purchase order gives the vendor authority to ship the required goods and binds the unit for payment upon compliance with its terms.

The purchase order register has two functions. First, it is a register in which purchase orders issued are recorded and monitored. Second, it serves as an encumbrance journal which allows setting aside (encumbering) certain resources to cover the impending future obligation to the vendor created by the purchase order. The usefulness and importance of the first function is fairly evident. However, the second function can be of even greater importance in controlling expenditures and preventing over-expenditure of appropriations, particularly at year-end.

## *Revenue Ledger*

The Revenue Ledger is a subsidiary ledger in which estimated and actual revenue are recorded and monitored in detail. The ledger is used to make the following entries:

- Estimated revenue
- Actual revenue received during the month, by type
- Actual revenue received year-to-date, by type

- The remaining unreceived balance for each type of revenue

A separate ledger sheet should be maintained for each revenue source, except where transactions against that account are so few that a separate sheet is inappropriate.

### *Expenditure Ledger*

The Expenditure Ledger may also be called the "Appropriation Ledger." In either case, this is a subsidiary ledger in which appropriations, encumbrances and expenditures are recorded and monitored. The ledger is used to make the following entries:

- Appropriations
- Encumbrances on the appropriations
- Actual expenditures
- The balance of the appropriation available

A separate ledger sheet should be maintained for each type of expenditure detailed in the appropriation-expenditure ledger.

## Additional Support Requirements

To be effective, an accounting system must have more than just a defined process and a collection of journals and ledgers. The most important of these additional support requirements are described below.

### *Personnel*

The "best" accounting system is unlikely to remain so indefinitely without competent professionals to work with it. As important as it may be that technically qualified personnel be hired to work in the accounting and finance function, it certainly is of equal importance that a strong program of continuing education be encouraged. Programs offered by employee associations and other professional groups are among the best guarantees that personnel will remain qualified.

### *Appropriate Authorizations*

Accounting systems should provide authorization by more than one local official. Transactions can be better verified when accountability is shared and a series of authorizations are made, depending upon the significance of the transaction. Systems should also provide for adequate documentation of the required authorizations.

### *Sufficient Documentation*

Adequate records and documents to support the accounting treatment for a particular transaction are important. Documentation must be valid and relevant. If authorization and record keeping systems are adequate, they help to ensure that sufficient documentation is available.

### *Internal Control*

The accounting process must have adequate systems for efficient physical control and processing of assets, maintenance of accurate records, and data files. Internal control ensures safeguarding of assets and reduces the problems associated with error detection, fraud, or embezzlement. In many municipalities, nonsupervisory employees involved with these duties are controlled by the nature of their duties and work flow. In general, proper control exists if one employee's work is "automatically verified" by another employee in the normal course of work and without duplicating efforts. For example, an adequate bank reconciliation procedure can also disclose problems with vouchers payable or payroll routines, early or late payments, missing signatures, voided checks, or skips in a prenumbered series.

A sound system of internal control will assure that there is proper:

- Record keeping
- Physical custody of assets and data files
- Authority to use assets and create liabilities

The purpose of this manual is not to prescribe a system of internal control, but to identify the internal control concepts and encourage the installation of practical controls.

### *Consistency*

For comparability, usefulness, and meaningful evaluation, accounting information must be recorded and reported on a consistent basis. The accounting principles used as the basis for recording transactions should be used consistently from one year to the next. Should a municipality find it necessary to change a particular accounting principle, proper disclosure of the change should be made in its external financial reports for the year of the change in accordance with applicable professional literature.

### *Defined Accounting Periods*

Local governments are intended to operate indefinitely. Organizational progress cannot be accurately determined until the continuum of activities is artificially subdivided and measured at desired intervals. This will generally be a municipality's fiscal year, but may for particular purposes be either a shorter or longer period.

## Bookkeeping

This section provides a very rudimentary overview of bookkeeping procedures through a discussion of the way accounts are increased or decreased with debits and credits. Although the discussion here is fairly simple, the concepts form the foundation of modern double entry accounting and should be understood by all accounting officials in every local unit of government.

## *Accounts Classifications*

To aid in record keeping and effective presentation of financial information, general ledger accounts are classified into groups:

- Balance Sheet Accounts - assets, liabilities and fund equity
- Budgetary Accounts - revenues and expenditures

In governmental accounting, budgetary accounts are kept in the same accounting records as asset, liability, and fund equity accounts. They are used to record fund operations only for a single accounting period (generally one year) and are closed at the end of the period.

## *Key Definitions.*

**Revenues** represent increases in assets owned by the local unit, 'and an increase in the fund balance. Cash receipts may or may not constitute revenue. For example, a tax collection for taxes owed is a revenue, but proceeds from a tax anticipation note payable is only a receipt, not a revenue, since a corresponding liability is created with the bank. Likewise, the proceeds of a sale of an investment are not revenue since one asset (cash) is increased while another asset (investment) is reduced.

**Expenditures** are incurred to pay for operations, maintenance or matured debt of any given fund. Expenditures result in a decrease in assets and a decrease in the fund balance. On an accrual basis, an expenditure, rather than decreasing an asset (cash), may increase a liability (accounts payable).

## *The Accounting_Equation*

All activities of the local unit which affect the amount of or relationship between the assets, liabilities, and fund equity can be reduced to entries in its financial records (purchases, tax collections, borrowing, investments, and others). Each transaction will have a ' <u>dual effect</u> on the municipal records but will not change the fundamental accounting equation:

ASSETS = LIABILITIES + FUND EQUITY

The purchase of a capital asset only changes the type of asset. Thus, one asset is increased while another is decreased. Tax collections, on the other hand, affect the balance sheet accounts and the revenue accounts; a new asset is received (a balance sheet account) and revenue is also received (a revenue account). Tax collections thus increase municipal assets and fund equity equally.

The fundamental accounting equation can now be expanded to illustrate how every possible transaction that affects a fund can be recorded:

ASSETS = LIABILITIES + FUND EQUITY + REVENUES - EXPENDITURES

To use this model and track the dual effect of each transaction, the amount of each type of asset, liability and fund equity (increases and decreases) must be systematically recorded. This is done by using the Uniform Chart of Accounts and a standardized, controlled recording method. This can be illustrated by using separate "T" accounts, and conventional "debits" and "credits" (debits and credits are often abbreviated as "dr" and "cr").

### *"T" Accounts*

A "T" account is the format used to segregate increases and decreases in each account balance, as follows:

**Real Estate Taxes (Account Title)**

| Debit (DR) | Credit (CR) |
|---|---|

Each transaction is expressed in terms of its debit or credit effect on a given account. if an amount is entered on the left side of the "T," the account is "debited"; if entered on the right, the account is "credited." The effect of each entry (or transaction) is expressed in terms of debits or credits (not left and right or increases and decreases in the account). The "account balance" is the difference between the total debits and total credits.

### *Balance Sheet Account*

If the accounting equation is overlayed with the "T" account structure, the assets will appear on the left (debit) side and the liabilities and fund equity are recorded on the right (credit) side.

To maintain balance in the accounting equation, decreases in assets are recorded on the right or credit side, and decreases in liabilities and fund equity are recorded on the left or debit side. Asset accounts typically have a debit balance; and liability accounts and fund equity typically have a credit balance. The accounting equation always remains in balance and debits always equal credits.

### *Revenue and Expenditure Accounts*

The concept and reasoning behind increasing assets with debits, and increasing liabilities and fund equity with credits, is fairly straightforward. Sometimes confusion exists concerning why expenditures are increased by debits and revenue accounts are increased by credits. There is sound reasoning for this, too.

The fund balance is on the right side of the accounting equation and it normally has a credit balance. Increases to the fund balance (via credits) or decreases (via debits) are seldom made directly. They are usually recorded in other accounts which describe the nature of the transaction.

The fund balance is determined as follows:

Opening credit balance in the Fund Balance Account

| | |
|---|---|
| + Revenue Accounts | (credit balances increasing equity) |
| - Expenditures | (debit balances decreasing equity) |
| Ending Fund Balance | (equity) |

To summarize, the five basic classifications of accounts are affected by debits and credits as follows:

| Account Classification | Effect of | |
|---|---|---|
| | **Debits** | **Credits** |
| Assets | + | - |
| Liabilities | - | + |
| Fund Equity | - | + |
| Revenue | - | + |
| Expenditures | + | - |

These relationships are critical to an understanding of double-entry accounting.

## *Sample Transactions*

The initial step in recording a given transaction is to identify its dual effect. The following are samples of how individual transactions would be analyzed for recording in the individual accounts of a municipality's General Fund.

1. Joe Smith pays $10 for a license

**Cash**

| Debit | Credit |
|---|---|
| $10 | |

**Revenue - License**

| Debit | Credit |
|---|---|
| | $10 |

**Explanation:** A receipt of cash in payment of a license means revenue for the municipality. Accordingly, the accounts reflect the increase in the amount of the asset "Cash" and an equal increase in license revenues received. There is a debit and a credit; therefore, the accounting equation remains in balance.

2. The municipality buys supplies for $25 and pays cash

**Supplies**

| Debit | Credit |
|---|---|
| $25 | |

**Cash**

| Debit | Credit |
|---|---|
| | $25 |

**Explanation:** The purchase of supplies is an expenditure which also reduces the assets of the municipality by an equal amount.

3. The municipality invests $5,000 in marketable securities

| Investments | |
|---|---|
| Debit | Credit |
| $5000 | |

| Cash | |
|---|---|
| Debit | Credit |
| | $5000 |

**Explanation:** Investments change an asset (cash) into another kind of asset (investments).

### *Basis of Accounting*

The sample transactions illustrated above represent "cash basis" accounting, recording expenditures when cash is actually paid out or recognizing revenue when it is received.

The cash basis is a simple method. This does not imply, however, that the cash basis is an entirely satisfactory approach. A major problem with it is that it ignores the existence of other resources which are available or being used by the municipality, which should be accounted for in order to more accurately present the true picture of the municipality's financial position.

To illustrate the differences, assume the municipality has just received an invoice in the amount of $500 for architectural services it has purchased. The invoice states that payment is due in 30 days. Using the cash basis, the transaction will not be recorded in the accounting records until the date the invoice is actually paid, up to 30 days. Consequently, any financial reports issued by the municipality prior to the payment would not reflect that $500 of services were performed, nor would they show the $500 claim against the municipality for payment. Thus, cash basis accounting does present certain problems. For this reason, the accrual and modified accrual approaches are the methods on which financial reports should be prepared and on which they will be prepared under the revised system.

Under a strict accrual basis, all transactions are recorded in the accounting records when they arise, rather than when cash is paid or received. Therefore, in the example above, the purchase of services and the obligation created would have been recorded as soon as the actual transaction took place. That is, the expenditure would have been recognized when the services were invoiced and have been established to indicate that there was a $500 obligation due.

## Additional Source Material

Accountants or other municipal officials who desire a fuller discussion of the concepts addressed in this chapter will find that there are many worthwhile texts on the subject. Among those which may be referred to are the following:


- Governmental Accounting, Auditing, and Financial Reporting, November 1980, Municipal Finance officers' Association of United States and Canada

- Fund Accounting Theory and Practice, Edward S. Lynn and Robert J. Freeman, 1974, Prentice-Hall, Inc.

- Your Massachusetts Government, Elwyn E. Mariner, 1973, Mariner Books

- Federal Grants-In-Aid Accounting and Auditing Practice, Cornelius E. Tierney, 1977, American Institute of Certified Public Accountants