

# **UNDERSTANDING GOVERNMENTAL ACCOUNTING**

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# UNDERSTANDING GOVERNMENTAL ACCOUNTING

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There are two primary reports issued by cities: Annual Audits, which are called **COMPREHENSIVE ANNUAL FINANCIAL REPORTS (CAFR)**, and Annual Budgets, which are usually called **ANNUAL OPERATING BUDGET**. The annual audit is a report on last year, prepared by an auditing firm. The annual budget is a report on next year, prepared by the director of finance. One is telling what has happened and the other is telling what someone thinks will happen next year. This is a very important distinction.

There are three types of statements presented in the reports: Balance Sheets, Income Statements, and Cash-Flow Statements. A balance sheet is a "snap-shot" taken at the close of business on the last day of the fiscal year that shows what the city owns and what the city owes, with the difference being the fund balance or equity. An income statement lists total income for the year and subtracts the expenses for the year, with the difference being operating surplus. A cash-flow statement is an income statement based solely on cash transactions. An income statement will show a purchase as expense when the purchase is actually made, while a cash-flow statement will show a purchase as an expense when the bill is actually paid. The difference between an income statement and a cash-flow statement is only a matter of timing.

## GENERAL FUND

The **GENERAL FUND** is the main operating fund of the city. The money in this fund normally can be used for any legal purpose. For most cities there are very few things that the General Fund cannot spend its money on.

One complicating factor in municipal accounting is the two different presentations used for the governmental funds – **GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)** and budgetary method. The GAAP rules apply to all local, county and state governments. Budgetary method rules vary from state to state and city to city and do not always include all items of revenues and expenditures. The budgetary statements only serve one purpose – to show compliance with the state's budgetary statutes. The budgetary statements are not always a reliable report of what actually occurred. Therefore, the budgetary presentation will only be used when discussing the budgets. The GAAP presentation will be used for all other purposes.

The most important number for the General Fund is the "**CHANGE IN FUND BALANCE**" or profit (loss). Naturally, a profit is good and a loss would be considered as bad. One year, by itself, is not adequate to make a judgment as to the real earnings of the General Fund. Both the GAAP and budgetary presentations are on a cash basis. This can cause year-to-year distortions. To understand the net income number, we need to examine its components. There are two primary sources of revenue for the General Fund – revenues and transfers in. There are two primary types of expenses – expenditures and transfers out. The things to examine are the year-to-year changes. What we would like to see is a steady growth in both revenue and expenditures, with each growing at about the same percentage. Transfers are not as important as revenues and expenditures, because they tend to be discretionary.

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## GOVERNMENTAL FUNDS

The General Fund and the next four groups of funds are called the “**GOVERNMENTAL FUNDS**”. These other funds are essentially extensions of the General Fund, because they are used to finance the same services and agencies found in the General Fund. The discussions involving those funds will be covered under the heading of “Governmental Funds”. That analysis will cover all governmental funds, including the General Fund. The governmental funds in their entirety can be considered the “**SUPER GENERAL FUND**”. When all of the governmental funds are combined into one presentation, all transactions that attempt to make the General Fund look poorly are no longer relevant.

Governmental Funds are primarily supported by tax revenues, fines, federal and state grants, and general obligation bond proceeds. There is usually little relationship between the revenues and expenditures. For example, when a person pays a sales tax, he has no direct influence on how it will be used. Governmental Funds include the General Fund, plus the following groups of funds:

**SPECIAL REVENUE FUNDS** receive money restricted by law, or contract, for specific purposes. The names of these funds are usually self-explanatory. One of the most common funds in this group is a motor fuel tax fund. Most states share their motor fuel tax with cities. The use of the tax is usually restricted to streets and highways. Typically, the state will require that the money be accounted for in a Special Revenue Fund. Another common Special Revenue fund is one that receives a sales or income tax that is earmarked by the electorate for a specific purpose. It is common to find a fund reported as a Special Revenue Fund that is not really restricted and could actually be used for General Fund purposes.

Most Special Revenue Funds are not really needed, because there are more eligible expenditures in other funds that would more than deplete these funds. For example, cities that receive motor fuel tax spend more each year on streets and highways than the annual receipts from the state. However, many cities will have a large balance in that fund because they have elected to not spend those funds and instead use General Fund revenues. Most of the balances and revenues in Special Revenue Funds could be legally spent for items currently being purchased by other non-restricted funds. City officials will claim that is not correct, until they want to use the money.

**DEBT SERVICE FUNDS** are used to pay the annual payments on the outstanding bonds. This type of fund was once called a "sinking fund." Certain revenues are deposited into these accounts monthly and payments to bond holders are paid, as required by various bond indentures. The money in these funds is not available for general expenditures. However, it is possible to abuse these funds. A city can simply put more than is required into these funds and subsequently transfer the over-funding back to the General Fund to correct the "mistake."

**CAPITAL PROJECT FUNDS** are used for capital outlay expenditures. Typically, proceeds from bond issues are deposited into a capital project fund and subsequently spent for the intended project. Some of the fund receipts may come from other funds. The primary purpose of this group of funds is to keep bond receipts and capital expenditures from distorting the financial statements of the operating funds. These funds are often used to hide money. Funds are

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transferred into the group with no specific purpose. If these funds are growing rapidly, there is probably something suspicious happening.

**PERMANENT FUNDS** are actually endowment funds (the original donation can never be spent) and only the earnings can be spent. A common permanent fund is a cemetery maintenance fund. Prior to **GOVERNMENTAL ACCOUNTING STANDARDS BOARD STATEMENT 34 (GASB 34)**, these funds were reported as Fiduciary Funds. Unless there is something unusual, these funds can be ignored.

## PROPRIETARY FUNDS

The second type of funds is called "**PROPRIETARY FUNDS**". These funds provide a service and charge a fee for that service. There are two types of proprietary funds:

**ENTERPRISE FUNDS** are most often used to account for the city's utilities. The funds in this group are for activities where the city is selling a service or product, just like commercial enterprises. Most Enterprise Funds are nothing but subsidiaries of the General Fund.

**INTERNAL SERVICE FUNDS** are used to account for activities that benefit more than one department or fund. The maintenance garage is the most common fund in this group. Each department is a "customer" and is charged for the services provided. Self-insurance funds are also common. Some cities use Internal Service Funds for the data processing department and the cost of general overhead expenses. In the long term, these funds should be break-even activities. The Internal Services Funds are just extensions of the General Fund. They only provide an orderly way of accounting for goods and services that are used by several departments.

## UNDERSTANDING THE RELATIONSHIP OF THE FUNDS

Typically, the well run and financially healthy city will be restricting the General Fund to a small or modest profit over the long haul. There may be alternating years of profits and losses, but the overall trend will be not allow any significant growth. This is done by employing two basic strategies.

The first is spending from the General Fund rather than one of the other funds when it would have been legal to have spent from the other fund. This allows any build up to be in the other funds, which will appear to not be available to most people.

The second is to borrow as little as possible for capital assets expenditures. If there is cash available, they use all of it before borrowing any. With governmental accounting rules, expenditures for capital assets are treated as a 100% expense for the year of purchase.

These two tactics together can make the General Fund always look anemic. To fully understand the financial condition of a city, a more global approach must be used.

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## SAMPLE BALANCE SHEET

### SMALL CITY, USA BALANCE SHEET AT SEPTEMBER 30, XXXX

#### ASSETS (EVERYTHING THE CITY OWNS)

CASH IN THE BANK	\$500,000
MONEY OWED TO THE CITY FOR WATER AND SEWER BILLS	\$250,000
EQUIPMENT THE CITY OWNS	\$1,000,000
BUILDINGS THE CITY OWNS	\$5,000,000
LAND THE CITY OWNS	\$2,000,000
<b>TOTAL ASSETS (TOTAL OF EVERYTHING THE CITY OWNS)</b>	<b>\$8,750,000</b>

#### LIABILITIES (EVERYTHING THE CITY OWES TO OTHERS)

UNPAID BILLS FOR LAST MONTH	\$100,000
WATER METER DEPOSITS HELD BY THE CITY	\$500,000
VACATIONS OWED TO EMPLOYEES	\$700,000
BONDS PAYABLE TO BONDHOLDERS	\$3,000,000
ENCUMBRANCES (THINGS ORDERED BUT NOT DELIVERED)	\$2,000,000
<b>TOTAL LIABILITIES (TOTAL OWED TO OTHERS)</b>	<b>\$6,300,000</b>
<b>FUND BALANCE (ASSETS MINUS LIABILITIES)</b>	<b>\$2,250,000</b>

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## SAMPLE INCOME STATEMENT

SMALL CITY, USA  
INCOME STATEMENT  
FOR THE YEAR ENDED SEPTEMBER 30, XXXX

INCOME OR REVENUE (ALL OF THE MONEY THAT THE CITY RECEIVED)

TAXES RECEIVED	\$4,000,000
WATER AND SEWER BILLS PAID TO THE CITY	\$3,000,000
TRAFFIC FINES COLLECTED BY THE CITY	\$600,000
LICENSE FEES COLLECTED BY THE CITY	\$400,000
<b>TOTAL INCOME OR REVENUE</b>	<b>\$8,000,000</b>

EXPENSES (EVERYTHING THE CITY SPENT )

SALARIES PAID	\$3,000,000
SUPPLIES PURCHASED	\$1,500,000
NEW EQUIPMENT AND VEHICLES PURCHASED	\$1,500,000
<b>TOTAL EXPENSES</b>	<b>\$6,000,000</b>
<b>NET PROFIT (INCOME MINUS EXPENSES)</b>	<b>\$2,000,000</b>

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## SAMPLE BUDGET

### SMALL CITY, USA BUDGET FOR NEXT YEAR

#### ESTIMATED REVENUE

	THIS YEAR'S BUDGET	NEXT YEAR'S BUDGET
TAXES	\$3,500,000	\$4,000,000
WATER AND SEWER BILLS	\$2,500,000	\$3,000,000
TRAFFIC FINES	\$500,000	\$600,000
LICENSE FEES	\$300,000	\$400,000
<b>TOTAL ESTIMATED REVENUE</b>	<b>\$6,800,000</b>	<b>\$8,000,000</b>

#### ESTIMATED EXPENSES

	THIS YEAR'S BUDGET	NEXT YEAR'S BUDGET
SALARIES	\$3,500,000	\$4,000,000
SUPPLIES	\$2,000,000	\$2,500,000
NEW EQUIPMENT	\$2,000,000	\$2,500,000
<b>TOTAL ESTIMATED EXPENSES</b>	<b>\$7,000,000</b>	<b>\$9,000,000</b>
<b>ESTIMATED NET PROFIT (LOSS OR DEFICIT)</b>	<b>(\$200,000)</b>	<b>(\$1,000,000)</b>

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## GLOSSARY OF TERMS

**ASSETS** - Things of value, i.e. money, receivables, equipment, buildings, etc.

**AUDIT** - An independent examination of the city's financial statements for accuracy and completeness.

**BALANCE SHEET** - A report that lists everything owned and everything owed on the last day of the reporting period.

**BUDGET** - A forecast for what management thinks will be the income and expenses for the next year.

**BUDGETARY BASIS** - This is a method of accounting prescribed by state law for cities and counties. It has different rules than GAAP. (See GAAP) Basically, this is a cash-basis method of accounting and it is the method that cities really used to measure results. The audit has some statements prepared on another basis. GAAP statements are not used by city officials. Budgetary accounting is the language spoken at the courthouse.

**BUSINESS-TYPE ACTIVITIES** – Enterprise and Internal Service Funds.

**CAPITAL OUTLAYS** - The purchasing of fixed assets, such as buildings, trucks, autos, equipment, etc., versus consumable assets, such as office supplies.

**CARRYOVER** - The amount of unencumbered cash on hand at the close of a fiscal year. It has nothing to with last year's budget.

**COMPREHENSIVE ANNUAL FINANCIAL REPORT (CAFR)** - A Comprehensive Annual Financial Report with an introduction and statistical section presented in the prescribed manner for cities. This type of report is usually only issued by larger counties.

**CURRENT ASSETS** - Basically, this is the cash, investments, and accounts receivable and other items that can be readily converted to cash.

**CURRENT LIABILITIES** - These are the normal bills currently not paid.

**DEFICIT** - This is when expenditures during the year are greater than the revenues. The difference is funded by the "Carryover" (see above). Contrary to popular belief, cities can have a deficit budget as long as there is enough cash in the bank at the beginning of the year to cover the deficit. A city that has \$500,000 in the bank at December 31<sup>st</sup> can approve a budget that has \$4,000,000 in revenues and \$4,500,000 in expenditures. This is a deficit budget. What cities cannot do is fund a deficit budget by borrowing money. A deficit may be called a loss, net loss, or expenditures in excess of revenues. Some cities incorrectly call it a budgetary shortfall.

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**DEPRECIATION** - The annual expensing of a capital asset. With depreciation, an asset with a life of 5 years that cost \$10,000 would be expensed as \$2,000 per year, rather than the whole \$10,000 in year one.

**ENCUMBRANCE** - Something ordered and not yet paid. It is actually more than an account payable. An account payable is what is owed and unpaid for a good or service that has been provided. An encumbrance goes further. It includes items ordered, but not yet delivered. This could include orders that can be canceled.

**EXPENDITURES** - This is money spent during the year. This is found on the income statement.

**EQUITY** - This is the difference between assets and liabilities. Most governmental funds call this the fund balance. This number is found on the balance sheet.

**FIXED ASSETS** - Assets that last a period of years. Examples are buildings, vehicles, streets, water plants, etc.

**FUND** - A distinct account for a specific purpose. Each fund has its own financial statements. It may not have a separate bank account, because most cities commingle money.

**FUND BALANCE** - Assets minus liabilities. The General Fund only has current assets and current liabilities on its balance sheet. The Enterprise and Internal Service Funds have other non-current assets and liabilities. Fund Balance is also called reserve or reserves.

**GAAP** - Generally accepted accounting principles. GAAP is a set of rules for preparing financial statements. This is the "gospel" as prescribed by the accounting industry.

**GASB** - Governmental Accounting Standards Board. This is the group that issues the rules for municipal accounting. The statements are named GASB-1, GASB-2, etc.

**GASB – 34** – The new rules for governmental financial statements. This new model will be phased in over period of years beginning with 2001. Larger cities must change first, then the smaller cities.

**INCOME STATEMENT** - A report that lists all of the revenues and expenditures for the year. The difference between the two numbers is operating surplus (profit) or net loss (deficit).

**INDEPENDENT AUDITOR'S REPORT** - The auditor's findings as to the fairness of the presentation of the financial statements. Most of this letter is boilerplate.

**INTRODUCTION SECTION** - This is cover letter presented before the auditor's report and financial statements. It is written by the management of the city and is not subjected to the audit procedures. It could actually contradict the financial statements. The introduction is to the Comprehensive Annual Financial Report what the editorial page is to the daily newspaper.

**LONG-TERM-DEBT (L-T-D)** - Loans and Notes Payable. Cities usually call these Bonds Payable. It is amounts owed by a city that are not going to be paid within the next twelve months.

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**NET INCOME (LOSS)** - The difference between total revenues and total expenditures for the year - Profit or Loss.

**NET REVENUES** - Same as operating surplus.

**NOTES TO FINANCIAL STATEMENTS** - This is supplemental information presented after the financial statements. It is required disclosures that could have an impact on the reader's interpretation of the statements. Most of the notes are boilerplate. The notes or footnotes are part of the audit and are actually prepared by the auditors.

**REPORTING ENTITY** - This is the name given to all entities included in the CAFR. An example would be the City of Springfield, the Springfield Municipal Authority, and the Springfield Airport Authority.

**RESERVES** - See Fund Balance

**REVENUES** - Income or money received during the year. This is found on the income statement.

**RETAINED EARNINGS** - This is the total of all operating surplus since a fund was established. Only the Enterprise and Internal Service Funds report this figure. The average reader of Comprehensive Annual Financial Reports should not give much time to this number. Unless you understand accrual accounting very well, you will be in trouble.

**STATEMENT OF REVENUES, EXPENDITURES AND CHANGES IN FUND BALANCE** - An income statement for most city funds, except Enterprise and Internal Service Funds.

**STATEMENT OF REVENUES, EXPENDITURES AND CHANGES IN RETAINED EARNINGS** - An income statement for Enterprise and Internal Revenue Funds.

**STATISTICAL SECTION** - This is a ten year summary of key numbers for the city. While the information found in this section can be very interesting, it can also be misleading. The statistical section is prepared by the director of finance and is not subjected to the audit procedures.

**Surplus** - The opposite of deficit. It may be called profit, net income, revenues in excess of expenditures, or excess revenues. Some cities incorrectly call it a budgetary surplus.

**TRANSFER** - Money moved from one fund to another. This is an expense for the paying fund and revenue for the receiving fund. This is not a loan, but more like a gift.