

EXHIBIT 4-1 Fund categories

Governmental funds	Used to account for activities primarily supported by taxes, grants, and similar revenue sources
Proprietary funds	Used to account for activities that receive significant support from fees and charges
Fiduciary funds	Used to account for resources that a government holds as a trustee or agent on behalf of an outside party that cannot be used to support the government's own programs

The number of funds necessary for *accounting* purposes (high level of detail) may be greater than the number of funds needed for *financial reporting* purposes (lower level of detail). Accordingly, the practical application of the Number of Funds principle often involves treating two or more of the funds used for accounting purposes as a single fund for financial reporting purposes.⁵

Fund categories

Financial activities for state and local governments fall into three broad categories. Some activities are financed through taxes, grants, and similar nonexchange revenues (general government). Other public-sector activities rely to a significant degree on fees and charges and operate more like a business (utilities). In still other cases, the government may serve as a trustee or agent on behalf of one or more outside parties (pension plan). Accordingly, there are three broad categories of funds (see Exhibit 4-1):

- *Governmental funds* are used to account for activities primarily supported by taxes, grants, and similar revenue sources;
- *Proprietary funds* are used to account for activities that receive significant support from fees and charges; and
- *Fiduciary funds* are used to account for resources that a government holds as a trustee or agent on behalf of an outside party and that *cannot* be used to support the government's own programs.⁶

Fund types

Within each of the three broad categories just described, individual funds are further categorized by *fund type*.

5. There are a number of practical steps a typical government can take to reduce the number of individual funds that it presents in its financial reports: 1) consider combining numerous smaller debt service "funds" into a single fund; consider combining numerous smaller capital project "funds" into a single fund; consider combining grants for similar purposes into a single special revenue fund; and consider using internal service funds only when necessary to support the assessment of charges on an accrual basis. All the same, separate funds must be reported for individual external investment pools and individual postemployment benefit plans. See the Government Finance Officers Association's best practice on "Improving the Effectiveness of Fund Accounting" (2004).

6. Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, paragraph 69.

EXHIBIT 4-2 Governmental fund types

General fund	Main operating fund used to account for and report all financial resources not accounted for and reported in another fund
Special revenue funds	Used to account for and report the proceeds of specific revenue sources that are restricted or committed to expenditure for specified purposes other than debt service or capital projects
Capital projects funds	Used to account for and report financial resources that are restricted, committed, or assigned to expenditure for capital outlays, including the acquisition or construction of capital facilities and other capital assets
Debt service funds	Used to account for and report financial resources that are restricted, committed, or assigned to expenditure for principal and interest
Permanent funds	Used to account for and report resources that are restricted to the extent that only earnings, and not principal, may be used for purposes that support the reporting government's programs—that is, for the benefit of the government or its citizenry

Governmental funds

All governmental funds can be classified into one of five fund types: the general fund, special revenue funds, debt service funds, capital projects funds, and permanent funds (see Exhibit 4-2).

General fund. Accountants describe a government's main operating fund as the general fund. Authoritative accounting standards define the general fund as the fund used by default "to account for and report all financial resources not accounted for and reported in another fund" [emphasis added].⁷ Consequently, a government can report only one general fund.⁸

Special revenue funds. Generally accepted accounting principles (GAAP) provide special revenue funds "to account for and report the proceeds of specific revenue sources that are restricted or committed to expenditure for specified purposes other than debt service or capital projects" [emphasis added].⁹ Inherent in this description are two criteria that must be met before a special revenue fund may be used:

- "Expenditure for specified purposes." Special revenue funds are designed to help determine and demonstrate that resources that must be used for a specified purpose are, in fact, used for that purpose.¹⁰ Such a limitation on spending may be imposed by external parties (creditors, grantors, contributors, other govern-

7. GASB Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, paragraph 29.
 8. NCGA Interpretation 9, *Certain Fund Classifications and Balance Sheet Accounts*, paragraph 10.
 9. GASB Statement No. 54, paragraph 30. *Restrictions* are limitations that are legally enforceable by parties external to the government. *Commitments* are limitations that a government's highest level of decision making formally imposes prior to the end of the fiscal year.
 10. A limitation on the *circumstances* under which resources can be spent (stabilization arrangements), if specific and nonroutine, is viewed as a limitation on the purpose of expenditure (see GASB Statement No. 54, paragraph 21).

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ments), by constitutional provisions, by enabling legislation,¹¹ or by action taken by the government's own highest level of decision-making authority.¹²

- "Proceeds of specific revenue sources." A limitation on how resources may be spent is not enough, by itself, to justify the use of a special revenue fund. At the core of each special revenue fund must be resources derived from one or more specific revenue sources. A surplus in the general fund, for instance, is not a revenue source; therefore, a city council's decision to commit a portion of such a surplus to road repair would not be sufficient to justify the use of a special revenue fund. Conversely, a special revenue fund would be appropriate for gasoline tax revenues restricted for spending on road repair. Once a special revenue fund has been properly established, other resources that become available for the same purpose may be reported there as well,¹³ provided that inflows from the core revenue sources are expected to remain a substantial portion of the fund's total inflows.¹⁴

The core revenue sources of a special revenue fund must be reported as direct revenue of that fund, even if the resources are first received in some other fund and only later remitted to the special revenue fund.¹⁵ Thus, a government would make the following initial journal entries for gasoline taxes collected in the general fund, but accounted for in a special revenue fund:

	<u>DR</u>	<u>CR</u>
<i>General fund:</i>		
Cash	\$100	
Due to other funds – special revenue fund (Collections from gasoline tax)		\$100
	<u>DR</u>	<u>CR</u>
<i>Special revenue fund:</i>		
Due from other funds – general fund	\$100	
Revenue – gasoline tax (Collections from gasoline tax)		\$100

Frequently the use of a special revenue fund is legally required. Otherwise, the use of the special revenue fund type is permitted rather than mandated for financial reporting purposes.¹⁶ Special revenue funds are used extensively, especially for grants.

11. Accountants describe resources subject to any of these limitations as *restricted* (see GASB Statement No. 54, paragraphs 8 and 9).

12. Accountants describe resources subject to this last limitation as *committed* (see GASB Statement No. 54, paragraphs 10-12). Commitments must be approved prior to the close of the fiscal year (although the specific amount, which may depend on a formula, does not have to be known at the time of approval).

13. As a practical matter, governments may wish to refrain from commingling monies from different grants in a single special revenue fund, unless explicitly permitted to do so.

14. GASB Statement No. 54, paragraph 31. For a revolving loan program properly reported in a special revenue fund, the point of reference may be *fund balance* rather than inflows.

15. GASB Statement No. 54, paragraph 30.

16. The general fund of a blended component unit must be reclassified as a special revenue fund by the primary government to avoid reporting more than one general fund (GASB Statement No. 14, *The Financial Reporting Entity*, paragraph 54). (See Chapter 6.)

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States may use a special revenue fund (if not the general fund) to account for their administration of the federal food stamp program.¹⁷ A special revenue fund also may be used (rather than a permanent fund) to account for restricted revenues that must be "permanently invested" (requirement to maintain a minimum fund balance) pursuant to enabling legislation.¹⁸ Special revenue funds may not be used for amounts held in trust.¹⁹

Capital projects funds. Governments tend to distinguish their operating activities from their capital activities, just as they tend to distinguish their operating budget from their capital budget. Accordingly, GAAP provide *capital projects funds* "to account for and report financial resources that are restricted,²⁰ committed,²¹ or assigned²² to expenditure for capital outlays including the acquisition or construction of capital facilities and other capital assets."²³

One important reason governments wish to distinguish capital outlays from operating outlays is to avoid distorting operating trend data ("spikes" in operating expenditures during peak periods of major construction). The acquisition of many capital assets, however, is more or less routine from one period to the next (new vehicles for the motor pool). Typically a capital projects fund is *not* used for such routine capital outlays, which are reported instead by function (general government, public safety, parks and recreation) in the general fund. Rather, capital projects funds tend to be used primarily for *major* projects and acquisitions (construction of a new city hall or purchase of a new fire truck) and for capital acquisition or construction financed with borrowed or contributed resources (and thus of special interest to the resource provider).

The use of a capital projects fund frequently is required by debt covenants, grant contracts, law, or regulation. Otherwise the use of the capital projects fund type is permitted rather than mandated for financial reporting purposes. Capital projects funds can be a valuable management tool for multi-year projects. The use of a capital projects fund would *not* be appropriate for the acquisition of assets to be held in trust.²⁴

Debt service funds. Governments frequently accumulate resources in anticipation of debt service payments, either to fulfill legal or contractual obligations (revenue-supported debt) or voluntarily (general obligation debt). GAAP provide *debt*

17. GASB Statement No. 24, *Accounting and Financial Reporting for Certain Grants and Other Financial Assistance*, paragraph 6.

18. GASB *Comprehensive Implementation Guide*, 7.49.1.

19. GASB Statement No. 54, paragraph 30.

20. Limitations that are legally enforceable by parties external to the government.

21. Limitations that a government's highest level of decision making formally imposes prior to the end of the fiscal year.

22. Limitations that reflect a government's intentions as expressed by its highest level of decision making or by a body or individuals delegated for that purpose.

23. GASB Statement No. 54, paragraph 33.

24. GASB Statement No. 54, paragraph 33.

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service funds "to account for and report financial resources that are restricted,²⁵ committed,²⁶ or assigned²⁷ to expenditure for principal and interest."²⁸

The essential purpose of a debt service fund is to account for *accumulations of resources*. Absent such an accumulation (capital lease), it is common to account for debt service in the general fund rather than in a separate debt service fund.

The use of a debt service fund frequently is legally mandated. If so, GAAP require that it be reported as such in a government's financial report. Likewise the reporting of a debt service fund is required whenever "financial resources ... are being accumulated for principal and interest maturing in future years." Otherwise, the use of the debt service fund type is permitted, rather than mandated, for financial reporting purposes. The use of a debt service fund would *not* be appropriate for debt reported as a liability in a proprietary fund.

Permanent funds. GAAP indicate that *permanent funds* "should be used to account for and report resources that are restricted to the extent that only earnings, and not principal, may be used for purposes that support the reporting government's programs—that is, for the benefit of the government or its citizenry."²⁹ A good example of the proper use of a permanent fund would be to account for a perpetual care endowment for a municipal cemetery.³⁰

The use of permanent funds is strictly limited to resources that may be used to "support the reporting government's programs—that is, for the benefit of the government or its citizenry." Endowment-like arrangements for the benefit of outside parties (individuals, private organizations, other governments) are properly reported in the fiduciary funds category as private-purpose trust funds.³¹

As noted previously, the use of special revenue funds, debt service funds, and capital projects funds often is permitted rather than mandated for financial reporting purposes.³² The use of permanent funds, on the other hand, normally is obligatory for financial reporting purposes,³³ except for special purpose governments engaged solely in business-type activities.³⁴ Also, a permanent fund may be used (instead of a special revenue fund) to account for restricted revenues that must be "permanently invested" pursuant to enabling legislation.³⁵

25. Limitations that are legally enforceable by parties external to the government.

26. Limitations that a government's highest level of decision making formally imposes prior to the end of the fiscal year.

27. Limitations that reflect a government's intentions as expressed by its highest level of decision making or by a body or individuals delegated for that purpose.

28. GASB Statement No. 54, paragraph 34.

29. GASB Statement No. 54, paragraph 35. *Expendable* trusts whose resources can be used to support a government's programs are properly reported in a special revenue fund.

30. GASB Statement No. 34, footnote 32.

31. GASB Statement No. 54, paragraph 35.

32. These fund types "are used to account for and report...", not "should be used to account for and report ..." (GASB Statement No. 54, paragraphs 30, 33, and 34, emphasis added).

33. Permanent funds and the general fund "should be used to account for and report...", not "are used to account for and report ..." (GASB Statement No. 54, paragraphs 29 and 35, emphasis added).

34. Such entities need report only a corresponding balance of *restricted net position*. See GASB *Comprehensive Implementation Guide*, 7.49.3.

35. GASB *Comprehensive Implementation Guide*, 7.49.1.