



Governmental vs. Enterprise Fund Accounting

In this, the inaugural edition of the REAC's *PHA GAAP Flyer*, the focus will be on governmental vs. enterprise fund accounting. The REAC, in consultation with some of the nation's largest accounting firms, has concluded that in most, if not all instances, PHAs should use enterprise fund accounting. The basis for the REAC's position, along with the compelling reasons why PHAs should use enterprise fund accounting follows.

FUND ACCOUNTING

In order to prepare financial statements that comply with generally accepted accounting principles (GAAP), PHAs and their auditors must be familiar with two key concepts: 1) fund accounting and 2) the basis of accounting and measurement focus used by funds.

According to the National Council on Governmental Accounting Statement No. 1 (NCGAS 1), entitled *Governmental Accounting and Financial Reporting Principles*, a fund is defined as:

"...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."

Under governmental GAAP there are eight different fund types which are categorized into three different activities: governmental, proprietary (i.e. business type), and fiduciary. The eight funds, by category, are listed in *Exhibit 1*.

Exhibit 1: Fund Types

Governmental Funds

- General fund
- Special revenue funds
- Capital project funds
- Debt service funds

Proprietary (business-type)

- Enterprise funds
- Internal service funds

Fiduciary

- Trust funds
- Agency funds



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In addition to the eight funds types listed in Exhibit 1, two account groups are reported by governments – the *general fixed asset account group* and the *general long-term debt account group*.

Governmental Funds

GAAP requires state and local governments to use governmental funds to account for "governmental-type activities". Governmental-type activities

include services largely funded through non-exchange revenues (taxes are the most common example). When state and local governments employ governmental fund accounting, the general fund is used to account for all financial resources of the government except for those required to be accounted for in another fund. Under GAAP, a compelling reason must exist before another fund type is utilized. The two account groups provide what are essentially listings of the governmental funds' long-term assets and liabilities. Page 2

Enterprise Funds

GAAP requires state and local governments to use the enterprise fund type to account for “business-type activities” – activities similar to those found in the private sector. Business-type activities include services primarily funded through user charges.

NCGAS 1 defines the purpose of enterprise funds as:

“...to account for operations (a) that are 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 users charges; or (b) 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.”

State and local governments should use an enterprise fund to account for its activities when the criteria of either (a) or (b) are met. In most cases, PHAs should use enterprise funds because their activities closely resemble the characteristic described in (a) above. Moreover, it is important to note that the total cost of the activity does not have to be paid for by the user charges. The government (or other governmental entity – in this case HUD) may subsidize a significant portion of the costs of the enterprise fund.

BASIS OF ACCOUNTING AND MEASUREMENT FOCUS

The two most important distinguishing features of governmental accounting and financial reporting are the basis of accounting and measurement focus used. Not all funds of a government use the same basis of accounting and measurement focus, further distinguishing and complicating governmental accounting and financial reporting. A simple rule of thumb is that the basis of accounting determines *when* transactions will be recorded and the measurement focus determines *what* transactions will be recorded.¹

Basis of Accounting

Basis of accounting refers to when revenues, expenditures, expenses, and transfers (and the related assets and liabilities) are recognized and reported in the financial statements. Examples of accounting basis include cash, tax, accrual, and modified accrual. Essentially, the basis of accounting deals with timing issues. *Government funds* use the modified accrual basis of accounting. *Enterprise funds* use the accrual basis of accounting.

Measurement Focus

Measurement focus determines what transactions will be reported in the various funds’ operating statement. The differences in the measurement focus of governmental vs. enterprise funds is highlighted in *Exhibit 2*.

Exhibit 2: Measurement Focus

Governmental funds use a measurement focus known as the *flow of current financial resources*.² This focus measures financial resources available to the entity in the near future as a result of transactions and events of the fiscal period reported. Therefore, long-term assets and liabilities will not be reflected on the balance sheets of governmental funds.

Enterprise funds use a measurement focus known as the *flow of economic resources*.³ This measurement focus is generally the same as that used by commercial entities. Both long-term assets and liabilities are reported on the balance sheet of enterprise funds.

COMPELLING REASONS WHY PHAs SHOULD USE ENTERPRISE ACCOUNTING

Included in *Exhibit 3* is a list of seven compelling reasons why PHAs should use enterprise fund accounting.

“GAAP requires state and local governments to use the enterprise fund type to account for “business-type activities” – activities similar to those found in the private sector.”

Exhibit 3: Reasons to use Enterprise Funds

- 1 PHAs activities meet the definition of an enterprise fund under NCGAS 1.
- 2 PHAs operate property development/management concerns similar to companies in the private sector. Therefore, PHAs operations are “business-type activities”.
- 3 PHAs do not have the authority or the ability to raise taxes. Thus, the flow of current financial resources focus does not apply to PHAs.
- 4 The enterprise fund type works better than the governmental fund type for PHAs that participate in joint ventures and mixed financing transactions.
- 5 Equity in fixed assets is an important item to consider when evaluating PHAs.
- 6 More accountants are familiar with full accrual accounting than modified accrual accounting.

GASBS 20 requires PHAs to use proprietary fund accounting. Page 3

A detailed explanation of each of the compelling reasons follows:

- It is HUD’s position that a typical PHA’s activities meet the definition of an enterprise fund under NCGAS 1 (see previous discussion on enterprise funds).
- In essence, PHAs are property development/management concerns and, therefore, should be managed and accounted for in a manner similar to their private sector counterparts. In fact, the only major difference between PHAs and private sector development/management concerns is that HUD, rather than the tenants, fund some of the PHA’s costs. As previously noted, the total cost of a state or local government’s activity does not have to be paid for by user charges. Another governmental entity (such as HUD) may subsidize a significant portion of those costs. Thus, a PHA’s operations are “business-type activities” similar to those found in the private sector.
- PHAs do not have the authority or the ability to raise taxes to increase their resources in future years. For example, unlike state and local governments, PHAs can not raise taxes to cover long-term debt obligations. PHAs must rely on each year’s funds to support that year’s operations. As a result, a PHA’s focus should be on whether the entity is economically better off as a result of the events and transactions that have occurred during the fiscal year reported. In other words, PHAs have an economic flow of resources focus rather than a current flow of resources focus. Therefore, PHAs should use the full accrual method of accounting and report both long-term assets and liabilities on their balance sheets.
- The enterprise fund type works better than the governmental fund type for PHAs that participate in joint ventures and mixed financing transactions. Enterprise funds are allowed to follow FASB pronouncements unless those pronouncements conflict with or contradict GASB pronouncements. FASB guidance in this area is more clearly defined than that of the GASB.
- It is HUD’s position that a PHA’s equity in its fixed assets

is an important item to consider when evaluating that entity’s financial condition (i.e. a PHA should have net equity in its fixed assets). The governmental model does not measure this element.

- More accountants and auditors are familiar with the full accrual basis of accounting and flow of economic resources measurement focus than are familiar with the modified accrual basis/flow of current resources focus. Therefore, the number of qualified accounting resources available to PHAs increases when the enterprise fund type is utilized.



- The Governmental Accounting Standards Board (GASB) Statement 20, *Accounting and Reporting for Proprietary Funds and Other Governmental Entities that use Proprietary Fund Accounting* provides PHAs with interim guidance on business-type accounting and financial reporting for proprietary activities. Paragraph 5 of GASBS 20 states:

“The requirements of this statement apply to accounting and financial reporting for proprietary activities – that is, proprietary funds and other governmental entities that use proprietary fund accounting including public benefit corporations and authorities (emphasis added)...”.

“The trend in governmental accounting is toward the full accrual basis and flow of economic resources measurement focus. By utilizing the enterprise fund type, PHA will be better prepared to implement GASBS 11.”

Accordingly, it is HUD’s position that most, if not all PHAs are covered by GASBS 20 and, therefore, should use enterprise fund accounting.

As further outlined in the Current Developments section below, the trend

in governmental accounting is toward the full accrual basis of accounting and flow of economic resources measurement focus. By utilizing the enterprise fund type, PHAs will be better prepared to implement GASBS 11.

CURRENT DEVELOPMENTS

During May 1990, the Governmental Accounting Standards Board (GASB) issued Statement 11, *Measurement Focus and Basis of Accounting – Governmental Fund Operating Statements*. During June 1993 the GASB issued GASBS 17, *Measurement Focus and Basis of Accounting -- Governmental Fund Operating Statements: Amendment of the Effective Dates of GASB Statement No. 11 and Related Statements -- an amendment of GASB Statements No. 10, 11, and 13*, which deferred indefinitely the effective date of GASBS 11. Page 4

A key provision of GASBS 11 included a requirement that governments report activities in the governmental funds using the accrual basis of accounting and *the flow of financial resources* measurement focus.

During January 1997, the GASB issued an Exposure Draft (ED) titled *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments*. The reporting model that may result from this ED is far different from those originally contemplated when GASBS 11 was first issued. If issued as a GASB pronouncement, the ED would require governments to prepare financial statements from **both** an *entity-wide perspective* and a *fund perspective*.

Entity-Wide Perspective

Entity-wide financial statements would provide information about the primary government and its component units without displaying funds or fund types. The financial statements would distinguish between the governmental and business-type activities of the primary government and between the total primary government and its discretely presented component units. (The entity-wide perspective would not include fiduciary activities.) All information would be reported using the *economic resources measurement focus* (emphasis added) and *the accrual basis of accounting* (emphasis added), as enterprise funds do today.⁴

Fund Perspective

Fund perspective financial statements would provide information about the primary government's fund types, including fiduciary funds and blended component units. Governments would present separate financial statements for each fund category – governmental, proprietary, higher education, and fiduciary – and would no longer present a combined balance sheet. (General capital assets and general long-term liabilities currently reported in account groups would be reported only at the entity-wide perspective, as assets and liabilities of governmental activities.) As is currently required, governmental fund financial statements would focus on fiscal accountability and would report the flows and balances of *current financial resources* (emphasis added) using the *modified accrual basis of accounting* (emphasis added). Proprietary and fiduciary fund financial statements would report operating results and financial position using the economic resources measurement focus and the accrual basis of accounting. The fund perspective also would include component units that are fiduciary in nature.⁵

Current Status

In response to this ED, the GASB has received a significant number of comment letters and has also heard public testimony at meetings throughout the summer of 1997.⁶ After much

deliberation it appears that the GASB is close to finalizing the new reporting model. In fact, the GASB's First-Quarter 1999 Technical Plan indicates that the Board is on track to issue the new reporting model Statement in June 1999.⁷

CONCLUSION

The trend in governmental accounting is headed toward the full accrual basis of accounting and the flow of economic resources measurement focus. The compelling reasons listed above make it abundantly clear that in most, if not all cases, PHAs should utilize the enterprise fund type when preparing their financial statements in accordance with generally accepted accounting principles. Furthermore, by converting from HUD's regulatory basis of accounting directly to the enterprise fund type, PHAs will find it easier to implement GASBS 11, when it becomes effective.

1 *Wiley GAAP for Governments 1999*, page 55, John Wiley & Sons, Inc. 1999.

2 *Wiley GAAP for Governments 1999*, page 58, John Wiley & Sons, Inc. 1999.

3 *Wiley GAAP for Governments 1999*, page 58, John Wiley & Sons, Inc. 1999.

4 GASB Exposure Draft, January 31, 1997.

5 GASB Exposure Draft, January 31, 1997.

6 *Wiley GAAP for Governments 1999*, page 12, John Wiley & Sons, Inc. 1999.

7 GASB Action Report, No. 166, January 1999, Vol. 16, No.1.

“All information would be reported using the economic resources measurement focus and the accrual basis of accounting as enterprise funds do today.”

