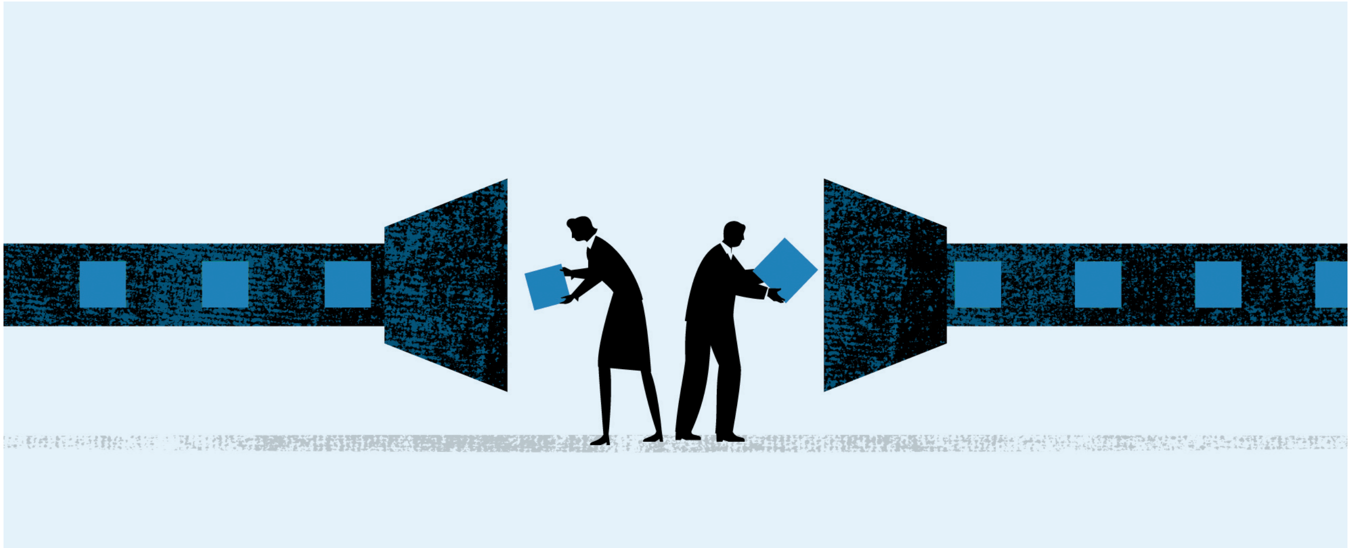

ACCOUNTING

Inside Stories #1

Distinguishing Between Internal Cash Flows and Internal Resource Flows

BY MICHELE MARK LEVINE

As we often discuss, the Governmental Accounting Standards Board (which defines the generally accepted accounting standards for governments) uses a financial reporting model based on the financial accountability of elected officials. In government, financial statements can include any number of legally separate governmental entities in cases where elected officials of one government are financially accountable for the affairs of other governments.[1] In this article (and in several future *GFR* articles), we'll explore some of the complexities that arise from this special form of consolidation, termed a *financial reporting entity*. Some of the topics may seem straightforward when viewed in isolation, but submissions to GFOA's Certificate of Achievement for Excellence in Financial Reporting Award program demonstrate that many governments struggle to properly account for these internal activities.

For a refresher on when and how multiple governments should be included in a single financial reporting entity, please review the article, "Puzzling Pieces: Component Unit Identification, Classification, Disclosure, and Display," in the April 2022 issue of *GFR* (available at gfoa.org/materials/gfr422-puzzling-pieces).

Before we jump into the first topic of the series, one more refresher may be helpful: what is meant by the term *reporting* unit. Reporting units within a financial reporting entity do not have a one-to-one correspondence to the individual legally separate governmental entities in that financial reporting entity. A reporting unit may be a single legal governmental entity; however, it can also be simply a part of a legal entity, or even an aggregation of multiple legal entities. Specifically, a reporting unit may be:

- A single legal entity such as general or special purpose government (for example, a primary government total, an individual discretely presented component unit, or DCPU).
- A part of a government, such as:
  - Governmental activities reported in government-wide financial statements.
  - Business-type activities reported in government-wide financial statements.
  - An individual fund or segment (such as, a major governmental or enterprise fund in fund financial statements within the basic financial statements, or any individual fund in combining financial statements).
  - An aggregation or consolidation of individual funds (as in, total nonmajor governmental funds, total governmental funds, total internal service funds).
- An aggregation or consolidation of governments (for example, a total of all the discretely presented component units of a primary government, an entity-wide total of a primary government and its component units).

Generally, a reporting unit corresponds to a column displayed on a government's statement of net position.

To account for and report internal activity properly, we must distinguish between intra-entity transactions[2] and other events that result in reportable resource flows (such as revenues and expenditures/expenses) between reporting units within a financial reporting entity, on one hand, and other intra-entity *cash* flows that occur when one reporting unit within the financial reporting unit simply receives or disburses cash related to activities that are properly reported entirely in another reporting unit, on the other hand.

Transfers between funds, the interfund equivalent of nonexchange transactions, and payments for interfund services provided and used represent inflows of resources to the receiving fund and outflows to the paying fund. This would be the case if a parks department operating in a government's general fund pays usage-based water fees to a water fund. Similarly, nonexchange payments by one government to another (for example, a primary government providing an operating subsidy to a discretely presented component unit transit authority) and exchange or exchange-like payments by one government to another (such as, the primary government paying a lump sum to the transit authority to provide monthly transit passes to its child welfare caseworkers) represent inflows and outflows of resources.

In contrast, the initial inflow or outflow of cash through one fund—essentially, a conduit—when the cash is received or paid on behalf of a second fund that properly accounts for the underlying activities, should not be recorded as a revenue or expenditure/expense in that conduit fund. The use of one fund as a conduit for another generally occurs as a matter of convenience, when a general operating bank account associated with one fund is used for all or most activity of a government, or when analysis is required to properly identify the composition of cash flows (as in, when taxes levied for different purposes are received in a single account or payroll attributable to employees of all funds is initially paid through one account). In these cases, the payments or receipts should result in an interfund receivable and payable between the two funds, and a simultaneous resource inflow or outflow for the *second* fund.

For example, assume that all cash from the state in which a county is located comes via electronic funds transfer into the county's main operating bank account, which is associated with the county's general fund. Further assume that the county receives $100,000, which is an unrestricted operating subsidy from the state for the county's bus operations, which are accounted for in a transit enterprise fund. On the date of the receipt, the *general fund* would record:

DR.	Cash	$100,000	
CR.	Due to transit enterprise fund		$100,000

To record receipt of state grant revenue for transit operations on behalf of the transit fund

On the same date, the transit fund would recognize its grant revenue and the amount due from the general fund.

DR.	Due from general fund	$100,000	
CR.	State transit operating grant revenue		$100,000

To record receipt by the county's general fund of state transit operating grant revenue

Notice that only the transit fund—the fund that is entitled to the grant—recognizes a resource flow (revenue). There is no resource flow in (no operating statement effect on) the general fund; only its balance sheet accounts are affected.

The initial inflow or outflow of cash through one fund—essentially, a conduit—when the cash is received or paid on behalf of a second fund that properly accounts for the underlying activities, should not be recorded as a revenue or expenditure/expense in that conduit fund.

Ultimately, the cash may be moved to the transit fund, in which case the general fund would record an entry that is the exact reverse of the one shown above (debit *due to transit enterprise fund* and credit *cash*), and the transit fund would debit *cash* and credit *due from the general fund*. It's also possible that the general fund might use the cash to make payment on behalf of the transit fund, such as if payroll for transit employees is paid by the general fund. Assuming that the full $100,000 is used to pay transit salaries, the entries would be:

On the date payroll, the *general fund* would record:

DR.	Due to transit enterprise fund	$100,000	
CR.	Cash		$100,000

To record transit employee payroll paid on behalf of the transit fund

On the same date, the transit fund would recognize its payroll expenses and the reduction of the amount due from the general fund.

DR.	Payroll expense	$100,000	
CR.	Due from general fund		$100,000

To record payment by the county's general fund of transit employee payroll

Notice again that only the transit fund—the fund that is responsible for the payroll costs—recognizes the outflow of resources.

Unfortunately, many governments incorrectly recognize inflows and outflows in the fund from or to which the initial cash flow occurs, rather than treating it as simply the cash conduit, effectively "grossing-up" the reported resource flows in that fund. In our initial example, the entries might have been erroneously recorded as follows:

Upon receipt of grant funds from state:

DR.	Cash	$100,000	
CR.	State grant revenue		$100,000

To record receipt of state grant revenue for public health and for transit operations in the transit fund

Then, when the money is moved to the transit fund, these governments erroneously recognize transfers—other financing sources or other financing uses—which are resource flows in governmental funds:

DR.	Transfer to transit fund	$100,000	
CR.	Cash		$100,000

To record transfer of state grant revenue for public health and for transit operations in the transit fund

Unfortunately, many governments incorrectly recognize inflows and outflows in the fund from or to which the initial cash flow occurs, rather than treating it as simply the cash conduit, effectively "grossing-up" the reported resource flows in that fund.

By mis-recording in this manner, the general fund is reporting both an inflow (grant revenue) and an outflow (transfer out to transit fund), improperly "grossing up" activity reported by the fund. In addition to overstating both inflow and outflows in the general fund, this effectively reclassifies the operating subsidy provided by the state to look like an operating subsidy (transfer) from the county in the transit fund's financial reporting.

Instead of recognizing a transfer, the general fund in this example might have reduced the reported state grant revenue (for example, reversing the initial erroneous entry by debiting state grant revenue and crediting cash) when paying the transit fund. Then, if both transactions occurred in the same financial reporting period, the net effect would be the same as the illustration of the correct entries above. During the period between the cash receipt by the general fund and payment of funds over to the transit fund, however, the general fund's revenue would be overstated, as would its assets, and the amount due to the transit fund would be understated, while the transit fund's revenue and assets would both be understated.

Interfund balances ("due to" and "due from") and transfers are eliminated when fund financial statements are consolidated into government-wide financial statements, when the funds involved are reported in the same government-wide reporting unit (as in, both are governmental activities or both are business-type activities), or in the government-wide statements, when activity crosses between governmental and business-type activities. The interfund services provided and used—the interfund equivalent of exchange or exchange-like transactions (such as, the transit fares paid for the child welfare case workers)—are not eliminated, as doing so would understate operating costs of the customer fund and understate operating revenue of the supplier fund.

Now, what if the cash conduit reporting unit was not just in a different fund from the reporting unit to which the activity belongs, but the two are discrete entities within the financial reporting entity? This would be the case if, in the example above, the state transferred the transit subsidy to the county as before, but the county's transit was operated by a transit authority that was a discretely presented component unit (DCPU) rather than an enterprise fund of the county. The answer here is substantively the same as when both parties were funds of the primary government, except that the county would report an amount payable to the transit authority (rather than an interfund "due to") and the authority would report an amount receivable from the county (rather than an interfund "due from"). If the amounts are material, these payables and receivables should be reported separately from amounts payable to, or receivable from, parties external to the financial reporting entity in both the primary government's and the DPCU's reporting units. Eliminations between the primary government and the DPCUs, like what was described above for interfund activity, would be required only if a financial consolidated reporting entity-wide total were presented, which is fairly uncommon.

Michele Mark Levine is director of GFOA's Technical Services Center.

COMING UP

Watch this space for more Inside Stories discussing other topics related to activities internal to a financial reporting entity or with related parties, such as accounting for certain complex financial activity with blended component units, joint ventures, and the appropriate reporting and disclosures when defined benefit pensions and other postemployment benefits (OPEB) are provided to employees of multiple reporting units within a financial reporting entity that represents as a single employer in a pension or OPEB plan.