

FINANCIAL MANAGEMENT FOR GEORGIA LOCAL UNITS OF ADMINISTRATION

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3	March 2017	I-15	Capital Projects Funds

INTRODUCTION

Local Units of Administration (LUAs) often acquire or construct major capital facilities. Such facilities assist the LUA in providing education to its students (e.g., construction of a high school). In this instance, a financial reporting vehicle often is needed to demonstrate compliance with legal and contractual provisions and to compile certain cost data. The capital projects fund type provides such a mechanism and is used, according to the Governmental Accounting Standards Board's 2015-2016 *Codification of Governmental Accounting and Financial Reporting Standards (2015-2016 Codification)*, Section 1300.106, "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 asset." Capital projects funds exclude capital acquisition or construction of capital assets for proprietary or fiduciary funds. Capital assets financed by general obligation bond proceeds should be accounted for in a capital projects fund.

Capital projects funds should be established when legally mandated. Georgia LUAs are required to use a capital projects fund when they enter into a new school building project or major renovation to a school building. They also could be used when capital acquisition or construction is financed, in whole or in part through intergovernmental revenues or major private donations. In addition, capital projects funds can be useful when capital acquisition or construction is financed over several accounting periods.

When an LUA issues general obligation debt to finance capital construction, it should demonstrate that the proceeds have been used in accordance with the related debt agreement and voter-approved bond issue. Therefore, LUAs in the past ordinarily established separate capital projects funds for each bond issue. Likewise, when capital construction was not financed by debt, LUAs often established separate funds for each project or closely related group of projects to provide additional controls over expenditures. However, with the information systems now available, many LUAs no longer need to establish separate funds for individual bonds issues or projects. Instead, these LUAs now

use sub-funds within a single capital projects fund to maintain the integrity of the data on individual projects and bond issues. Insofar as this practice can be used to eliminate unnecessary funds, it conforms to the "minimum number of funds" accounting principles and is encouraged. However, LUAs should evaluate carefully the needs of users of their financial statements for information on individual bond issues and projects before adopting such an approach.

Capital projects funds report capital outlays as expenditures rather than as assets. Accordingly, construction in progress (i.e., the accumulated cost of a construction project not completed) never appears in a capital projects fund. Instead, construction in progress is reported in the governmental activities column on the Statement of Net Position for the government-wide financial statements. See Chapters I - 17 (Capital Assets) and II - 2 (Financial Statements) for detailed information on the Capital Assets and the basic financial statements.

Assets remaining in a capital projects fund after the completion of a project normally are transferred to the debt service fund as an operating transfer out if debt related to the project is still outstanding. If not, an operating transfer out typically is made to the fund that provided the resources for the project. Deficits related to completed projects are eliminated most often by operating transfers to the capital projects fund from the general fund.

BUDGETARY ISSUES

Many LUAs establish capital improvement programs to plan for their capital needs and the means of financing them over a number of years. Often such LUAs review the portion of the capital plan related to the coming fiscal year when preparing the annual budget and incorporate all or part of it as a "capital budget" component of the broader annual appropriated budget (see Chapter IV – 3 for a discussion of capital improvement programs). Other LUAs, however, do not provide for capital projects in their annual appropriated budgets. Instead, such LUAs adopt project-length budgets for their capital projects and rely on mechanisms such as bond indentures to ensure proper control over expenditures (Chapter IV – 2 discusses project-length budgets). This project-length focus is in keeping with the natural life cycle of capital projects. No matter which method is chosen, LUAs need to ensure that budgetary compliance is demonstrated in their financial reports.

Presentation of budgetary information for capital projects funds is not a required component of external financial statements according to GASB Statement 34. Budget comparisons are required for the general fund and each major special revenue fund with a legally adopted budget. However, the Department of Education requires budgeting capital projects funds. Budgets for capital projects funds vary depending on whether or not the funding is through local revenue (ad valorem), GSFIC funding, or SPLOST funding. The budgeting will depend on the resources, the voter-approved or state approved projects, and the time frame allotted for the projects.

ACCOUNTING ISSUES

The capital projects fund type uses the modified accrual basis of accounting and the flow of current financial resources measurement focus. Therefore, accounting for capital projects funds is essentially similar to the accounting used by other governmental funds.

Nevertheless, questions still arise regarding the classification of financial resources, temporary deficits, premiums and discounts, and interest capitalization.

Classification of Financial Resources

Financial resources used for capital acquisition and construction are classified based on their source. Operating transfers from other funds, as well as the proceeds of most bond issuances, are reported as "other financing sources" and are shown in a subsection of the statement of revenues, expenditures and changes in fund balances, following the excess (deficiency) of revenues over (under) expenditures. Interest on investments, intergovernmental grants and private donations, on the other hand, are reported as revenues.

Temporary Deficits

Sometimes capital projects funds report a temporary deficit, if, for instance, an LUA uses short-term borrowing to finance the early stages of construction. For example, an LUA decides to finance a three-year school building project with general obligation bonds that will be issued in the second year of the project. To begin the project, the LUA issues short-term bond anticipation notes (BANs). If the BANs do not meet the criteria set forth in the 2015-2016 *Codification*, Section B50.102 for inclusion in the governmental activities column of the government-wide financial statements, they are reported as a liability of the capital projects fund. Because the debt is reported in the fund, any expenditures incurred during the first year would create a deficit since there are no revenues or other financing sources reported in the fund. This deficit is temporary because it will be eliminated when the bond proceeds budgeted for the project are received in the second year. Concern over such deficits ought to be tempered by consideration of the measurement focus and basis of accounting applicable to the capital projects fund category. Unlike "retained earnings" in the commercial model, the unassigned fund balance of governmental funds is designed to reflect only net expendable, available financial resources. A deficit in a capital projects fund, therefore, demonstrates only that uses of expendable available financial resources have exceeded sources. A deficit does not necessarily indicate that the LUA is facing financial difficulties.

Premiums and Discounts

Another accounting issue for capital projects funds is the proper treatment of premiums or discounts on bond issuances. As noted earlier, capital projects funds use the flow of current financial resources measurement focus. Amortization is not appropriate under this measurement focus because the amounts so recognized would not represent an increase or decrease in expendable available financial resources. Therefore, bonds issued are reported as Other Financing Sources – Bond Proceeds on the operating statement for the fund. Care

should be taken to ensure that the amount reported as "proceeds" is computed correctly. Sometimes issuance costs are withheld from bond proceeds as an additional discount or reduction of premium. In such instances, only the amount representing an adjustment of the face value of the bonds to their present value should be subtracted or added to determine the amount of the proceeds, which are then accounted for as an Other Financing Source. Any amounts withheld for issuance costs should be included in the calculation of proceeds and then reported separately as an expenditure under the debt service classification on the statement of revenues, expenditures and changes in fund balances. See Chapter II -3 for information regarding adjustments related to bond premiums, discounts, and issuance costs necessary for the preparation of the government-wide financial statements.

Interest Capitalization

According to the 2015-2016 Codification section 1400.123, interest expense should be capitalized for the following types of assets: assets constructed or otherwise produced for a government’s own use, assets intended for sale or lease that are constructed, investments accounted for by the equity method while the investee has activities in progress necessary to commence its planned principal operations provided that the investee’s activities include the use of resources to acquire qualifying assets for its operations, and assets donated or granted to other entities.

ILLUSTRATIVE JOURNAL ENTRIES

The following discussion and journal entries illustrate the financial transactions required for the establishment and the operation of a capital projects fund during the first year of the project.

Transaction - an interfund receivable of \$300,000 is established in the capital projects fund for the general fund's portion of the project’s cost.

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Interfund accounts receivable	0132	\$300,000	
Other financing sources – operating transfers from other funds	5200		\$300,000

Explanation - An offsetting journal entry would be reported in the general fund.

Transaction - the LUA sells general obligation bonds in the amount of \$4 million to cover the majority of their share of the cost of the building project.

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Cash in bank	0101	\$4,000,000	
Other financing sources-sale of bonds	5100		\$4,000,000

Transaction - the LUA determines that it can invest \$3,839,000 of the cash in the capital projects fund and still meet its cash needs for the immediate future.

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Investments	0111	\$3,439,000	
Cash in bank	0101		\$3,439,000

Transaction - the capital projects fund received \$200,000 as partial payment from the general fund for its portion of project costs.

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Cash in bank	0101	\$200,000	
Interfund accounts receivable	0132		\$200,000

Transaction - the LUA records \$5,161,000 of encumbrances for purchase orders issued and contracts approved.

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Encumbrances	(function/object)	\$5,161,000	
Fund balance - Assigned for Encumbrances 0753			\$5,161,000

Explanation - The LUA accounting software should automatically post these amounts to the Encumbrances Control (0603) account.

Transaction - the LUA agrees to a change-order request from the contractor that will raise by \$15,000 the contract amount related to the project.

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Encumbrances	(function/object)	\$15,000	
Fund Balance			
Assigned for Encumbrances	0753		\$15,000

Transaction - the LUA receives progress billings of \$2,979,000. These amounts have been encumbered. The LUA also receives invoices for goods and services totaling \$255,000. However, the related purchase orders used to establish the encumbrance amounted to \$253,000. Of the \$2,979,000 of progress billings, \$149,000 is to be withheld, in accordance with the provisions of the contracts, until the projects are completed satisfactorily.

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Fund balance – Assigned for Encumbrances	0753	\$3,232,000	
Encumbrances	(function/object)		\$3,232,000

(Note: amount removed from encumbrances is \$2,979,000 plus original encumbrance for goods and services \$253,000.)

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Expenditures	Various Exp.	\$3,234,000	
Construction Contracts payable	0433		\$2,830,000
Accounts payable	0421		\$255,000
Construction Contracts Retainage Payable	0432		\$149,000

(Note: expenditure totals progress billing of \$2,979,000 plus the actual invoice of \$255,000.)

Transaction - the LUA files for reimbursement from the GSFIC for the amount of the expenditures incurred (including retainage) and matching requirements have been met.

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Intergovernmental Accounts Receivable - State	0141	\$3,234,000	
State Capital Outlay Grants	3600		\$3,234,000

Transaction - the capital projects fund redeems investments that originally cost the LUA \$2,004,000. The redemption price of \$2,149,000 includes \$145,000 of interest.

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Cash in bank	0101	\$2,149,000	
Investments	0111		\$2,004,000
Earnings on investments or deposits	1500		\$145,000

Transaction - the LUA pays \$2,830,000 due on contracts payable.

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Construction Contracts payable	0433	\$2,830,000	
Cash in bank	0101		\$2,830,000

Transaction - the LUA accrues interest of \$64,000 on its capital projects fund investments at year end.

<u>Description</u>	<u>Account No.</u>	<u>DR</u>	<u>CR</u>
Interest receivable	0114	\$64,000	
Investment Income	1500		\$64,000

Explanation - Since the amount is considered available at year-end, it is recognized as revenue as of June 30.

Summary

1. Capital projects funds are used as a financial reporting vehicle often to demonstrate compliance with legal and contractual provisions and to compile certain cost data.
2. Capital projects funds exclude capital acquisition or construction of capital assets for proprietary or fiduciary funds.
3. Presentation of budgetary information for capital projects funds is not a required component of external financial statements according to GASB Statement 34. Budget comparisons are required for the general fund and each major special revenue fund with a legally adopted budget. However, the Department of Education requires budgeting capital projects funds.
4. Financial resources used for capital acquisition and construction are classified based on their source. Operating transfers from other funds, as well as the proceeds of most bond issuances, are reported as "other financing sources."
5. Sometimes capital projects funds report a temporary deficit, if, for instance, an LUA uses short-term borrowing to finance the early stages of construction. This deficit is temporary because it will be eliminated when the bond proceeds budgeted for the project are received in the second year.
6. Bonds issued in a Capital Projects Fund are reported as Other Financing Sources – Bond Proceeds on the operating statement for the fund.
7. Interest expense should be capitalized for the following types of assets: assets constructed or otherwise produced for a government's own use, assets intended for sale or lease that are constructed, and investments accounted for by the equity method provided that the investee's activities include the use of resources to acquire qualifying assets for its operations, and assets donated or granted to other entities.