



SECOND EDITION



Essentials of Accounting

for Governmental

and Not-for-Profit

Organizations



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ESSENTIALS OF ACCOUNTING FOR GOVERNMENTAL AND NOT-FOR-PROFIT ORGANIZATIONS

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PREFACE

The preface to the first edition of this text noted that the text was intended to provide a much more comprehensive coverage of accounting and financial reporting standards for governmental and not-for-profit organizations than is available in Advanced Accounting texts, but that would be brief enough to allow coverage of the material in less than a three semester-hour or four quarter-hour course. The first edition was well received by instructors whose objective is to teach public administration majors and others who need to be able to use financial reports of governments and not-for-profit organizations, as well as by instructors whose objective is to stress preparation for the Uniform CPA Examination. This edition of the text and the accompanying *Instructor's Guide* and the *Suggested Quiz and Examination Questions and Problems* booklet have been revised in accord with suggestions of users of the first edition as well as to incorporate changes in standards issued by the Governmental Accounting Standards Board, the Financial Accounting Standards Board, the United States General Accounting Office, and the American Institute of Certified Public Accountants.

The authors are indebted to the members of the Governmental Accounting Standards Board, and to the GASB's research staff, for access to their thinking, as well as permission to quote the GASB publications. The authors also wish to express their appreciation to the American Institute of Certified Public Accountants, which allowed use of questions and problems for Uniform CPA Examinations and permitted quotations from its publications, particularly in the audit guide series.

The authors would appreciate suggestions from users of this text for improvement of the presentation of material in the chapters, and suggestions for additional or improved questions and exercises.

Leon E. Hay
John H. Engstrom

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Chapter 1

THE FRAMEWORK FOR ACCOUNTING AND FINANCIAL REPORTING FOR GOVERNMENTAL AND NOT-FOR-PROFIT ORGANIZATIONS

Many persons who practice accounting and many who teach accounting maintain that there is only one “body of generally accepted accounting principles” (GAAP) which applies to accounting and financial reporting by all entities. Although a number of attempts have been made, no one has ever succeeded in producing a definitive description of universal GAAP. In place of a concise statement of GAAP, a series of statements of accounting and financial reporting standards have been issued by organizations whose pronouncements are accepted as authoritative. One such organization in the United States is the Financial Accounting Standards Board (FASB). The FASB sets standards for financial reports published by profit-seeking businesses for distribution to stockholders and creditors, and others not actively involved in the management of the business.

A second organization, the Governmental Accounting Standards Board (GASB), sets accounting and financial reporting standards for state and local governments in the United States. A separate standards-setting organization was considered necessary because governments have no stockholders or other owners, they render services with no expectation of earning net income, and have the power to require taxpayers to support financial operations whether or not they receive benefits

in proportion to taxes paid. Further, the form of government in the United States requires interrelationships between a state government and local governments established in conformity with state law, and interrelationships within any one government between the executive and legislative branches, that have no parallel in business organizations. Thus, it is to be expected that GASB standards, discussed in the chapters of this book devoted to accounting for state and local governments, differ in many respects from FASB standards discussed in books concerned with financial accounting for businesses.

Commonly, colleges and universities, voluntary health and welfare organizations, libraries, museums, churches, and so on are similar to governments in that they exist to render services to constituents with no expectation of earning net income from those services, have no owners, and seek financial resources from persons who do not expect either repayment or economic benefits proportionate to the resources provided. At the present time, however, the FASB has the authority to establish accounting and financial reporting standards for nongovernmental not-for-profit entities, while the GASB has the authority to establish standards for not-for-profit entities whose financial data may be included in the financial statements of a governmental reporting entity.¹ Neither the FASB nor the GASB has issued statements explicitly intended to establish a comprehensive set of accounting and financial reporting standards for not-for-profit entities. The FASB has established standards for recognition of depreciation and has proposed standards for recognition of revenue from contributions, which supersede certain portions of AICPA audit guides and Statements of Position issued prior to 1982. Accordingly the chapters of this book concerned with colleges and universities, hospitals, voluntary health and welfare organizations, and other not-for-profit entities are based on pronouncements of the American Institute of Certified Public Accountants (AICPA) and other bodies whose pronouncements are considered as authoritative, as amended by FASB statements applicable to nongovernmental entities. Illustration 1-1 lists the major sources of GAAP for governments and not-for-profit entities.

OBJECTIVES OF ACCOUNTING AND FINANCIAL REPORTING

Both the Financial Accounting Standards Board and the Governmental Accounting Standards Board have taken the position that the establishment of accounting and financial reporting standards should be guided by conceptual considerations in order that the body of standards be internally consistent and that the standards address broad issues expected to be of importance for a significant period of time. The corner-

¹According to a proposal approved for exposure by the Financial Accounting Foundation, each governmentally owned college, university, health care institution, and gas or electric utility is to be required to follow FASB financial reporting standards unless its governing board makes an irrevocable election to follow GASB standards.

ILLUSTRATION 1–1 Major Sources of Accounting and Financial Reporting Standards for Governmental and Not-for-Profit Organizations

<i>Organization</i>	<i>Major Sources of Standards</i>
Federal government agencies	U.S. General Accounting Office, <i>GAO Policy and Procedures Manual for Guidance of Federal Agencies, Title 2—Accounting</i> . U.S. Office of Management and Budget, <i>U.S. Government Standard General Ledger</i> . U.S. Department of the Treasury, <i>Treasury Financial Manual</i> .
State and local governments	Governmental Accounting Standards Board, <i>Statements, Interpretations, and Technical Bulletins</i> .
Public schools	National Center for Education Statistics, <i>Financial Accounting for Local and State School Systems</i> .
Colleges and universities*	American Institute of Certified Public Accountants (AICPA), <i>Audits of Colleges and Universities</i> . National Association of College and University Business Officers, <i>College and University Business Administration</i> .
Health care providers*	AICPA, <i>Audit and Accounting Guide, Audits of Health Care Providers</i>
Voluntary health and welfare organizations*	AICPA, <i>Audits of Voluntary Health and Welfare Organizations</i> .
Other not-for-profit organizations*	AICPA, <i>Audits of Certain Nonprofit Organizations</i> .

*The FASB has the responsibility for issuing financial reporting standards for nongovernmental, not-for-profit organizations. The GASB has jurisdiction over financial reporting of governmentally related not-for-profit organizations. Also see footnote 1 on p. 2.

stone of a conceptual framework is said to be a statement of the objectives of financial reporting.

Objectives of Financial Reporting by Not-for-Profit Entities

In its *Statement of Financial Accounting Concepts No. 6*, the FASB emphasized that its concern is with financial reporting to users who lack the authority to prescribe the information they want and who must rely on the information management communicates to them. Further, the FASB believes that such persons use financial information for only economic decisions. Therefore, the FASB stresses that the objective of financial reporting by not-for-profit organizations is to provide information to “present and potential resource providers and others in making rational decisions about allocating resources to not-for-profit organizations.”²

²Financial Accounting Standards Board, *Statement of Financial Accounting Concepts No. 6* (Norwalk, Conn., 1985), par. 9.

Objectives of Accounting and Financial Reporting for Governmental Units

The Governmental Accounting Standards Board was established in 1984 as the successor to the National Council on Governmental Accounting (NCGA). In 1987 the GASB issued its *Concepts Statement No. 1, Objectives of Financial Reporting* for state and local governments. In that statement the Board noted:

The Board believes that financial reporting plays a major role in fulfilling government's duty to be publicly accountable in a democratic society. Public accountability is based on the belief that the taxpayer has a "right to know," a right to receive openly declared facts that may lead to public debate by the citizens and their elected representatives. Use of financial reporting by citizens and legislative and oversight officials is pervasive. . . .³

Financial reports of state and local governments, according to the Governmental Accounting Standards Board, are used primarily: (1) to compare actual financial results with the legally adopted budget; (2) to assess financial condition and results of operations; (3) to assist in determining compliance with finance-related laws, rules, and regulations; and (4) to assist in evaluating efficiency and effectiveness.

PRINCIPLES OF ACCOUNTING AND FINANCIAL REPORTING FOR STATES AND LOCAL GOVERNMENTS

The objectives of accounting and financial reporting for states and local governments are reflected in 12 principles which are set forth and explained in the GASB *Codification of Governmental Accounting and Financial Reporting Standards*. Those principles which are most important for the purposes of this chapter are reproduced below. Chapters 2 through 10 of this book present more detailed explanations of the principles and illustrate their application to accounting and financial reporting of governmental units. The first principle states:

A governmental accounting system must make it possible both: (a) to present fairly and with full disclosure the financial position and results of financial operations of the funds and account groups of the governmental unit in conformity with generally accepted accounting principles; and (b) to determine and demonstrate compliance with finance-related legal and contractual provisions.

The American Institute of Certified Public Accountants (AICPA) accepts the GASB as being vested with the responsibility for the issuance

³Governmental Accounting Standards Board, *Concepts Statement No. 1, Objectives of Financial Reporting* (Norwalk, Conn., 1987), p. ii.

of pronouncements on governmental accounting standards. Auditors of state and local governmental entities should look to GASB pronouncements as the primary source of generally accepted accounting principles.⁴ However, some state laws require governmental units to follow practices (such as cash basis accounting) which are not consistent with generally accepted accounting principles. In those cases, financial statements and reports prepared in compliance with state law are considered to be “special reports” or “supplemental schedules” and are **not** the basic general purpose financial statements discussed in the section “Governmental Financial Reporting.”

The financial managers of governmental units are called upon to demonstrate compliance with numerous legal and contractual requirements. Accordingly, fund accounting is required. Fund accounting, and the term **fund**, are defined by the GASB as:

Governmental accounting systems should be organized and operated on a fund basis. A fund is defined as a **fiscal and accounting entity** with 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.⁵ (Emphasis added.)

Note that the definition of the word **fund** given above requires that two conditions must be met for a fund, in a technical sense, to exist: (1) there must be a **fiscal entity**—assets set aside for specific purposes, and (2) there must be a double-entry **accounting entity** created to account for the fiscal entity.

States and local governments use seven types of funds to achieve the objectives outlined above. The seven funds are organized into three categories:

Governmental Funds

Four fund types are classified as **governmental** funds. These are:

1. The **general fund**, which accounts for most of the basic services provided by the governmental unit. Technically, this fund accounts for all resources other than those required to be accounted for in another fund.

⁴American Institute of Certified Public Accountants, *Statement on Auditing Standards No. 52, The Meaning of “Present Fairly in Conformity with Generally Accepted Accounting Principles” in the Independent Auditor’s Report* (New York, 1988), par. 1.

⁵Governmental Accounting Standards Board, *Codification of Governmental and Financial Reporting Standards*, 2nd ed. (Norwalk, Conn., 1987), par. 1100.102.

2. **Special revenue funds**, which account for resources that are legally restricted, other than for debt service, major capital projects, and trust and agency relationships. Accounting for general funds and special revenue funds is discussed in Chapters 2 and 3 of this text.
3. **Capital projects funds**, which account for major capital projects other than those financed by proprietary or trust funds. Capital projects fund accounting is illustrated in Chapter 4.
4. **Debt service funds** (discussed in Chapter 6), which account for the payment of principal and interest on general long-term debt.

Measurement focus The GASB states that the four types of funds listed above are segregations of the financial resources and related liabilities of governmental-type activities; that is, activities undertaken in response to the needs of the public. Governmental-type activities are financed by taxes and other involuntary contributions from persons (and organizations) who do not receive services in any way related to the contributions they make. GASB standards provide that accounting systems of governmental funds are designed to measure (a) the extent to which financial resources obtained during a period are sufficient to cover claims incurred during that period against financial resources and (b) the net financial resources available for future periods. Thus, governmental funds are said to have a **flow of financial resources measurement focus**, as distinguished from business organizations which have an income determination measurement focus. Note that measurement focus refers to **what** is being expressed in reporting an entity's financial performance and position. Since all resources of governmental funds are raised in order to be expended, these funds are called **expendable funds**. Generally, governmental funds account only for assets held in the form of cash or which are expected to be turned into cash during the normal operations of the fund. If prepaid expenses and/or supplies inventories of a governmental fund are material in amount, and are expected to be consumed in the year following balance sheet date, they should be reported as current assets of the fund. Governmental funds do not account for fixed assets used in fund operations; fixed assets of this nature are called **general fixed assets**, and are placed under accounting control by recording them in the **General Fixed Assets Account Group (GFAAG)**. The GFAAG is only an accounting entity, not a fiscal entity; therefore, not a fund. Chapter 5 discusses accounting and reporting standards for the GFAAG.

Each governmental fund accounts for current liabilities which are to be paid from assets of that fund. Liabilities to be paid in the future (such as claims and judgments, compensated absences, and pension contributions) and long-term debt related to the acquisition of general fixed assets is recorded in the **General Long-Term Debt Account Group**

(GLTDAG).⁶ As is true of the GFAAG, the GLTDAG is only an accounting entity, not a fiscal entity; therefore, not a fund. Chapter 7 discusses accounting and reporting standards for the GLTDAG.

Basis of accounting The flow of financial resources measurement focus is accomplished by using an **accrual basis of accounting** to recognize the increases and decreases in net financial resources. Basis of accounting refers to **when** the effects of transitions or events should be recognized for financial reporting purposes. Until recently the basis of accounting for governmental funds was described as the “modified accrual” basis. From a practical viewpoint, the accrual basis now specified in GASB standards and the modified accrual basis formerly required both mean that accrual accounting, as it is understood in accounting for business organizations, is used in accounting for governmental funds to the extent that it is reasonable to do so. No transaction or event can be recorded in accounts unless the effects of the transaction or event can be expressed in terms of a monetary unit. Thus, it is said the effects must be **measurable**. An amount need not be known exactly to be measurable; it is considered measurable if a reasonable estimate can be made. In business accounting financial resource inflows must not only be measurable to be recognized as revenues of period, they must also be earned. In the case of governmental funds, the concept of earning is not always as clear-cut as it is in businesses. Under the modified accrual basis of accounting formerly required for governmental funds the criteria for recognition of revenues were **measurable** and **available** to finance expenditures of the fiscal period. Although the term “available” was dropped along with the term “modified accrual,” the concept still exists in that GASB standards provide that property tax collections received before the period for which the taxes were levied should be reported as deferred revenues, a liability, rather than as revenues.

Under the accrual basis of accounting for governmental funds the rule is that expenditures are recognized when goods or services are received; thus, generally, in the case of expenditures, the accrual basis for governmental funds is the same as the accrual basis for business organizations. In the case of interest on general long-term debt, expenditure recognition under the governmental fund accrual basis does diverge from the business accrual basis, as explained in Chapter 6.

⁶In 1987 the GASB proposed that all liabilities to be paid in the future, except long-term debt related to the acquisition of general fixed assets, be reported by the fund incurring the debt. As of mid-1989, the 1987 proposal has not been adopted; all general long-term debt is reported in the GLTDAG.

Proprietary Funds

Two types of funds used by state and local governments are classified as **proprietary** funds. The term indicates that the funds are used to account for a government's ongoing organizations and activities that are similar to those often found in the private sector. Proprietary funds are discussed in Chapter 8. The two types of proprietary funds are:

1. **Enterprise funds**, which are used when resources are provided primarily through the use of service charges to those receiving the benefit, or where it is deemed best to display a matching of revenues and expenses in the manner used by business enterprises. Examples of enterprise funds would be water and other utilities, airports, swimming pools, and transit systems.
2. **Internal service funds**, which account for services provided by one department or government, such as a print shop or motor pool, to another on a cost reimbursement basis.

Proprietary funds are considered to be “nonexpendable,” in that the revenues are generated through user charges intended to cover operating costs and expenses. Proprietary funds use accrual accounting, in the same manner as business enterprises.

Fiduciary Funds

The third general category of funds used by state and local governments is called **fiduciary**. These are:

Trust and agency funds, which account for resources for which the governmental unit is acting as a trustee or as a collecting/disbursing agent. The type of accounting used by trust and agency funds depends upon the nature and purpose of the fund. **Agency funds** and **expendable trust funds** are accounted for in a manner similar to governmental funds. **Nonexpendable trust funds** and **pension trust funds** are accounted for in a manner similar to proprietary funds. Fiduciary funds are discussed in Chapter 9.

Transactions and events which require recognition in two or more fund types and/or account groups are discussed in Chapter 10.

Number of Funds Required

In the GASB Summary Statement of Principles, the principle which follows the definition of fund types and account groups is often overlooked. This principle states that *governmental units should establish and maintain those funds required by law and sound financial administration*. It means exactly what it says: If in a specific governmental unit state law and/or agreements with creditors do not require that the re-