



FREEMAN
SHOULDERS

GOVERNMENTAL
AND
NONPROFIT
ACCOUNTING
THEORY AND PRACTICE
SIXTH EDITION

REVISED FOR GASB STATEMENT 34

**"BASIC FINANCIAL STATEMENTS—AND MANAGEMENT'S DISCUSSION
AND ANALYSIS—FOR STATE AND LOCAL GOVERNMENTS"**

GOVERNMENTAL AND NONPROFIT ACCOUNTING

Theory and Practice

Sixth Edition

Revised for GASB *Statement 34*

"Basic Financial Statements—and
Management's Discussion and Analysis—
for State and Local Governments"

Robert J. Freeman
Texas Tech University

Craig D. Shoulders
Virginia Polytechnic Institute and State University

Prentice Hall
Upper Saddle River, New Jersey 07458

Executive Editor: Annie Todd
Editorial Assistant: Fran Toepfer
Editor-in-Chief: PJ Boardman
Executive Marketing Manager: Beth Toland
Production Editor: Marc Oliver
Associate Managing Editor: Sondra Greenfield
Manufacturing Buyer: Lisa DiMaulo
Senior Manufacturing Supervisor: Paul Smolenski
Senior Manufacturing/Prepress Manager: Vincent Scelta
Design Manager: Patricia Smythe
Cover Designer: Steve Frim
Cover Photo: Courtesy of Jefferson County Public Information
Composition: Omegatype Typography, Inc.

Copyright © 2000, 1999, 1996, 1993, 1988, 1983 by Prentice-Hall, Inc.
Upper Saddle River, New Jersey 07458

All rights reserved. No part of this book may be reproduced, in any form or by any means, without permission in writing from the publisher.

Library of Congress Cataloging-in-Publication Data

Freeman, Robert J.

Governmental and nonprofit accounting : theory and practice / Robert J. Freeman, Craig D. Shoulders.—Rev. 6th ed.

p. cm. — (Charles T. Horngren series in accounting)

Includes bibliographical references and index.

ISBN 0-13-026469-5

1. Municipal finance—United States—Accounting. 2. Local finance—United States—Accounting. 3. Finance, Public—United States—Accounting. 4. Fund accounting—United States. 5. Nonprofit organizations—United States—Accounting. I. Shoulders, Craig D. II. Title. III. Series.

HJ9777.A3 L95 2000

657'.835'00973—dc21

99-049060

Prentice-Hall International (UK) Limited, *London*
Prentice-Hall of Australia Pty. Limited, *Sydney*
Prentice-Hall Canada, Inc., *Toronto*
Prentice-Hall Hispanoamericana, S.A., *Mexico*
Prentice-Hall of India Private Limited, *New Delhi*
Prentice-Hall of Japan, Inc., *Tokyo*
Simon & Schuster Asia Pte. Ltd., *Singapore*
Editora Prentice-Hall do Brasil, Ltda., *Rio de Janeiro*

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1



GOVERNMENTAL AND NONPROFIT ACCOUNTING

Charles T. Horngren Series in Accounting
Charles T. Horngren, Consulting Editor

Advanced Accounting, 7/E

Beams/Brozovsky/Shoulders

Auditing: An Integrated Approach, 7/E

Arens/Loebbecke

Financial Statement Analysis, 2/E

Foster

Governmental and Nonprofit Accounting: Theory and Practice, 6/E

Freeman/Shoulders

Financial Accounting, 3/E

Harrison/Horngren

Cases in Financial Reporting, 2/E

Hirst/McAnally

Cost Accounting: A Managerial Emphasis, 9/E

Horngren/Foster/Datar

Accounting, 4/E

Horngren/Harrison/Bamber

Introduction to Financial Accounting, 7/E

Horngren/Sundem/Elliot

Introduction to Management Accounting, 11/E

Horngren/Sundem/Stratton

*Dedicated in Loving Honor
of Our Wives*

Beverly Freeman and Nancy Shoulders

*Who embody for us
the declaration of the Holy Scriptures
about a
Virtuous Wife*

*. . . For her worth is far above rubies.
The heart of her husband safely trusts in her;
So he will have no lack of gain.
She does him good and not evil all the days of her life. . . .*

—Proverbs 31:10–12

PREFACE

Governmental and nonprofit accounting, reporting, and auditing continue to evolve rapidly. Indeed, significant changes in the basic state and local government financial reporting model are on the not-too-distant horizon. Moreover, the ever-increasing scrutiny and accountability to which governments and nonprofit organizations are being subjected by the Congress, practitioners, investors and creditors, standards setters, and academicians clearly signal that their accounting, reporting, and auditing concepts, standards, and practices probably will continue to evolve rapidly. One result of this increased attention is that it is now virtually impossible to pass the Uniform CPA Examination without an understanding of governmental and nonprofit accounting.

We have *updated* this sixth edition of our text to incorporate the relevant portions of all authoritative pronouncements issued through mid-1998. This coverage includes GASB Statement 31 which requires fair value accounting for most investments of state and local governments and GASB Statement 32 which changes the reporting of Internal Revenue Code 457 deferred compensation plans to correspond to changes in the legal status of those plans. Too, other key GASB projects—including those on the proposed new financial reporting model and on service efforts and accomplishments reporting—are discussed.

In addition, while retaining the successful approach, comprehensiveness, and other strengths that have long been hallmarks of this text, we have further refined and improved the emphasis on the foundational aspects of governmental accounting and financial reporting—such as the nature and purposes of the various accounting entities—and the *unique approach for teaching* the state and local government accounting and reporting *model* that has proven so successful for students.

Not-for-Profit Organization Coverage

The sixth edition reorders three chapters to efficiently handle accounting and reporting for not-for-profit organizations, which are the most potentially cumbersome areas to address. This area is challenging not only because SFASs 116 and 117 permit a myriad of alternatives for nongovernment, not-for-profit health care organizations, colleges and universities, voluntary health and welfare organizations, and other nonprofit organizations, but also because GASB standards prohibit government entities from applying those FASB standards. Thus, for each of those types of organizations, there are two or more sets of reporting principles, practices, and/or standards that might apply.

Having found that students learn most effectively if they have an opportunity to master one of these multiple approaches or models before delving into another, we segregated the coverage of the not-for-profit organizations as follows:

- Chapter 16 covers accounting for government colleges and universities. Nongovernment university accounting and reporting are dealt with in an appendix to Chapter 18. This is accomplished by building on the coverage of SFASs 116 and 117 which comprises the core of that chapter and on material learned in Chapter 16 that applies to both nongovernment and

government colleges and universities. Addressing government college and university accounting immediately after completing the state and local government coverage should help students receive maximum benefit from the similarity of the two as they learn the uniquenesses of the government college and university model.

- Chapter 17 covers accounting and reporting for government health care organizations. As with colleges and universities, nongovernment health care organizations accounting and reporting are addressed in a separate appendix to Chapter 18. Students who have learned the requirements of SFASs 116 and 117 in Chapter 18 and special health care topics such as accounting for patient service revenues in Chapter 17 can bring that information together efficiently. This approach enables the students to understand nongovernment health care organization accounting and reporting with little additional effort.
- Chapter 18 discusses and illustrates SFASs 116 and 117 thoroughly in the context of nongovernment voluntary health and welfare organizations and other nonprofit organizations. The use of funds is not presumed in this chapter since the focus is on conveying the financial reporting requirements for these organizations. The discussion, diagrams, and illustrations allow students to grasp the key provisions of SFASs 116 and 117 quickly. As noted previously, the appendices facilitate understanding how these standards are applied in nongovernment colleges and universities and in nongovernment health care organizations.

Updated Single Audit Coverage

Coverage of single audit requirements has been updated for the latest revision of OMB Circular A-133, the 1998 OMB Circular A-133 Compliance Supplement, and the latest AICPA single audit guidance through mid-1998. This coverage includes the risk-based approach to identifying major federal programs and current single audit reporting requirements.

Problem Material

In addition to the normal adjustment and updating of problem material and questions, the sixth edition incorporates two new features in the end-of-chapter material. The first is the inclusion of a few short, focused exercises in most chapters that should help students master certain specific concepts. The second is the addition of a research problem at the end of most chapters. The Internet can be used to facilitate meeting the requirements of many of these research problems.

Pedagogical Refinements

Our unique approach to introducing students to the state and local government model—which allows them to understand and apply that model better and more quickly—is still a central feature of the sixth edition. This approach combines a strong emphasis on the underlying nature of the various fund types and account groups with transaction analysis using the accounting equations of the various fund types and account groups to break students out of the “business accounting mindset” and help them understand how the “pieces” of the government model complement one another. Many who have used prior editions of the text have attested to the effectiveness of this approach in the college classroom. This pedagogy **enables students to grasp concepts and principles** at this **early** stage, where without it most would not understand until well into the course. Indeed, for many this approach provides the “key” to unlock the door to understanding state and local government accounting and financial reporting.

Other Changes

Several other aspects of this revision are noteworthy as well. Among these are the following:

- **Chapter 5** explains and illustrates GASB Statement 31 on accounting for investments.
- **Financial reporting** is covered in two chapters in the sixth edition. Chapter 13, “Financial Reporting: The CAFR and GPFS” covers the basic financial reporting requirements and presumes a simple situation. Chapter 14, “Financial Accounting and Reporting: Complex Reporting Entities and Non-GAAP Bases of Accounting,” addresses more advanced reporting issues that are encountered by complex entities or entities that use non-GAAP bases of accounting during the year.
- **Chapter 15 of this revised sixth edition covers the key requirements of the new reporting model standard: GASB Statement 34, “Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments.”** This chapter provides an effective tool for professors and students to deal with this time of transition from the current standards to the new reporting model. The current standards remain in effect for some governments for fiscal years ending on or before June 15, 2004. Large governments must apply *Statement 34* for fiscal years ending after June 15, 2002. All governments have the option of early implementing the new model. Chapter 15 points out the major changes required from the current guidance (covered in Chapters 2 to 14), and explains and illustrates the requirements of the new model. This approach should help students master both the current model and the new model efficiently.
- **Chapter 19, “Federal Government Accounting,”** has been updated for recent changes in federal financial management and in accounting and reporting for federal agencies. Bruce K. Michelson of the U.S. General Accounting Office provided invaluable assistance in determining the appropriate depth of coverage for this important chapter and in updating for changes since the last edition.

Acknowledgments

We are grateful for the many excellent suggestions made by the individuals who reviewed the fifth edition in preparation for this edition:

Charles Fazzi, Robert Morris College
 Frederk M. Stiner, Jr., University of Delaware
 Donald Keller, California State University—Chico
 Saleha B. Khumawala, University of Houston

Likewise, we appreciate the reviews of the drafts of various chapters and other significant assistance contributed by the following individuals:

David R. Bean, Director of Research, Governmental Accounting Standards Board
 Rob Garner, City of Orlando, Florida
 George Hunt, Texas Tech University
 Norwood J. (Woody) Jackson, Jr., U.S. Office of Management and Budget
 James A. Lampe, Texas Tech University
 Bruce K. Michelson, U.S. General Accounting Office
 G. Michael (Mickey) Miller, City of Orlando, Florida
 David R. Olson, University of Illinois at Springfield
 G. Robert Smith, Auburn University
 Penelope S. Wardlow, Governmental Accounting Standards Board

George Hunt assisted us throughout the revision process and also searched numerous comprehensive annual financial reports to identify government financial statement examples for the text. Sharendale Bruni not only managed and produced the manuscript for the text in an efficient and professional manner, but also used her professional background and experience to assist in other ways with supplements and other issues that had to be addressed.

Finally, we can never adequately express our love and appreciation to our wives, Beverly Freeman and Nancy Shoulders. Their contributions to all that we do—including the revision of this text—are essential. They encouraged, supported, and advised us as we labored over this revision and took care of many responsibilities that were rightfully ours in order to enable us to have the time and the energy to complete this task. Clearly, they multiply what we are able to accomplish by their help and support. Indeed, Beverly and Nancy are full partners in all that we do.

Robert J. Freeman
Craig D. Shoulders

BRIEF CONTENTS

Preface xxiii

- 1 Governmental and Nonprofit Accounting
Environment and Characteristics 1

PART I: STATE AND LOCAL GOVERNMENT ACCOUNTING AND REPORTING

- 2 State and Local Government Accounting
Environment, Objectives, and Principles 22
- 3 Budgeting, Budgetary Accounting, and Budgetary Reporting 70
- 4 General and Special Revenue Funds 112
- 5 Revenue Accounting—Governmental Funds 169
- 6 Expenditure Accounting—Governmental Funds 212
- 7 Capital Projects Funds 266
- 8 Debt Service Funds 310
- 9 General Fixed Assets; General Long-Term Debt
Introduction to Interfund-Account Group Accounting 349
- 10 Trust and Agency (Fiduciary) Funds 394
- 11 Internal Service Funds 427
- 12 Enterprise Funds
Summary of Interfund-Account Group Accounting 459
- 13 Financial Reporting: The CAFR and GPFS 505
- 14 Financial Accounting and Reporting
Complex Reporting Entities and Non-GAAP Bases of Accounting 542
- 15 The New Government Reporting Model: GASB Statement 34 580

PART II: FEDERAL AND NONPROFIT ORGANIZATION ACCOUNTING AND REPORTING

- 16 Accounting for Colleges and Universities 627
- 17 Accounting for Health Care Organizations 678
- 18 Non-SLG Not-for-Profit Organizations:
SFAS 116 and 117 Approach 714
- 19 Federal Government Accounting 758

PART III: PUBLIC SECTOR AUDITING

- 20 Auditing 796
- Index 839

CONTENTS

Preface xxiii

CHAPTER 1 Governmental and Nonprofit Accounting *Environment and Characteristics* 1

Characteristics and Types of G&NP Organizations	1
Growth and Importance of the G&NP Sector	2
The G&NP Environment	2
Objectives of G&NP Accounting and Financial Reporting	5
Characteristics of G&NP Accounting and Financial Reporting	6
Funds and Fund Accounting	7
Budgets and Appropriations	8
Some Other Distinguishing Characteristics	10
Summary Comparison with Commercial Accounting	10
Authoritative Sources of G&NP Accounting Principles and Reporting Standards	11
Evolution of Separate Principles	12
AICPA Audit and Accounting Guides	12
The FASB	13
The GASB	14
GAAP Hierarchy	16
Concluding Comments	17

PART I: STATE AND LOCAL GOVERNMENT ACCOUNTING AND REPORTING

CHAPTER 2 State and Local Government Accounting *Environment, Objectives, and Principles* 22

Environment and Objectives	23
Environment—Governmental-Type Activities	23
Users of Financial Reports—Governmental-Type Activities	28
Uses of Financial Reports—Governmental-Type Activities	29
Environment, Users, and Uses—Business-Type Activities	29
Objectives of Financial Reporting	31
The GASB Principles	32
GAAP and Legal Compliance	32
Fund Accounting	34
Transaction Analysis and Fund Accounting	41
Fixed Assets and Long-Term Liabilities	44
Basis of Accounting	46
The Budget and Budgetary Accounting	48
Classification and Terminology	49
Financial Reporting	53
Concluding Comments	56

APPENDIX 2-1 EVOLUTION OF ACCOUNTING PRINCIPLES	57
Initial Evolution (1900–1933)	57
National Committees on Municipal and Governmental Accounting (1934–1974)	58
National Council on Governmental Accounting (1974–1984)	60

CHAPTER 3 Budgeting, Budgetary Accounting, and Budgetary Reporting 70

Budgetary Planning, Control, and Evaluation	71
Planning	71
Control	71
Evaluation	72
Basic Budgetary Terminology	72
Capital vs. Current Budgets	72
Tentative vs. Enacted Budgets	73
General vs. Special Budgets	74
Fixed vs. Flexible Budgets	74
Executive vs. Legislative Budgets	75
Budgetary Approaches and Emphases	75
The Budget as Information	75
Recommended Budgeting Framework and Practices	76
Alternative Expenditure Budgeting Approaches	76
The Object-of-Expenditure Approach	77
Budget Preparation	80
Overview	81
Preliminary Steps	81
Preparing the Budget	82
Legislative Consideration and Action	83
Budget Execution	84
Budgetary Accounting Overview	85
General Ledger	85
Revenues and Expenditures Subsidiary Ledgers	85
Budgetary Reporting Overview	90
The Budgetary Basis	91
Interim Budgetary Statements	91
Annual Budgetary Statements	93
Concluding Comments	95
APPENDIX 3-1 ALTERNATIVE EXPENDITURE BUDGETING APPROACHES	95
The Performance Approach	95
Advantages	96
Limitations	97
Comment	97
The Program and Planning-Programming-Budgeting (PPB) Approaches	98
Advantages	99
Limitations	100
Comments	100
Zero-Base Budgeting	100

In Sum	102
Selecting an Appropriate Approach	103
CHAPTER 4 General and Special Revenue Funds	112
Measurement Focus	113
Purposes and Assumptions of This Chapter	113
General Fund Accounting Illustrative Example	114
Entries during 19X1	115
Alternative Account Structure and Entries	123
Adjusting Entries at Year End	124
Preclosing Trial Balances—End of 19X1	125
Closing Entries—End of 19X1	125
Reserve for Encumbrances	130
The Budgetary Fund Balance Account	131
Postclosing Trial Balances—End of 19X1	132
Balance Sheets	133
The Interim Balance Sheet	133
The Year-End Balance Sheet	133
Unreserved Fund Balance	134
Fund Balance Reserves	134
Unreserved Fund Balance Designations	135
Due To/From and Advance To/From	136
Exclusion of Fixed Assets and Long-Term Debt	136
Statement of Revenues, Expenditures, and Changes in Fund Balance	137
Total Fund Balance Approach	137
Residual Equity Transfers	138
Restatements	139
Statement of Revenues, Expenditures, and Changes in Fund Balance—Budget and Actual	139
Entries during 19X2	142
Combining SRF Statements	143
Concluding Comments	147
APPENDIX 4-1 GENERAL LEDGER WORKSHEET AND SUBSIDIARY LEDGERS	147
CHAPTER 5 Revenue Accounting—Governmental Funds	169
Revenue Definition and Recognition	169
Classification of Revenue Accounts	171
General Fund Revenues	171
Revenues of Other Funds	172
Revenues of a Fund versus Revenues of the Governmental Unit	172
Taxes	172
Taxpayer-Assessed Taxes	173
Property Taxes	174
Property Tax Statements	183
Licenses and Permits	183

Intergovernmental Revenues	184
Intergovernmental Revenue Account Classifications	184
Accounting for Intergovernmental Revenues	185
Charges for Services	189
Fines and Forfeits	191
Miscellaneous Revenues	192
Revenue Budget Revisions	197
Changes in Accounting Principles	198
Changed GASB Standards	198
Prospective Application	199
Retroactive Application	199
Concluding Comments	199
CHAPTER 6 Expenditure Accounting—Governmental Funds	212
Expenditure Definition and Recognition	213
Expenditure Accounting Controls	215
Expenditure Accounting Procedures	216
Personal Services	216
Materials and Supplies	218
Other Services and Charges	223
Classification of Expenditures	226
Accounting for Allocations and Allotments	227
Appropriations Revisions	228
Adjusting Entries	229
Encumbrances	230
Debt Service	230
Claims and Judgments	231
Compensated Absences	235
Pension Plan Contributions	237
Changes in Accounting Principles	238
Changes between Alternative Principles	238
Changed GASB Standards	239
Concluding Comments	239
APPENDIX 6-1 CLASSIFICATION OF EXPENDITURES	240
Classification by Function or Program	240
Classification by Organization Unit	242
Classification by Activity	242
Classification by Character	244
Classification by Object Classes	245
APPENDIX 6-2 ACCOUNTING FOR ANNUAL APPROPRIATIONS—	
VARIOUS ENCUMBRANCES ASSUMPTIONS	246
Assumption A1	247
Assumption A2	247
Assumption B	248

APPENDIX 6-3 ACCOUNTING FOR CONTINUING APPROPRIATIONS 249

Assumption C1 249

Assumption C2 250

CHAPTER 7 Capital Projects Funds 266

CPF Operations and Accounting Standards 267

Sources of Financial Resources 268

Number of Funds Required 268

Capital Projects Fund Life Cycle 268

The Budget 269

Interim Financing 270

Costs Charged to Projects 271

Intergovernmental Revenues 272

Bond Premiums, Discounts, and Issuance Costs 273

CPF Case Illustration Begun—19X1 273

Alternative Account Structure and Entries 274

Budgetary Entry 274

19X1 Transactions and Events 275

Preclosing Trial Balance—End of 19X1—Project Incomplete 276

Closing Entries—End of 19X1—Project Incomplete 276

Financial Statements—End of 19X1—Project Incomplete 280

CPF Case Illustration Concluded—19X2 283

19X2 Transactions and Events 285

Financial Statements—End of 19X2—Project Complete 287

Other CPF Operations, Accounting, and Reporting Matters 289

Bond Anticipation Notes (BANs) 289

Investment of Idle Cash; Arbitrage 290

Disposing of Fund Balance or Deficit 291

Reporting Several Projects Financed Through One Fund 291

Combining CPF Statements 292

Concluding Comments 294

APPENDIX 7-1 DETAILED GENERAL LEDGER WORKSHEET 294

APPENDIX 7-2 GENERAL LEDGER WORKSHEET
AND SUBSIDIARY LEDGERS 294

CHAPTER 8 Debt Service Funds 310

DSF Environment, Financing, and Expenditure Recognition 311

Types of Long-Term Debt 311

Fixed vs. Variable Interest Rates 312

Planning Debt Service Payments 312

Bond Registration and Fiscal Agents 313

Required DSF Reserves 313

Bond Ratings 314

Bond Insurance 314

Sources of Financing 314

DSF Investments 315

Debt Service Expenditure Recognition 315

Debt Service Fund for a Serial Bond Issue	316
Illustrative Entries	317
Financial Statements	319
Special Assessment Debt Service Funds	321
Illustrative Entries	322
Financial Statements	324
Other Conventional DSF Considerations	325
Nonaccrual of Interest Payable	325
Combining Balance Sheet	325
Combining Operating Statement	326
Single Debt Service Fund for Several Bond Issues	326
Pooling of Investments	327
Debt Service Funds for Deep Discount Issues	328
Debt Service Fund for a Term Bond Issue	329
Sinking Fund Requirements	329
Refundings	331
Reasons for Refundings	331
Refundings Defined	331
Defeasance of Old Debt	332
Debt Service Funds for Refundings	333
Current Refunding—Retirement of Old Debt	334
Advance Refunding—Legal and In-Substance Defeasance of Old Debt	335
Use of Both Existing Resources and New Debt	
Proceeds in Refundings	335
Financial Statement Presentation of Refundings	336
Advance Refunding Disclosures	336
Concluding Comments	339

CHAPTER 9 General Fixed Assets; General Long-Term Debt

***Introduction to Interfund-Account Group Accounting* 349**

General Fixed Assets	349
General Fixed Assets Defined	350
Acquisition and Initial Valuation	350
Classification	351
Infrastructure GFA	353
Capitalization Policy	354
GFA Property Records	355
Inventory of Fixed Assets	355
Additions, Betterments, and Renewals	356
Depreciation/Accumulated Depreciation	356
Recording Fixed Asset Acquisitions	357
Sale, Retirement, or Replacement	362
Intragovernmental Sale, Transfer, and Reclassification	364
Property Damaged or Destroyed	366
General Fixed Assets Statements and Schedules	367