

INTRODUCTION TO  
GOVERNMENTAL AND  
NOT-FOR-PROFIT  
ACCOUNTING

Fourth Edition



Joseph R. Razek  
Gordon A. Hosch  
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FOURTH EDITION



# **INTRODUCTION TO GOVERNMENTAL AND NOT-FOR-PROFIT ACCOUNTING**

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***To our families***

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# Preface

This is a basic-level text on governmental and not-for-profit accounting. Although the emphasis is on governmental units, other not-for-profit organizations are covered in some depth.

The text is organized and structured in a manner that permits its use by a number of different types of readers. For example, people interested only in accounting for general state and local governments can skip the chapters on the federal government, not-for-profit organizations, health care entities, and colleges and universities. People interested in accounting for not-for-profit hospitals can concentrate on the not-for-profit organization and health care entity accounting chapters. Public administration students who have not had a course in basic accounting could start with the independent chapter on the fundamentals of accounting and draw selectively on the governmental and other chapters.

Consistent with the focus on flexibility, this text can be used by people who want to emphasize the accumulation and reporting of financial information; they can answer the questions and cases and work the exercises and problems at the end of each chapter. Those who are interested in a more conceptual approach can avoid the presentation of detailed journal entries and financial statements by concentrating on the conceptual and analytical aspects of the text, questions, cases, exercises, and problems.

To make this text even more flexible, we have divided most of the chapters into independent modules, which can be covered as separate units. Thus a section or two may be assigned for a particular class meeting, while an entire chapter may be assigned for another meeting.

This text can be used by the following major groups because of its built-in flexibility:

1. Nonaccounting majors (e.g., students in public administration programs) who desire a basic understanding of general, governmental, not-for-profit, and health care accounting and reporting.
2. Accounting majors who wish to learn the fundamentals of governmental and not-for-profit accounting in less than a full semester.
3. Accounting majors who desire a full semester course on governmental and not-for-profit accounting. This text provides an excellent basis for discussing governmental and not-for-profit topics.
4. Persons employed by governmental and not-for-profit organizations, including the federal government, health care entities, colleges and universities, and voluntary health and welfare organizations.

5. Persons preparing for civil service examinations.
6. Persons preparing for the Uniform Certified Public Accountant (CPA) and the Certified Government Financial Manager (CGFM) examinations.
7. Persons who wish, on their own, to learn about the accounting and reporting practices of governmental and not-for-profit organizations.

In order to facilitate the transition into interfund accounting we have included, in chapter 2, a conceptual preview of the individual fund financial statements. This preview permits a full discussion, throughout the text, of transactions that affect several funds.

## New Features of This Edition

We have increased coverage of several key areas in this edition and have added new problems and exercises, several of which are taken from past CPA examinations. We have also added thought-provoking ethics cases to provide increased flexibility in how this text is used. Many chapters contain a vignette, showing how the material covered is applied in a real-world situation, and minicases that present the reader with issues requiring judgment and provide a vehicle for class discussion.

All chapters have been updated to cover significant recent changes made in governmental and not-for-profit accounting and financial reporting by the accounting standards-setting bodies. Appropriate coverage has also been given to accounting changes that will become effective after this text is published and to anticipated changes that were being discussed while the text was being written. This includes Governmental Accounting Standards Board (GASB) *Statement No. 31* (Investments), *No. 33* (Nonexchange Transactions), and *No. 34* (Basic Financial Statements). It also includes Financial Accounting Standards Board (FASB) *Statement No. 116* (Contributions), *No. 117* (Not-for-Profit Reporting), and *No. 124* (Investments), as well as recent federal financial reporting changes approved by the Principals of the Federal Accounting Standards Advisory Board.

The chapters on not-for-profit accounting, health care accounting, and college and university accounting have been reorganized and rewritten. The not-for-profit accounting chapter covers voluntary health and welfare and other not-for-profit organizations, and also serves to introduce the accounting and reporting requirements for not-for-profit health care entities and colleges and universities. The health care and college and university chapters cover both the general principles for each industry as well as the differences affecting the governmental and not-for-profit segments of each industry. The health care chapter also has new modules on interpreting and analyzing hospital financial statements through typical financial ratios and intra-industry comparisons. These modules and the related problems will stimulate student interest in and discussion of the uses of accounting information.

The materials on state and local government financial reporting have been updated for coverage of the new financial reporting model, the reporting entity, and financial condition analysis. New examples have been added to more clearly describe the nature of lease accounting. In addition, the module on pension trust funds has been rewritten to reflect new GASB pronouncements in simpler format. Finally, extra

material has been included on the measurement of pension costs and other postemployment benefits.

The materials on budgeting have been updated. Balanced budgets are discussed and excerpts from the law of one state are included. Readers can follow a complete set of illustrations to prepare a budget and a control report for a governmental unit. The problems in this chapter form a case, permitting readers to prepare a complete budget using individual problem materials. These problems have been adapted for a computer project, with additional data and “what-ifs” which, along with a template, are available to adopters.

The chapter on fundamentals of accounting has been rewritten to make the text more readily adaptable for teaching public administration and other nonaccounting majors. The problems, all of which are new, take the student from transaction analysis through preparation of journal entries, posting to ledgers, preparation of trial balances and financial statements, and closing entries.

As in the third edition, this text includes actual financial statements issued by governmental and other units. The use of actual financial statements adds an element of “real world” application to the text.

## Acknowledgments

We would like to express our most sincere appreciation to the many students, faculty members, and members of the professional community who have reviewed this text and offered suggestions for improvement. We also offer our special thanks to the following people:

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# Brief Contents

Chapter 1	Introduction to Accounting for Nonbusiness Organizations	1
Chapter 2	The Use of Funds in Governmental Accounting	11
Chapter 3	The Budgetary Process	60
Chapter 4	The Governmental Fund Accounting Cycle General and Special Revenue Funds—An Introduction	111
Chapter 5	The Governmental Fund Accounting Cycle General and Special Revenue Funds—Special Problems	146
Chapter 6	The Governmental Fund Accounting Cycle Debt Service Funds, Capital Projects Funds, and Account Groups	202
Chapter 7	The Governmental Fund Accounting Cycle Proprietary-Type Funds and Pension Trust Funds	260
Chapter 8	The Governmental Fund Accounting Cycle Expendable Trust Funds, Nonexpendable Trust Funds, Agency Funds, and Special Assessment Accounting	311
Chapter 9	The Governmental Fund Accounting Cycle Comprehensive Annual Financial Report and Current Issues	356
Chapter 10	Federal Government Accounting and Reporting	426
Chapter 11	Accounting for Not-for-Profit Organizations	455
Chapter 12	Accounting for Health Care Organizations	496
Chapter 13	Accounting for Colleges and Universities	547
Chapter 14	Fundamentals of Accounting	591



# Contents

**Preface** ix

**CHAPTER 1 Introduction to Accounting for Nonbusiness Organizations** 1

What Is Accounting? 2 Environment of Nonbusiness Accounting and Reporting 3  
Users of Accounting Information 4 Generally Accepted Accounting Principles  
(GAAP) 5 The Entity Concept 5 Planning and Control 6 The Matching  
Concept 6 Consistency 6 Periodicity 6 Establishing Generally Accepted  
Accounting Principles 6 Review Questions 9 Cases 9 Exercises 9

**CHAPTER 2 The Use of Funds in Governmental Accounting** 11

The Framework of Fund Accounting 13 Governmental-Type Funds and  
Account Groups 17 Proprietary-Type Funds 32 Fiduciary-Type Funds 38  
Review Questions 44 Cases 46 Ethics Cases 46 Exercises 46 Problems 51

**CHAPTER 3 The Budgetary Process** 60

Budget Laws 61 Types of Budgets 63 Approaches to Budgeting 64  
Preparing a Budget 67 Using Budgetary Information 94 Governmental  
Budgeting in Practice—Clark County, Nevada 96 Review Questions 101  
Cases 102 Exercises 102 Problems 106

**CHAPTER 4 The Governmental Fund Accounting Cycle**  
General and Special Revenue Funds—An Introduction 111

A Basic Fund Accounting System 113 A More Refined System 120  
Summary Problem 129 Review Questions 132 Cases 133 Ethics Cases 133  
Exercises 133 Problems 138

**CHAPTER 5 The Governmental Fund Accounting Cycle**  
General and Special Revenue Funds—  
Special Problems 146

Property Tax Accounting 147 Budgetary Accounting 154 Interfund  
Transactions 160 Accounting for Grants 163 Other Problems 163 Year-end  
Financial Statements 167 Summary Problem 168 Governmental Accounting



in Practice—Jefferson Parish, Louisiana 183   Review Questions 187   Cases 188  
Ethics Cases 189   Exercises 189   Problems 193

**CHAPTER 6   The Governmental Fund Accounting Cycle**

Debt Service Funds, Capital Projects Funds,  
and Account Groups      202

Measurement Focus and Basis of Accounting 203   Debt Service Funds 204  
Governmental Accounting in Practice—The City of Columbus, Ohio 212  
Capital Projects Funds 213   Governmental Accounting in Practice—The City  
of Columbus, Ohio 227   Account Groups: General Fixed Assets Account  
Group 228   Governmental Accounting in Practice—The City of New Orleans 234  
Account Groups: General Long-Term Debt Account Group 235  
Governmental Accounting in Practice—The City of New Orleans 240   Review  
Questions 243   Cases 243   Ethics Cases 244   Exercises 244   Problems 249

**CHAPTER 7   The Governmental Fund Accounting Cycle**

Proprietary-Type Funds and Pension Trust Funds      260

Proprietary-Type Funds: Internal Service Funds 261   Governmental  
Accounting in Practice—The City of Columbus, Ohio 267   Proprietary-Type  
Funds: Enterprise Funds 268   Governmental Accounting in Practice—The City  
of Columbus, Ohio 278   Use of Special Assessments for Services 282  
Fiduciary-Type Funds: Pension Trust Funds 282   Measurement of Annual  
Pension Cost 291   Reporting Pension Expense (Expenditure) 292   Financial  
Reporting for Defined Contribution Plans 292   Other Postemployment  
Benefits 292   Governmental Accounting in Practice—The City of Baton Rouge  
and Parish of East Baton Rouge Employees' Retirement System 292   Review  
Questions 296   Cases 297   Ethics Case 297   Exercises 298   Problems 301

**CHAPTER 8   The Governmental Fund Accounting Cycle**

Expendable Trust Funds, Nonexpendable Trust Funds,  
Agency Funds, and Special Assessment Accounting      311

Fiduciary-Type Funds: Expendable Trust Funds 312   Governmental Accounting  
in Practice—The City of New Orleans, Louisiana 316   Fiduciary-Type Funds:  
Nonexpendable Trust Funds 317   Governmental Accounting in Practice—  
The State of New York 326   Fiduciary-Type Funds: Agency Funds 328  
Governmental Accounting in Practice—The City of Birmingham, Alabama 332  
Special Assessment Projects 333   Review Questions 336   Cases 337  
Ethics Cases 337   Exercises 338   Problems 344

**CHAPTER 9   The Governmental Fund Accounting Cycle**

Comprehensive Annual Financial Report  
and Current Issues      356

Major Components of the CAFR 357   The Reporting Entity 383   Interim  
Financial Reporting 390   The Certificate of Excellence in Financial

Reporting 391 The Audit Report 394 Current Issues 396 Final GASB Statement 408 Financial Condition Analysis 410 Review Questions 413 Cases 414 Ethics Case 415 Exercises 415 Problems 417 Summary Problems for Chapters 4–9 422

## **CHAPTER 10 Federal Government Accounting and Reporting 426**

The Federal Budgetary Process 427 Federal Versus State and Local Governmental Accounting 430 Types of Funds Used in Federal Accounting 432 Federal Accounting Standards 433 The Federal Agency Accounting Cycle 435 Financial Statements Used by Federal Agencies 442 Review Questions 447 Cases 447 Exercises 448 Problems 452

## **CHAPTER 11 Accounting for Not-for-Profit Organizations 455**

Description of Not-for-Profit Organizations 456 Internal Accounting Versus External Reporting—Overview 458 Funds Used 458 Financial Statements 459 Contributions 464 Other Accounting Matters 470 Illustrative Transactions of and Financial Reporting by Not-for-Profit Organizations 474 Review Questions 485 Exercises 486 Problems 490

## **CHAPTER 12 Accounting for Health Care Organizations 496**

Health Care Service Providers 497 Sources of Generally Accepted Accounting Principles 497 Funds Used by Hospitals 498 Accounting Procedures for the General Funds 501 Accounting Procedures for Donor-Restricted Funds 509 Financial Statements 514 Financial Statement Analysis 524 Review Questions 529 Cases 530 Ethics Cases 531 Exercises 532 Problems 535

## **CHAPTER 13 Accounting for Colleges and Universities 547**

Recent History and Sources of Authority 548 Funds Used by Colleges and Universities 550 Other Matters—Governmental Colleges and Universities 563 Effect of FASB *Statement Nos. 116* and *117* on Not-for-Profit College Accounting 565 Financial Statements of Governmental Colleges and Universities 568 Financial Statements of Not-for-Profit Colleges and Universities 577 Review Questions 581 Exercises 582 Problems 585

## **CHAPTER 14 Fundamentals of Accounting 591**

The Accounting Equation; Transaction Analysis 592 The Accrual Basis of Accounting 600 Accruals, Deferrals, and Amortizations 601 Recording Transactions: Debits and Credits 602 Financial Statements 616 Closing the Books and Other Matters 620 Review Questions 625 Exercises 625 Problems 629

## **Index 635**

A decorative graphic featuring a large, stylized number '1' in the center. The word 'CHAPTER' is written in a smaller, sans-serif font across the middle of the '1'. On either side of the '1' and 'CHAPTER' text are two rows of small, dark gray triangles pointing upwards, creating a symmetrical, architectural look.

# CHAPTER 1

## Introduction to Accounting for Nonbusiness Organizations

### Learning Objectives

**After completion of this chapter, you should be able to:**

- Describe the characteristics of nonbusiness organizations
- Describe the nonbusiness accounting and reporting environment
- Describe the users and uses of accounting information
- Define the term generally accepted accounting principles (GAAP)
- Describe the concepts of entity, matching, consistency, and periodicity
- Describe the jurisdictions of the entities responsible for establishing GAAP
- Describe the characteristics of governmental entities
- Describe the hierarchy of GAAP and its implications

Accounting and reporting of economic events have evolved from their earliest form, writing on cave walls, to the present state of maintaining complex financial records and preparing sophisticated financial reports. Over this period of time, some changes have been revolutionary. Most, however, can best be described as evolutionary. Until recently there was not much interest in the accounting and reporting procedures used by governmental or other not-for-profit organizations. However, with the financial “crunch” encountered by some major cities during the 1970s, governmental accounting and reporting have become extremely important. In the not-for-profit field, the emergence of third-party insurers in the health-care field and the rapidly increasing inflation of the 1970s have created a great deal of interest in and attention upon the accounting and reporting problems of these organizations.

Another reason for greater interest in the accounting and reporting problems of governmental and not-for-profit organizations is the growing realization that the financial reports of these organizations are a means by which parties interested in them can evaluate their performance. Financial reports are often an important communication vehicle between these organizations and their constituents.

To simplify the terminology found in this text, we will use the term **nonbusiness organizations** to refer to both governmental units and not-for-profit organizations. This term was first used by the Financial Accounting Standards Board (FASB)<sup>1</sup> and is prevalent in the accounting literature.

Nonbusiness organizations have the following distinguishing characteristics:

1. Receipts of significant amounts of resources from resource providers who do not expect to receive either repayment or economic benefits proportionate to resources provided
2. Operating purposes other than to provide goods or services at a profit or profit equivalent
3. Absence of defined ownership interests that can be sold, transferred, or redeemed, or that convey entitlement to a share of a residual distribution of resources in the event of liquidation of the organization.<sup>2</sup>

## What Is Accounting?

**Accounting** has been defined as “the art of recording, classifying, and summarizing, in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof.”<sup>3</sup> Note the use of the word *art*. Accounting is an art in that, although it follows a specified set of rules, the final decisions as to what methods and procedures to use and how to present financial information are still up to the accountant. This, of course, is analogous to the artist who, while following specified rules of color and perspective, still dictates the final product.

<sup>1</sup>The FASB is the accounting rule-setting body of business and not-for-profit organizations.

<sup>2</sup>*Statement of Financial Accounting Concepts No. 4—Objectives of Financial Reporting by Nonbusiness Organizations* (Stamford, CT: Financial Accounting Standards Board, 1980), para. 6.

<sup>3</sup>AICPA, *Accounting Terminology Bulletin No. 2*.

Another approach to defining accounting is the **trained observer approach**.<sup>4</sup> Under this approach, the accountant is perceived as a trained observer who observes economic events (transactions) and reports on them. The receivers of the reports, the decision makers, then take actions that create new events—which are observed and reported on by the accountant, and so forth.

In short, accounting is a process of communicating financial information. To be effective, the accountant must communicate this information in a manner that is both *useful* and *understandable* to the user.

## Environment of Nonbusiness Accounting and Reporting

Nonbusiness organizations operate in a different economic, social, legal and political environment than commercial enterprises. As a result, their information needs are different, as are their accounting and reporting practices. Important aspects of the nonbusiness environment are as follows:

### **Inability to Measure Efficiency and Effectiveness by Means of Income Measures**

Commercial enterprises exist to enhance their owners' wealth. When these organizations do engage in social-type activities, it is with the intent of ultimately maximizing income. Because income is quantifiable and can be measured in monetary terms, it is a very useful means of evaluating efficiency and effectiveness of commercial organizations.

Nonbusiness organizations exist to provide services to their constituents. The value of these services often cannot be measured in monetary terms. For example, what is the value of a life saved by a team of paramedics? Furthermore, if a nonbusiness organization were to earn a profit, it would be assumed that sufficient services were not being provided or that resource providers were being overcharged or overtaxed. Thus, these organizations must look to other means for evaluating efficiency and effectiveness.

### **Lack of Harmony of Purpose**

If a commercial organization is to survive, its managers must have one overall goal: to make a profit. Without profits a commercial organization cannot survive. While managers of that organization may disagree on the means of making a profit, they seldom disagree on the importance of the profit itself.

Nonbusiness organizations, on the other hand, have many goals—the relative importance of each varying between both users and producers of services. As a result, the level of resources devoted to each activity is a function of the political process and conflict is often present within an organization's leadership.

### **Continuity of Leadership Not Very Common**

When a senior manager of a commercial enterprise leaves that organization, his or her place is usually taken by a hand-picked successor who, at least initially, continues the departing manager's policies. Change tends to be gradual and evolutionary in nature.

<sup>4</sup>For a more complete discussion of this approach, see Norton M. Bedford and Vahe Baladouni, "A Communication Theory Approach to Accountancy," *Accounting Review* (October 1962), pp. 650–59.

When a new administration takes over a nonbusiness organization, especially a governmental unit, the new administration usually makes a “clean sweep,” and new policies are quickly instituted. Furthermore, outgoing officials sometimes engage in practices designed to make their successors appear ineffective and to pave the way for their return to office. This lack of leadership continuity makes managerial accountability difficult to achieve.

### **Many Operational Decisions Governed by Legal Compliance**

Commercial organizations are free to provide only those goods and services they feel will enhance their profits. They cannot usually be required to provide goods and services against their will and, if they cannot cope with the legal or social environment, they are free to leave the market. Commercial organizations can also borrow money when convenient, subject only to requirements of lenders and investors.

Nonbusiness organizations, especially governmental units, are required by law (charter, constitution, and so on) to provide certain services. For example, most city charters provide for police and fire protection. Managers cannot refuse to provide these services because of cost or because they feel that residents do not deserve such services.

Nonbusiness organizations also are constrained as to when and how much money they can borrow. Most cities and states are subject to borrowing limits. In addition, new bond issues must be approved by the electorate and, in many cases, by a senior legislative body, such as a state legislature.

Because of these factors, accounting for nonbusiness organizations tends to focus on control and legal compliance. It is very conservative, and emphasis is placed on determining if a predetermined amount of resources (the budget) was spent to provide a given level of services. In effect, it measures an organization’s ability to perform a prescribed level of services with a given amount of resources, within the constraints of local, state, and federal laws.

## **Users of Accounting Information**

Generally speaking, users of accounting information of nonbusiness organizations fall into one of two categories: external or internal. **External users** are those persons or organizations who are *not* directly involved in the operations of the reporting entity. Among these users are the following:

1. *The federal government*—to evaluate the use of the proceeds of grants and to gather statistical information
2. *Bond-rating services*—to evaluate the creditworthiness of organizations issuing debt
3. *The electorate*—to evaluate the performance of elected officials; information is communicated to these persons primarily through the news media
4. *State legislative committees*—to oversee the operations of the various political subdivisions within the state
5. *Potential investors*—to determine the stability of the tax base

**Internal users** are those persons or groups of persons who are *directly* involved in the operations of the reporting entity. Among these users are the following:

1. *Program monitors*—to evaluate the activities of the programs
2. The *chief administrative officer*—to evaluate the financial operations and the effectiveness of the operating personnel of the organization
3. *Department heads*—to evaluate the performance of subordinates
4. The *mayor* and the *city council*—to determine the financial condition of the city and the need for additional resources
5. *Internal auditors*—to evaluate the effectiveness of financial and operating controls

## Generally Accepted Accounting Principles (GAAP)

The term **generally accepted accounting principles (GAAP)** has been defined as

... the consensus at a particular time as to which economic resources and obligations should be recorded as assets and liabilities by financial accounting, which changes in assets and liabilities should be recorded, when these changes should be recorded, how the assets and liabilities and changes in them should be measured, what information should be disclosed and how it should be disclosed, and which financial statements should be prepared.

Generally accepted accounting principles encompass the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. The standard of “generally accepted accounting principles” includes not only broad guidelines of general application, but also detailed practices and procedures.<sup>5</sup>

Before embarking on a study of the methods and procedures used by accountants, certain basic underlying concepts should be considered.

## The Entity Concept

The reporting unit is a specific, identifiable **entity**—a separate economic or political unit that stands apart from other economic or political units. The entity defines the boundaries of a particular financial report by describing whose assets, liabilities, and equities are included in the report. For example, General Motors is actually a series of separate but related companies. For financial reporting purposes, however, it is one company. Because of its *control* over them, General Motors and its subsidiaries are consolidated into one reporting unit. Similarly, many state governments have created legally separate corporations (often called public authorities) that are, nevertheless, part of the state’s financial reporting entity because of the *control* the state exercises over them.

In commercial (business) organizations the reporting unit is *one* entity, no matter how large. In nonbusiness organizations the organization as a whole is considered to be the *basic* reporting entity, just as in business enterprises. However, nonbusiness accounting is characterized by **fund accounting**. Funds, by definition, are *separate* fiscal and accounting entities. Until recently, nonbusiness financial reporting focused on

<sup>5</sup>*Statement No. 4*, “Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises” (New York: AICPA, 1970), paras. 137 and 138. Copyright © 1993 by American Institute of Certified Public Accountants, Inc. Reprinted with permission.

funds (or fund types). As a result of new requirements, however, financial reports of nongovernmental, not-for-profit organizations now focus on the entity as a whole, even though the organization may continue to use fund accounting for internal purposes. Financial reports of state and local governments still focus on fund types, but new requirements (in development while this text was being written) are expected to cause reporting changes both for the entity as a whole and for major individual funds.

## Planning and Control

**Planning** is the act of determining the amount of and type of resources to be received and expended by the organization during a given period. Another name for planning is *budgeting*. **Control** is the act of determining whether the resources received and expended are done so in accordance with the budget.

## The Matching Concept

The term **matching concept** denotes the fact that revenues are matched or compared with expenses (or expenditures). Business firms match revenues with expenses to determine their income for a period of time. Nonbusiness organizations match revenues with expenditures (or expenses) to determine the changes that take place in their fund balances over a period of time. In addition, they compare their actual revenues and expenditures (or expenses) with their budgetary authorizations to determine compliance with the budget. Governmental accounting generally emphasizes the inflows, outflows, and balances of expendable resources rather than the determination of revenues, expenses, and income.

## Consistency

The term **consistency** denotes the treatment of like transactions in the same manner during consecutive periods so that the financial statements will be comparable. Procedures, once adopted, should be followed from period to period by the reporting entity.

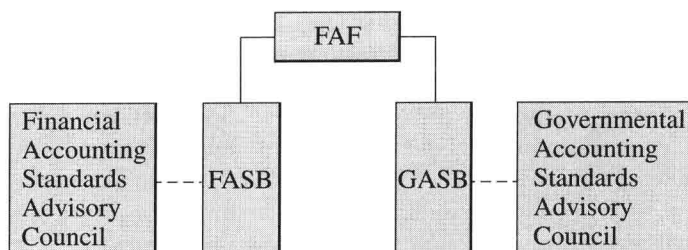
## Periodicity

The term **periodicity** denotes the practice of preparing financial reports that cover a defined period of time rather than the life of the reporting entity. The period used is generally one year, although quarterly and monthly reports (and sometimes daily and hourly reports) are common in certain instances.

## Establishing Generally Accepted Accounting Principles

As previously mentioned, generally accepted accounting principles are a consensus of acceptable concepts, practices, and so forth, in effect at a certain point in time. Determination of the acceptability of these concepts, practices, and so forth for governmen-





**EXHIBIT 1-1** Relationship between the FASB, the GASB, and the FAF

tal-type organizations is made by the Governmental Accounting Standards Board (GASB). The GASB is a seven-member board established in 1984 “. . . to promulgate standards of financial accounting and reporting with respect to activities and transactions of state and local governmental entities. The GASB is the successor organization to the National Council on Governmental Accounting (NCGA).”<sup>6</sup> Members of the GASB are appointed by the Financial Accounting Foundation (FAF). The members of the FAF are appointed by the American Institute of Certified Public Accountants (AICPA) and other financial and accounting-related organizations.

Determination of the acceptability of accounting principles for business organizations is made by the Financial Accounting Standards Board (FASB). The FASB is a seven-member board appointed by the Board of Trustees of the FAF. Both the GASB and the FASB have an advisory council that provides guidance in the standards-setting process. The GASB-FASB structure is shown in Exhibit 1-1.

A determination made by the FAF in 1989 clarified the implications of the jurisdiction arrangement made when the GASB was established. The 1989 ruling made it clear that the GASB’s jurisdiction included *all* state and local governmental entities, including government-sponsored colleges and universities, health-care providers, and utilities. The FASB establishes standards for all other entities, including not-for-profit colleges and universities and health-care providers. Each Board has primary responsibility for setting standards for entities in its jurisdiction; pronouncements of the other Board are not mandatory unless so designated by the Board with primary responsibility for the type of entity. The jurisdiction determination resulted in changing the hierarchy of generally accepted accounting principles, as discussed later in this chapter.

Under the jurisdiction arrangement, it is possible for the GASB and the FASB to establish different accounting and reporting standards for similar transactions of similar entities, such as colleges and universities. As discussed in chapters 12 and 13, this does, in fact, occur. The two Boards cooperate with each other, however, to keep differences to a minimum.

Because of the way some entities are organized, governed, and/or financed, it is not always clear whether a particular entity is a governmental one or a not-for-profit one. Governmental entities include traditional political subdivisions (such as states,

<sup>6</sup>GASB Codification, “Introduction,” *Governmental Accounting and Financial Reporting Standards*, p. xiii, as of June 30, 1993.