

# Essentials of ACCOUNTING *for* Governmental and Not-for-Profit Organizations

Seventh Edition



John H. Engstrom

Paul A. Copley\*

# Essentials of Accounting for Governmental and Not-for-Profit Organizations

Seventh Edition

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ESSENTIALS OF ACCOUNTING FOR GOVERNMENTAL  
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# Preface

The preface to the first six editions of this text noted that the text was intended to provide a much more comprehensive coverage of accounting and financial reporting for governmental and not-for-profit accounting 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 six editions have been well received by instructors whose objective is to provide less coverage of the material than is available in larger texts, such as *Accounting for Governmental and Nonprofit Entities* by Wilson, Kattelus, and Hay (McGraw-Hill, 13th edition) as well as those whose objective is to stress preparation for the CPA Examination. The text is also used by some who wish to supplement basic accounting and reporting principles with other materials.

This edition and the accompanying *Instructor's Guide* and the *Suggested Quiz and Examination Questions and Problems* have been revised in accord with suggestions of users of the first six editions and to incorporate changes in standards issued by the GASB, FASB, AICPA and Comptroller General.

This text presents materials up to date through GASB Statement 39, *Determining Whether Certain Organizations Are Component Units*; FASB Statement 136, *Transfer of Assets to a Not-for-Profit Organization or Charitable Trust that Raises or Holds Contributions for Others*; the AICPA's revised *Audits of State and Local Governments*; and the exposure draft of the Comptroller General's *Government Auditing Standards*.

This text uses a particular approach to present the governmental reporting model. The assumption is made that fund accounting is the basic model used for internal accounting and for part of the external reporting. Then, worksheet adjustments are made to produce the government-wide statements. After the introductory Chapter 1, Chapter 2 presents an overview of the financial reporting model. Chapter 3 presents budgetary accounting for the General and special revenue funds, leading to the Budgetary Comparison Schedule. Fund accounting and reporting are then presented for governmental (Chapters 4–5), proprietary (Chapter 6), and fiduciary (Chapter 7) funds. Chapter 8 presents a worksheet approach for the preparation of government-wide statements and reconciliation schedules. As has been the case for the first six editions, an integrated example (the Village of Elizabeth) is presented throughout as well as an integrated continuous problem (the City of Everlasting Sunshine). Chapter 9 presents an analysis of governmental financial statements, special-purpose government reporting, and reporting for public colleges and universities in accordance with GASB *Statement 35*.

The not-for-profit chapters for voluntary health and welfare organizations and other not-for-profits (Chapter 10), private sector colleges and universities (Chapter 11), and private sector health care entities (Chapter 12) continue the approach of reflecting assets and liabilities as common to all net asset classes and reflecting revenues, expenses, and net assets by net asset class. Chapter 13 presents the new

*Government Auditing Standards*, the single audit act and amendments, taxation of exempt organizations, and service efforts and accomplishments.

The authors are indebted to members of the Governmental Accounting Standards Board and to the GASB research staff for access to their ideas, as well as permission to use GASB materials. The authors also wish to express their appreciation to the American Institute of Certified Public Accountants for permission to use their materials.

The authors wish to express thanks to anonymous reviewers of the sixth edition of this text, to Lisa Cole for accuracy checking for the text and *Instructor's Guide*, to G. Robert (Smitty) Smith for accuracy checking of the *Suggested Quiz and Examination Questions*, and especially to Deborah Prasad of Walsh College for her extensive suggestions for the text and solutions materials. The authors also express thanks for the many users of this text for suggestions.

The authors would appreciate suggestions from users of this text for improvements in presentation of this material and suggestions for additional or improved questions and exercises. Please send suggestions to [Pcopley@terry.uga.edu](mailto:Pcopley@terry.uga.edu) or to [Jengstrom@niu.edu](mailto:Jengstrom@niu.edu).

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# Contents In Brief

## **Preface v**

- 1** Introduction to Accounting and Financial Reporting for Governmental and Not-For-Profit Organizations 1
  - 2** Overview of Financial Reporting for State and Local Governments 23
  - 3** Budgetary Accounting for the General and Special Revenue Funds 64
  - 4** Accounting for the General and for Special Revenue Funds 90
  - 5** Accounting for Other Governmental Fund Types: Capital Projects, Debt Service, and Permanent 126
  - 6** Proprietary Funds 158
  - 7** Fiduciary Funds; Interfund Transactions 192
  - 8** Government-Wide Statements; Fixed Assets; Long-Term Debt 224
  - 9** Analysis of Governmental Financial Statements; GASB Accounting for Special-Purpose Entities; Accounting for Public Institutions of Higher Education 261
  - 10** Accounting for Not-For-Profit Organizations 300
  - 11** College and University Accounting—Private Institutions 333
  - 12** Accounting for Hospitals and Other Health Care Providers 360
  - 13** Governmental Auditing; The Single Audit Act; Tax Exempt Organizations; Service Efforts and Accomplishments 386
- Appendix: Governmental and Not-For-Profit Accounting Terminology 414
- Index 435

# Contents

## **Preface v**

## **Chapter 1**

### **Introduction to Accounting and Financial Reporting for Governmental and Not-for-Profit Organizations 1**

#### **Objectives of Accounting and Financial Reporting 3**

- Objectives of Accounting and Financial Reporting for the Federal Government 3*
- Objectives of Financial Reporting by Not-for-Profit Entities 6*
- Objectives of Accounting and Financial Reporting for State and Local Governmental Units 6*

#### **Outline of the Text 6**

#### **State and Local Governmental**

#### **Financial Reporting 6**

- Comprehensive Annual Financial Report 7*
- Measurement Focus and Basis of Accounting 7*
- Fund Structure for State and Local Government Accounting and Reporting 10*
- Number of Funds Required 11*
- Budgetary Accounting 12*
- Accounting for Capital Assets, Including Infrastructure 12*
- Accounting for Long-Term Debt and Other Long-Term Liabilities 14*

#### **Additional Resources 14**

## **Chapter 2**

### **Overview of Financial Reporting for State and Local Governments 23**

#### **The Governmental Reporting Entity 24**

#### **Overview of the Comprehensive Annual Financial Report (CAFR) 25**

#### **Introductory Section 26**

#### **Financial Section 26**

##### *Auditor's Report 26*

##### *Management's Discussion and Analysis (MD&A) 27*

##### *Government-Wide Financial Statements 27*

##### *Fund Financial Statements 31*

##### *Notes to the Financial Statements 37*

##### *Required Supplementary Information*

##### *Other than MD&A 41*

##### *Combining and Individual Fund Statements and Schedules 45*

#### **Special Purpose Governments 45**

#### **Public Colleges and Universities 49**

#### **Other Governmental Not-for-Profit Organizations 54**

## **Chapter 3**

### **Budgetary Accounting for the General and Special Revenue Funds 64**

#### **Budgets as Legal Documents 65**

#### **Balance Sheet and Operating Statement Accounts 65**

#### **Budgets and Budgetary Accounts 66**

#### **Recording the Budget 68**

#### **Accounting for Revenues 69**

#### **Accounting for Encumbrances and Expenditures 70**

#### **Budget Revisions 75**

#### **Budgetary Comparison Schedule 75**

#### **Classification of Estimated Revenues and Revenues 75**

#### **Ad Valorem Taxes 77**

#### **Classification of Appropriations and Expenditures 79**

## Chapter 4

### Accounting for the General and for Special Revenue Funds 90

#### Accounting for Nonexchange Transactions 90

*Classes of Nonexchange*

*Transactions 91*

*Eligibility Requirements 91*

*Recognition Requirements for the Four Classes of Nonexchange*

*Transactions 92*

*Other Features of GASB*

*Statement 33 92*

#### Modified Accrual Accounting 94

*Revenue Recognition 94*

*Expenditure Recognition 94*

#### Interfund Transactions 95

*Interfund Loans 95*

*Interfund Services Provided and Used 95*

*Interfund Transfers 95*

*Interfund Reimbursements 95*

#### General Fund Account Structure 96

#### Illustrative Case—General Fund 96

*Recording the Budget 97*

*Re-establishment of Encumbrances 97*

*Recording Prior Year Property Taxes as Revenues 97*

*Tax Anticipation Notes Payable 98*

*Payment of Liabilities as Recorded 98*

*Encumbrance Entry 98*

*Recording Property Tax Levy 98*

*Collection of Delinquent Taxes 99*

*Collection of Current Taxes 99*

*Revenue Recognized on Cash Basis 100*

*Repayment of Tax Anticipation Notes 100*

*Recognition of Expenditures for Encumbered Items 100*

*Payrolls and Payroll Taxes 101*

*Payment of Vouchers and Other Items 101*

*Correction of Errors 102*

*Amendment of the Budget 102*

*Interfund Transactions 102*

*Write-off of Uncollectible Delinquent Taxes 104*

*Reclassification of Current Taxes 105*

*Accrual of Interest and Penalties 105*

*Deferral of Property Tax Revenue 106*

*Special Item 106*

*Preclosing Trial Balance 106*

*Closing Entries 107*

*Year-End Financial Statements 107*

#### Illustrative Case—Special Revenue Fund 108

*Motor Fuel Tax Revenues 110*

*Expenditures for Road Repairs 110*

*Reimbursement to General Fund 110*

*Reimbursement Grant Accounting 110*

*Closing Entry 111*

*Year-End Financial Statements 111*

#### Recognition of Inventories in Governmental Funds 111

## Chapter 5

### Accounting for Other Governmental Fund Types: Capital Projects, Debt Service, and Permanent 126

#### Capital Projects Funds 127

*Illustrative Case 128*

#### Acquisition of General Fixed Assets by Lease Agreements 132

#### Construction of General Fixed Assets Financed by Special Assessment

#### Debt 133

#### Debt Service Funds 134

*The Modified Accrual Basis—Meaning for Debt Service 135*

*Additional Uses of Debt Service Funds 135*

*Debt Service Accounting for Serial Bonds 136*

*Illustrative Case—Regular Serial Bonds 136*

*Debt Service Accounting for Deferred Serial Bonds 139*



*Debt Service Accounting for Term Bonds* 139  
*Debt Service Accounting for Capital Lease Payments* 139  
*Bond Refundings* 140  
*Permanent Funds* 140

**Financial Reporting for Governmental Funds** 142

*Balance Sheet—Governmental Funds* 142  
*Statement of Revenues, Expenditures, and Changes in Fund Balances—Governmental Funds* 142

**Chapter 6**

**Proprietary Funds** 158

**Internal Service Funds** 159  
*Establishment and Operation of Internal Service Funds* 159  
*Illustrative Case—Supplies Fund* 160

**A Note about Risk Management Activities** 164

**Enterprise Funds** 164  
*Illustrative Case—Water Utility Fund* 165  
*Accounting for Municipal Solid Waste Landfills* 171

**Proprietary Fund Financial Statements** 172  
*Statement of Net Assets* 172  
*Statement of Revenues, Expenses, and Changes in Fund Net Assets* 172  
*Statement of Cash Flows* 176

**Chapter 7**

**Fiduciary Funds; Interfund Transactions** 192

**Agency Funds** 193  
*Tax Agency Funds* 194  
*Accounting for Tax Agency Funds* 194  
*Financial Reporting for Agency Funds* 196

**Private-Purpose Trust Funds** 196  
*Accounting for Investments* 196  
*Illustrative Case—Private-Purpose Trust Funds* 198  
*A Note about Escheat Property* 199

**Investment Trust Funds** 200  
**Public Employee Retirement Systems (Pension Trust Funds)** 201

*Accounting and Reporting for Defined Benefit Pension Plans* 201  
*Summary of Employer Reporting* 206  
*A Note about IRS 457 Deferred Compensation Plans* 208  
*A Note about Other Postemployment Benefits* 208

**Interfund Transactions** 208  
*Reciprocal Interfund Activity—Interfund Loans* 209  
*Reciprocal Interfund Activity—Interfund Services Provided and Used* 209  
*Nonreciprocal Interfund Activity—Interfund Transfers* 210  
*Nonreciprocal Interfund Activity—Interfund Reimbursements* 210

**A Final Comment on Fund Accounting and Reporting** 211

**Chapter 8**

**Government-Wide Statements, Fixed Assets, Long-Term Debt** 224

**Conversion from Fund Financial Records to Government-Wide Financial Statements** 224

*Recording Capital Assets, Removing Expenditures for Capital Outlays, and Recording Depreciation* 225  
*Changing “Proceeds of Bonds” to Debt Liabilities, Changing Expenditures for Debt Service Principal to Reduction of Liabilities, and Adjusting for Interest Accruals* 227  
*Adjusting to Convert Revenue Recognition to the Accrual Basis* 228

|   |     |
|---|-----|
| <i>Adjusting to Record Expenses on Accrual Basis</i>                                | 229 |
| <i>Changing Proceeds on Sale of Fixed Assets to Gain on Sale of Fixed Assets</i>    | 229 |
| <i>Adding Internal Service Funds to Governmental Activities</i>                     | 229 |
| <i>Eliminating Interfund Activities and Balances within Governmental Activities</i> | 231 |
| <i>Eliminating Fiduciary Funds Worksheet to Illustrate the Adjustments</i>          | 232 |
| <b>Government-Wide Financial Statements</b>   | 233 |
| <i>Statement of Net Assets</i>  | 233 |
| <i>Statement of Activities</i>  | 236 |
| <i>Required Reconciliation to Government-Wide Statements</i>                        | 237 |
| <b>Accounting for Fixed Assets, Including Infrastructure</b>                        | 240 |
| <i>Accounting for General Fixed Assets</i>  | 241 |
| <i>Accounting for Infrastructure</i>  | 242 |
| <i>The Modified Approach for Reporting Infrastructure</i>                           | 243 |
| <i>Collections</i>  | 244 |
| <b>Accounting for Long-Term Debt</b>  | 244 |
| <i>Types of General Long-Term Debt</i>  | 245 |
| <i>Debt Disclosures and Schedules</i>   | 245 |

## Chapter 9

### **Analysis of Governmental Financial Statements, GASB Accounting for Special Purpose Entities, Accounting for Public Institutions of Higher Education 261**

|  |     |
|--|-----|
| <b>Analysis of State and Local Governmental Financial Statements</b> | 261 |
| <i>Public Finance Market</i>   | 262 |
| <i>Analysis of the Comprehensive Annual Financial Report</i>         | 262 |

|   |     |
|---|-----|
| <i>Additional Analysis</i>  | 266 |
| <b>GASB Statement 34 Reporting Rules for Special-Purpose Entities</b>                           | 266 |
| <i>Reporting by Special-Purpose Local Governments Engaged in Governmental Activities</i>        | 267 |
| <i>Reporting by Special-Purpose Local Governments Engaged Only in Business-Type Activities</i>  | 270 |
| <i>Reporting by Special-Purpose Local Governments Engaged Only in Fiduciary-Type Activities</i> | 270 |
| <b>Accounting and Financial Reporting for Public Colleges and Universities</b>                  | 271 |
| <i>The Environment of Public Higher Education</i>   | 271 |
| <i>Accounting and Financial Reporting for Public Institutions of Higher Education</i>           | 272 |
| <i>Illustrative Case—Northern State University—Beginning Trial Balance</i>                      | 274 |
| <i>Illustrative Case—Journal Entries</i>  | 275 |
| <i>Illustrative Case—Closing Entries</i>  | 281 |
| <i>Illustrative Case—Financial Statements</i>   | 284 |
| <b>Summary</b>  | 288 |

## Chapter 10

### **Accounting for Not-For-Profit Organizations 300**

|  |     |
|--|-----|
| <b>Organizations Covered in This Chapter</b>                 | 302 |
| <b>Overview of Not-for-Profit Accounting</b>                 | 302 |
| <i>Three Classes of Net Assets</i>                           | 302 |
| <i>Financial Reporting</i>                                   | 303 |
| <i>Note Disclosures</i>                                      | 303 |
| <i>Accounting, Including Reclassifications of Net Assets</i> | 304 |
| <i>Special Topics: Accounting for Contributions</i>          | 305 |
| <b>Illustrative Transactions and Financial Statements</b>    | 307 |

*Beginning Trial Balance* 307  
*Transactions* 308  
*Financial Statements* 315  
*Alternative Procedure for Recording  
Fixed Assets* 317

Performance Evaluation 320  
Summary of Academic Research 321  
Summary of Not-for-Profit Accounting  
and Reporting 321

## **Chapter 11**

### **College and University Accounting—Private Institutions 333**

Overview of Private College and  
University Accounting 334

*Net Asset Classification* 334  
*Financial Statements* 335  
*Revenue Reduction versus  
Expenses* 335  
*Academic Terms Encompassing More  
than One Fiscal Year* 336  
*Other Accounting Guidance* 336

Illustrative Transactions and Financial  
Statements 337

*Illustrative Transactions* 338  
*Illustrative Financial Statements for  
Private Colleges and Universities* 344

Split-Interest Agreements 344

Academic Research 349  
Summary of Accounting and  
Reporting 349

## **Chapter 12**

### **Accounting for Hospitals and Other Health Care Providers 360**

Accounting and Reporting  
Requirements of the *Health Care  
Guide* 361

Illustrative Transactions and Financial  
Statements 636

*Beginning Trial Balance* 363

*Illustrative Statements for Private  
Sector Not-for-Profit Health Care  
Entities* 370

Financial Reporting for Governmental  
Health Care Entities 374

Financial Reporting for Commercial  
(For-Profit) Health Care Entities 374  
Academic Research 375

Summary and Conclusions regarding  
Health Care Accounting and  
Reporting 375

## **Chapter 13**

### **Governmental Auditing; The Single Audit Act; Tax-Exempt Organizations; Service Efforts and Accomplishments 386**

Governmental Auditing 386

The Single Audit Act and  
Amendments 393

Tax-Exempt Organizations 396

*Applying for Tax-Exempt Status* 397

*Federal Filing Requirements* 398

*Public Disclosures* 402

*State Filing Requirements* 402

*Unrelated Business Income Tax  
(UBIT)* 402

*Summary and Some Conclusions  
Related to Exempt Entities* 403

Service Efforts and

Accomplishments 404

*Example of SEA Reporting: School  
Report Cards* 405

*Summary* 405

### **Appendix: Governmental and Not-For-Profit Accounting Terminology 414**

## **Index 435**

# Chapter One

## Introduction to Accounting and Financial Reporting for Governmental and Not- For-Profit Organizations

**G**overnments differ from business organizations discussed in other accounting courses in that governments have no stockholders or other owners, they commonly render services with no expectation of earning net income, and they have the power to require taxpayers to support financial operations whether or not the taxpayers receive benefits in proportion to taxes paid. Also, governments are not subject to federal, state, or local income taxes. Further, the form of government in the United States requires interrelationships that have no parallel in business organizations, between a state government and local governments established in compliance with state law and within any one government between the executive and legislative branches. Similarly, nongovernmental not-for-profit organizations 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.

Accounting and financial reporting standards for the federal government are recommended by the Federal Accounting Standards Advisory Board (FASAB). Recommendations of the FASAB are reviewed and become effective unless objected to by one of the principals, the U.S. General Accounting Office (GAO), the U.S. Department of the Treasury, or the U.S. Office of Management and Budget (OMB). These standards apply to financial reports issued by federal agencies and to the Consolidated Financial Report of the United States Government. Accounting and financial reporting standards for the federal government are beyond the scope of this book and are available at <http://www.fasab.gov/>.

Accounting and financial reporting standards for state and local governments in the United States are set by the Governmental Accounting Standards Board (GASB). The GASB also sets accounting and financial reporting standards for

governmentally related not-for-profit organizations, such as colleges and universities, health care entities, museums, libraries, and performing arts organizations that are owned or controlled by governments. Accounting and financial reporting standards for profit-seeking businesses and for nongovernmental not-for-profit organizations are set by the Financial Accounting Standards Board (FASB). The GASB and the FASB are parallel bodies under the oversight of the Financial Accounting Foundation (FAF). The FAF appoints the members of the two boards and provides financial support to the boards by obtaining contributions from business corporations; professional organizations of accountants, financial analysts, and other groups concerned with financial reporting; CPA firms; debt-rating agencies; and state and local governments (for support of the GASB). Because of the breadth of support and the lack of ties to any single organization or government, the GASB and the FASB are referred to as “independent standards-setting bodies in the private sector.” Standards set by the FASAB, GASB, and FASB are the primary sources of **generally accepted accounting principles (GAAP)** as the term is used in accounting and auditing literature.

FASAB, GASB, and FASB standards are set forth primarily in documents called **Statements**. From time to time, the boards find it necessary to expand on standards in documents called **Interpretations**. Boards also issue **Technical Bulletins** to explain the application of standards in certain situations or industries. Independent auditors are engaged to express their opinion that the financial statements of a client present fairly, in all material respects, the client’s financial position as of the end of a fiscal year and the results of its operations and its cash flows for the year then ended, in conformity with generally accepted accounting principles (GAAP). Since FASAB, GASB, and FASB Statements, Interpretations, and Technical Bulletins do not cover all possible situations, auditors often have need to refer to other publications. However, these other publications do not take precedence over Statements and Interpretations. Illustration 1–1 presents the hierarchy of GAAP published by the American Institute of Certified Public Accountants for the guidance of independent auditors.

Some organizations possess certain characteristics of both governmental and nongovernmental not-for-profit organizations, and it is necessary to determine whether those organizations are governmental or nongovernmental for purposes of applying GAAP, in accord with the hierarchy shown in Illustration 1–1. Recently, the FASB and GASB agreed upon a definition of a government. As reproduced in the AICPA *Audit and Accounting Guide: Not-for-Profit Organizations*, the definition is as follows:

Public corporations and bodies corporate and politic are governmental organizations. Other organizations are governmental organizations if they have one or more of the following characteristics:

- a. Popular election of officers or appointment (or approval) of a controlling majority of the members of the organization’s governing body by officials of one or more state or local governments;
- b. The potential for unilateral dissolution by a government with the net assets reverting to a government; or
- c. The power to enact and enforce a tax levy.

Furthermore, organizations are presumed to be governmental if they have the ability to issue directly (rather than through a state or municipal authority) debt that pays interest exempt from federal taxation. However, organizations possessing only that ability (to issue tax-exempt debt) and none of the other governmental characteristics may rebut the presumption that they are governmental if their determination is supported by compelling, relevant evidence.

## OBJECTIVES OF ACCOUNTING AND FINANCIAL REPORTING

All three standards-setting organizations—the Federal Accounting Standards Advisory Board, the Financial Accounting Standards Board, and the Governmental Accounting Standards Board—take the position that the establishment of accounting and financial reporting standards should be guided by conceptual considerations so that the body of standards is internally consistent and the standards address broad issues expected to be of importance for a significant period of time. The cornerstone of a conceptual framework is said to be a statement of the objectives of financial reporting.

### Objectives of Accounting and Financial Reporting for the Federal Government

The Federal Accounting Standards Advisory Board (FASAB) was established to recommend accounting and financial reporting standards to the “principals,” the U.S. Office of Management and Budget, the U.S. Department of the Treasury, and the U.S. General Accounting Office. The FASAB has passed three Statements of Federal Financial Accounting Concepts (SFFACs). These concepts apply to financial reporting for the federal government as a whole and for individual reporting agencies.

SFFAC 1, *Objectives of Federal Financial Reporting*, outlined four objectives that should be followed in federal financial reporting. The first, **budgetary integrity**, indicates that financial reporting should demonstrate accountability with regard to the raising and expending of moneys in accord with the budgetary process and laws and regulations. The second, **operating performance**, suggests that financial reporting should enable evaluation of the service efforts, costs, and accomplishments of the reporting entity. The third, **stewardship**, reflects the concept that financial reporting should enable an assessment of the impact on the nation of the government’s operations and investments. Finally, the fourth, **systems and controls**, indicates that financial reporting should reveal whether financial systems and controls are adequate.

SFFAC 2, *Entity and Display*, defines a reporting entity of the federal government, provides criteria to determine which entities should provide reports, and lists reports that should be provided. These reports are more extensive than required by the FASB or GASB.

SFFAC 3, *Management’s Discussion and Analysis*, indicates that “Each general purpose federal financial report (GPFFR) should include a section devoted to management’s discussion and analysis (MD&A),” and provides guidance regarding what should be included in that section.

## ILLUSTRATION 1-1 GAAP Hierarchy Summary

### *Established Accounting Principles*

| Nongovernmental Entities |  | State and Local Governments  | Federal GAAP Hierarchy  |
|--------------------------|--|--|---|
| .10a                     | FASB Statements and Interpretations, APB Opinions, and AICPA Accounting Research Bulletins   | .12a   | .14a  |
| .10b                     | FASB Technical Bulletins, AICPA Industry Audit and Accounting Guides, and AICPA Statements of Position                                   |  | FASAB Statements and Interpretations plus AICPA and FASB pronouncements if made applicable to federal governmental entities by a FASAB Statement or Interpretation  |
| .10c                     | Consensus positions of the FASB Emerging Issues Task Force and AICPA Practice Bulletins  | .12b   | .14b  |
| .10d                     | AICPA accounting interpretations, "Qs and As" published by the FASB Staff, as well as industry practices widely recognized and prevalent |  | FASAB Technical Bulletins and the following pronouncements if specifically made applicable to federal governmental entities by the AICPA and cleared by the FASAB: AICPA Industry Audit and Accounting Guides, and AICPA Statements of Position |
|                          |  | .12c   | .14c  |
|                          |  | Consensus positions of the GASB Emerging Issues Task Force <sup>2</sup> and AICPA Practice Bulletins if specifically made applicable to state and local governments by the AICPA | AICPA ACSEC Practice bulletins if specifically made applicable to federal governmental entities and cleared by the FASAB and Technical Releases of the Accounting and Auditing Policy Committee of the FASAB                                    |
|                          |  | .12d   | .14d  |
|                          |  | "Qs and As" published by the GASB Staff, as well as industry practices widely recognized and prevalent   | Implementation guides published by the FASAB staff and practices that are widely recognized and prevalent in the federal government   |



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|----|---|----|--|----|---|
| 11 | Other accounting literature, including FASB Concepts Statements; AICPA Issues Papers; International Accounting Standards Committee Statements; GASB Statements, Interpretations, and Technical Bulletins; FASAB Statements, Interpretations, and Technical Bulletins; pronouncements of other professional associations or regulatory agencies; AICPA <i>Technical Practice Aids</i> , and accounting textbooks, handbooks, and articles <sup>1</sup> | 13 | Other accounting literature, including GASB Concepts Statements; pronouncements in categories (a) through (d) of the hierarchy for nongovernmental entities when not specifically made applicable to state and local governments; FASB Concepts Statements; FASAB Statements; Interpretations, Technical Bulletins, and Concepts Statements; AICPA Issues Papers; International Accounting Standards Committee Statements; pronouncements of other professional associations or regulatory agencies; AICPA <i>Technical Practice Aids</i> ; and accounting textbooks, handbooks, and articles <sup>1</sup> | 15 | Other accounting literature, including FASAB Concepts Statements; pronouncements in categories (a) through (d) of the hierarchy in paragraph .10 when not specifically made applicable to federal governmental entities; FASB Concepts Statements; GASB Statements, Interpretations, Technical Bulletins, and Concepts Statements; AICPA Issues Papers; International Accounting Standards of the International Accounting Standards Committee; pronouncements of other professional associations or regulatory agencies; AICPA <i>Technical Practice Aids</i> ; and accounting textbooks, handbooks, and articles <sup>1</sup> |
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<sup>1</sup> In the absence of established accounting principles, the auditor may consider other accounting literature, depending on its relevance to the circumstances.

<sup>2</sup> As of the date of this edition of this text, the GASB had not organized such a group.

Source: AICPA Professional Standards: AU 411, The Meaning of "Present Fairly in Conformity with GAAP." Copyright © 2001 by the American Institute of Certified Public Accountants. Reprinted with permission.



## 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 to make 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.”<sup>1</sup>

## Objectives of Accounting and Financial Reporting for State and Local 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 following:

Accountability requires governments to answer to the citizenry—to justify the raising of public resources and the purposes for which they are used. Governmental accountability is based on the belief that the citizenry 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. Financial reporting plays a major role in fulfilling government’s duty to be publicly accountable in a democratic society.<sup>2</sup>

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

In 1994 the GASB issued its *Concepts Statement No. 2, Service Efforts and Accomplishments Reporting*, to encourage state and local governments to experiment with reporting more complete information about a governmental entity’s performance than can be displayed in traditional financial statements. Indicators of service efforts include inputs of nonmonetary resources as well as inputs of dollars. Indicators of service accomplishments include both outputs and outcomes.

## OUTLINE OF THE TEXT

The remainder of this chapter and Chapters 2 through 9 are concerned with accounting and financial reporting standards—generally accepted accounting principles—applicable to state and local governments in the United States. The remainder of this chapter provides an introduction to state and local governmental

<sup>1</sup> Financial Accounting Standards Board, *Statement of Financial Accounting Concepts No. 6* (Norwalk, Conn., 1985), par. 9.

<sup>2</sup> Governmental Accounting Standards Board, *Concepts Statement No. 1, Objectives of Financial Reporting* in *GASB Codification*, Appendix B, par. 56 (Norwalk, Conn., 2001).