
ACCOUNTING FOR GOVERNMENTAL AND NONPROFIT ENTITIES

LEON E. HAY

EIGHTH EDITION

ACCOUNTING FOR GOVERNMENTAL AND NONPROFIT ENTITIES

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of Accounting
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ACCOUNTING FOR GOVERNMENTAL AND NONPROFIT ENTITIES

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PREFACE

The Governmental Accounting Standards Board had its first meeting in June, 1984, only a few months before the seventh edition of this text went to press. The agreement under which the GASB was formed included the provision that after GASB has been in operation for approximately five years the Financial Accounting Foundation and the Governmental Accounting Standards Advisory Committee will conduct a "mandatory review" of the governmental accounting standards-setting structure. Present plans are that the review would be completed by the end of 1988, if possible. Concurrent with the review of the governmental accounting standard-setting structure the FAF is expected to review the business accounting standards-setting structure. As a result of the two reviews, decisions will be made whether to continue the two Boards without modification to the structure, whether to combine FASB and GASB, put GASB under an independent foundation separate from FAF, or take some other course of action for accounting standards-setting in the 1990's. Persons concerned with governmental accounting standards seem to be generally well impressed with the activities of the GASB. The Board has appointed task forces composed of governmental financial report users, preparers, and auditors to advise the Board on accounting and financial reporting topics on the Board's agenda. The topics have ranged from the purely conceptual (*Objectives of Financial Reporting*, GASB Concepts Statement No. 1) to the technical (*Advance Refundings Resulting in Defeasance of Debt*, GASB Statement No. 7); from the very broad (Measurement Focus/Basis of Accounting for Governmental Funds) to the very narrow (*Applying Paragraph 68 of GASB Statement No. 3*, GASB Technical Bulletin 87-1). The scope of the GASB's published pronouncements necessitated that this eighth edition of this text follow the seventh edition in a little more than three years, and the scope of GASB agenda items in progress indicates that the ninth edition may follow the eighth edition in less than three years. The author will continue to prepare an update to this text each time the GASB issues a pronouncement affecting the accounting and financial reporting standards discussed in the current edition; Richard D. Irwin will continue to distribute the updates to all persons on their list of adopters of the current edition.

As was true of each previous edition the author owes a debt of gratitude to the many professors; students; governmental financial report users, preparers and auditors who have shared with him their knowledge, experience, and views on governmental and not-for-profit organization accounting and financial reporting. In the preparation of this edition the author is greatly indebted to the standards-setters themselves, especially to James F. Antonio, Chairman, Governmental Accounting Standards Board; Martin Ives, Vice-Chairman, and Director of Research, Governmental Accounting Standards Board; and James R. Fountain, Assistant Director of Research, Governmental Accounting Standards Board.

Members of the American Institute of Certified Public Accountants Government Accounting and Auditing Committee have earned the author's thanks for sharing their perceptions of auditors' and users' concerns with financial reports of governments. Members of the AICPA Not-for-Profit Organizations Committee have been generous in their help in conveying an understanding of the concerns of auditors and users of financial reports of colleges and universities, hospitals, voluntary health and welfare organizations, and other not-for-profit entities. As was true of preceding editions of this text, the discussions in the chapters and the questions, exercises, and problems at the ends of the chapters are designed to meet the needs of readers who are concerned with the interpretation of financial reports and financial management decisions, as well as the needs of readers who are interested in the design and operation of accounting systems and the preparation of financial statements.

In addition to the many professors thanked by name in the Preface to the seventh edition who continued to give generously of their time and efforts in improving explanations in chapters of the text and improving the wording of questions, exercises, problems, and answers and solutions, a number of professors were motivated to obtain the *City of Bingham Continuous Problem Adapted for Microcomputer Solution* and give me suggestions for improving that problem as a learning device. I hope all those who helped so much will know that I appreciate their time and efforts, even though it is not possible to list the name of each in this Preface.

Bruce K. Michelson, of the United States General Accounting Office, and his co-workers were very helpful in reviewing the material now in Chapters 21 and 22 and providing materials and suggestions for the present revisions. Ronald J. Points, a member of the NCGA as a Federal Financial Executive, and now of Price, Waterhouse & Co., was of material assistance on many occasions and in many contexts, as were John R. Miller and S. Scott Showalter of Peat, Marwick, Main & Co.; Edward M. Klasny and James M. Williams of Ernst & Whinney; David R. Bean of the Government Finance Officers Association; and many others. Bobbye S. Hay, CPA, contributed greatly to this and previous editions, both technically and personally. Gary G. Johnson, McQueen Doctoral Research Fellow, devoted

many hours to helping in the preparation of the manuscript for this edition of the text.

The author appreciates the courtesy of the Governmental Accounting Standards Board in giving permission to quote their pronouncements and reproduce illustrations from their publications. The Government Finance Officers Association of the United States and Canada (formerly MFOA) generously gave permission to use materials published by it. Another valuable source of help has been provided by the American Institute of Certified Public Accountants which has allowed use of questions and problems from the certified public accountant examinations and which permitted quotations from its publications, particularly in the audit guide series. The National Center for Education Statistics provided materials so that the chapter on public school accounting in this edition would reflect the most recent authoritative pronouncements. The United Way of America graciously allowed the use in Chapter 20 of illustrations from *Standards of Accounting and Financial Reporting: A Guide for United Ways and Not-for-Profit Human Service Organizations*.

Although a number of persons helped refine the explanations in the chapters and the wording of the questions, exercises and problems, it is probable that errors, inconsistencies, and ambiguities remain in this edition. As readers encounter errors of omission or commission in this text, I urge them to let me know so that corrections can be made. Additionally, every user of this edition who has suggestions or comments about the material in the chapters—or the questions, exercises, or problems—is invited to share them with me.

Leon E. Hay

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Chapter 1

FINANCIAL REPORTING FOR GOVERNMENTAL AND NOT-FOR-PROFIT ENTITIES

In its *Concepts Statement No. 1, "Objectives of Financial Reporting,"* the Governmental Accounting Standards Board noted:

The Board believes that financial reporting plays a major role in fulfilling government's duty to be publicly accountable in a democratic society. Public accountability is based on the belief that the taxpayer has a "right to know," a right to receive openly declared facts that may lead to public debate by the citizens and their elected representatives. Use of financial reporting by citizens and legislative and oversight officials is pervasive.¹

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. Financial reports of not-for-profit organizations—voluntary health and welfare organizations, colleges and universities, hospitals, religious organizations, and others—have similar uses but, in recognition of the fact that the financial operations of not-for-profit organizations are generally not subject to as detailed legal restrictions as are those of governments, the Financial Accounting Standards

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

Board believes the financial reports for not-for-profit organizations should provide: (1) information useful in making resource allocation decisions; (2) information useful in assessing services and ability to provide services; (3) information useful in assessing management stewardship and performance; and (4) information about economic resources, obligations, net resources, and changes in them.²

Note the objectives of financial reporting for governments and not-for-profit entities stress the need for the public to understand and evaluate the financial activities and management of these organizations. All readers must already be aware of the impact on their lives, and on their bank accounts, of the activities of the layers of government they are obligated to support and of the not-for-profit organizations they voluntarily support. Since each of us is vitally affected, it is important that we be able to read intelligently the financial reports of governmental and not-for-profit entities. In order to understand the content of the financial reports it is necessary for the reader to make the effort to learn the accounting and financial reporting standards developed by authoritative bodies. The standards are explained and illustrated in Chapters 2 through 21 of this text. This chapter sets forth the distinguishing characteristics of governmental and not-for-profit entities and provides an overview of the objectives of accounting and financial reporting for these entities.

Distinguishing Characteristics of Governmental and Not-for-Profit Entities

In its *Statement of Financial Accounting Concepts No. 4*, the Financial Accounting Standards Board noted the following characteristics the Board felt distinguished governmental and not-for-profit entities from business organizations:

Receipts of significant amounts of resources from resource providers who do not expect to receive either repayment or economic benefits proportionate to the resources provided,

Operating purposes that are other than to provide goods or services at a profit or profit equivalent, and

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.³

² Financial Accounting Standards Board, *Statement of Financial Accounting Concepts No. 4, "Objectives of Financial Reporting by Nonbusiness Organizations"* (Stamford, Conn., 1980), pp. 19–23. In 1985 the FASB decided to replace the term *nonbusiness* with the term *not-for-profit*. Other organizations use the term *nonprofit* as a synonym for not-for-profit. The terms are used interchangeably in this text.

³ *Ibid.*, p. 3.

The Governmental Accounting Standards Board further distinguishes governmental entities in the United States from not-for-profit entities and from businesses by stressing that governments exist in an environment in which the power ultimately rests in the hands of the people. Voters delegate that power to public officials through the election process; the power is divided among the executive, legislative, and judicial branches of the government so that the actions, financial and otherwise, of governmental executives are constrained by legislative actions; and executive and legislative actions are subject to judicial review. Further constraints are imposed on state and local governments by the existence of the federal system in which higher levels of government encourage or dictate activities by lower levels and finance the activities (partially, at least) by an extensive system of intergovernmental grants and subsidies that require the lower levels to be accountable to the entity providing the resources, as well as to the citizenry. Revenues raised by each level of government come, ultimately, from taxpayers. Taxpayers are required to serve as providers of resources to governments even though they often have very little choice about which governmental services they receive and the extent to which they receive them. Since governments may have a monopoly on the services they provide to the public, the lack of a competitive marketplace makes it difficult to measure efficiency in the provision of the services. It is also extremely difficult to measure optimal quantity or quality for many of the services rendered by government—for example, how many police are “enough”? The Governmental Accounting Standards Board notes the determination of optimal quantity or quality of government services is complicated by the involuntary nature of the resources provided. “A consumer purchasing a commercial product can determine how much to purchase and may choose among ‘good,’ ‘better,’ or ‘best’ quality and pay accordingly. A group of individuals paying for governmental services (and paying in different proportions for services that some of them may not use or desire) presents a far more complex situation.”⁴

Sources of Financial Reporting Standards

Both the Governmental Accounting Standards Board and the Financial Accounting Standards Board have been cited in the first few pages of this chapter. The two Boards, generally referred to as the GASB and the FASB, are parallel bodies under the oversight of the Financial Accounting Foundation. The Financial Accounting Foundation appoints the members of the two Boards and supports the operating expenses of the Boards by obtaining contributions from business corporations; professional organizations of accountants, financial analysts, and other groups concerned with financial

⁴ Governmental Accounting Standards Board, *Concepts Statements No. 1*, p. 8.