

ACCOUNTING FOR
GOVERNMENTAL AND
NONPROFIT ENTITIES

Leon E. Hay

Sixth edition

Accounting for Governmental and Nonprofit Entities

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Sixth Edition

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Preface

THE TITLE of the first five editions of this text was *Governmental Accounting*—even though each edition contained chapters describing the application of generally accepted accounting principles to nonprofit entities such as public schools, colleges and universities, and hospitals. The current edition, the sixth, contains a new chapter which expands the coverage of the text to voluntary health and welfare organizations, and to the large number of types of nonprofit entities not covered by any American Institute of Certified Public Accountants publication until *Statement of Position 78-10* was released in January, 1979. Accordingly, it seemed time to change the title of the text to *Accounting for Governmental and Nonprofit Entities*.

The Financial Accounting Standards Board plans to release in 1980 a *Statement of Financial Accounting Concepts* on "Objectives of Financial Reporting by Nonbusiness Organizations." The term *nonbusiness organizations* is used by the FASB to include governmental entities as well as schools, colleges and universities, hospitals, and the organizations discussed in Chapter 20 of this text. Present plans of the FASB are to issue, as needed, *Statements of Financial Accounting Concepts* setting forth additional elements of the conceptual framework of accounting for nonbusiness organizations as well as for business enterprises. The Board has "agreed to exercise responsibility for all the specialized accounting and reporting principles and practices in existing AICPA Guides and SOPs" dealing with colleges and universities, hospitals, voluntary health and welfare organizations, and the types of nonprofit organizations covered in SOP 78-10. The Board's role in setting standards of accounting and financial reporting for state and local governmental units has not been determined as of this writing.

The Financial Accounting Standards Board added accounting and financial reporting by nonbusiness organizations to its already crowded agenda in

response to considerable public concern with financial reporting of major cities such as New York and Boston. New York's financial problems have received great publicity since 1975, and are credited with creating a wave of academic interest in financial accounting and reporting problems of entities which expend resources to render services to their constituents, rather than to generate earnings for distribution to owners and investors. For a decade or more prior to the wave of academic interest, however, committees of the American Institute of Certified Public Accountants concentrated on the application of generally accepted accounting principles and generally accepted auditing standards to state and local governmental units, and other nonprofit entities. The AICPA committees drew heavily on the work of organizations such as the National Council on Governmental Accounting (previously known as the National Committee on Governmental Accounting), the American Hospital Association, the National Association of College and University Business Officers, the National Health Council, the National Assembly of National Voluntary Health and Welfare Organizations, and similar organizations or persons interested in the financial management of each-type of nonprofit organization. The words *financial management* are important, because the FASB and the AICPA are concerned primarily with the information needs of users external to each reporting organization, whereas the "industry associations" have been concerned with the needs of internal users as well as external users. This text, also, is concerned with the financial information needs of managers in addition to the financial information needs of external users. 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.

The author is greatly indebted to the Municipal Finance Officers Association of the United States and Canada for permission to draw on materials issued under its own name and that of the National Council on Governmental Accounting. 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 Hospital Financial Management Association generously permitted the use of problems from its fellowship examinations. Chapter 19 on accounting for hospitals draws extensively upon the excellent manual published by the American Hospital Association. The United Way of America graciously allowed the use of illustrations from *Accounting and Financial Reporting: A Guide for United Ways and Not-For-Profit Human Service Organizations* in Chapter 20.

The author appreciates the help given by many persons in the employ of the Federal government in making available materials for Chapters 16 and 21, in

critically reviewing the chapters from the fifth edition, and in providing guidance for the present revisions of the chapters. D. L. Scantlebury of the United States General Accounting Office was particularly helpful in enlisting the assistance of his colleagues in the GAO and other Federal agencies. The National Center for Education Statistics graciously provided materials so that the chapter on public school accounting in this edition would reflect the most recent authoritative pronouncements. Roy E. Anderson, Assistant Director-Controller, Illinois Municipal Retirement Fund, reviewed and made very helpful suggestions for the material relating to public employee retirement funds. T. Melvin Holt, Illinois State University, A. J. Stagliano, University of Maryland, and Frank Weinberg, Golden Gate University, also contributed a number of thoughtful ideas for the improvement of the text, problems, and solutions.

Many valuable illustrations and suggestions for problems were obtained from published financial reports supplied by officials of the governmental units represented. Practicing CPAs, and administrators, accountants, budget officers, and auditors of state and local governmental units and nonprofit organizations have contributed much to the education of the author. They, as well as numerous colleagues in the teaching profession, and interested students, have been generous in suggesting improvements in the contents of the text. Dr. Ray M. Powell of Notre Dame, and Dr. John H. Engstrom of the University of Georgia each devoted many hours in constructive criticism of the prior edition and the various drafts of the manuscripts of this edition. Dr. Robert N. Anthony, as Consulting Editor of the Willard J. Graham Series in Accounting, and as author of the FASB Research Report, *Financial Accounting in Nonbusiness Organizations*, has been most helpful. Bobbye S. Hay, Manager of Financial Reports for Indiana University, contributed greatly to the development of Chapter 18, and criticized constructively other chapters.

The chapters, questions, exercises, and problems of this edition, and the answers to the questions and solutions to exercises and problems, have been subjected to careful and critical review by Martha Du Pre, a very able and conscientious undergraduate student at Indiana University. Martha has detected many (I hope all) of the errors and inconsistencies which creep into a text with 21 chapters, and close to 400 questions, exercises and problems. She has helped refine the explanations in the chapters and the wording of the questions, exercises and problems. If errors, inconsistencies, and ambiguities remain in this edition, I urge readers 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.

November 1979

Leon E. Hay

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Governmental and Nonprofit Entities— Accounting and Reporting: An Introduction

“NONBUSINESS ORGANIZATIONS,” the collective term used by the Financial Accounting Standards Board to refer to governmental units as well as to all other nonprofit organizations, account for at least 40 percent of the Gross National Product of the United States. (If “tax expenditures,” amounts left by tax laws in the hands of taxpayers to serve a public purpose—such as the exemption from Federal income taxation of interest on state and local government bonds, loan guarantees, and other items that are not included in appropriations budgets, are added to the appropriations, total governmental and other nonbusiness expenditures approximate 50 percent of GNP.)

Characteristics of Nonbusiness Entities

The term “nonbusiness” itself suggests to the reader that entities in this classification exist for reasons other than the attempt to earn net income for owners or investors. Indeed, a nonbusiness entity has no “owners” in the sense that businesses do. Persons and organizations who contribute resources to establish a nonbusiness entity, or to expand the scale of its operations, do so without the expectation of receiving a “return on investment,” or, even, a return *of* investment.

The typical reason for the organization of a nonbusiness entity is to render services to a group of constituents. In the usual case, administrators of a nonbusiness organization attempt to determine in advance the outflows of resources needed to provide services during a given time period, then attempt to secure an inflow of resources approximately equal to the desired outflow.

Some entities in the nonbusiness category may operate under very detailed and specific legal restrictions as to the sources of financial resources

they may utilize, the amounts they may raise from each source, and the uses they may make of the proceeds from each source—this is particularly true of local governmental units. Other entities in the nonbusiness sector are about as free as business enterprises from legal restriction as to the sources and uses of financial resources (only the most ingenuous reader would interpret that statement to mean that business enterprises operate without legal restrictions on both sources and uses of financial resources; regulation is all pervasive).

Financial Reporting by Nonbusiness Entities—Sources of Information

The primary focus of financial reporting by business enterprises “is information about earnings and its components.”¹ Clearly, the primary focus of financial reporting by nonbusiness entities differs from that of business enterprises. At the present time the objectives of financial reporting by nonbusiness organizations are under study by the Financial Accounting Standards Board. It is the announced intention of the Board to issue a series of statements of financial accounting concepts to set forth the Board’s view of each element of the conceptual framework of accounting for nonbusiness organizations as well as for business enterprises. Statements of financial accounting concepts are intended to furnish a basis for statements of financial accounting and reporting standards by the FASB. (The FASB is the sole organization within the private sector of the United States authorized to promulgate financial accounting and reporting standards binding upon the public accounting profession).

It appears probable that at least several years will elapse before there is a body of authoritative pronouncements by the Financial Accounting Standards Board sufficient to furnish a basis for a book designed to serve the needs of readers who are interested in gaining an ability to read intelligently the budgets and financial reports of governmental and nonprofit entities. Whether the reader’s interest is in becoming a better informed citizen; or in preparing for a career in the administration of nonbusiness organizations, their financial management, or the preparation or auditing of their financial statements and reports; it is necessary to obtain a sound knowledge of the application of generally accepted accounting principles to entities in the nonbusiness sector.

Currently, the most authoritative statements of the application of generally accepted accounting principles to state and local governmental units, colleges and universities, hospitals, voluntary health and welfare organizations, and other types of nonprofit organizations are found in the publications of the American Institute of Certified Public Accountants. The AICPA publications, generally in the Audit Guide series or the Statements of Posi-

¹Financial Accounting Standards Board, *Statement of Financial Accounting Concepts No. 1* (Stamford, Connecticut, 1978), p. ix.

tion series, tend to have evolved from the work of organizations of administrators, accountants, and auditors concerned with the accounting and reporting problems of specific types of nonbusiness entities. Thus, the AICPA's *Audits of State and Local Governmental Units* is closely related to the publications of the National Council on Governmental Accounting and its predecessor, the National Committee on Governmental Accounting. The AICPA's *Audits of Colleges and Universities* is related to the publications of the National Association of College and University Business Officers; the *Hospital Audit Guide*, to accounting and financial reporting publications of the American Hospital Association; and *Audits of Voluntary Health and Welfare Organizations*, to publications of the National Health Council and National Assembly of National Voluntary Health and Welfare Organizations. (It should also be noted that the current publications of "industry" associations have been modified in many respects subsequent to the publication of the AICPA audit guides.) Other useful sources of information about accounting and reporting practices of specific types of organizations are cited in the appropriate chapters of this text.

Organization of the Text

It is assumed that the reader of this text is familiar with principles of accounting for business entities, and therefore the text is focused upon the differences between accounting for governmental and nonprofit entities and accounting for business enterprises rather than the many similarities.²

Texts in accounting for governmental and nonprofit entities have traditionally begun by presenting the subject in terms of municipalities rather than states, the Federal government, or a certain type of nonprofit entity. There are good reasons for not breaking with this tradition: Many readers are more familiar with the organization and operation of governmental units than they are with any other type of nonprofit entity. The operations of a typical municipality are much easier for most persons to comprehend than are the far more complex operations of a state government or the almost unbelievably complex operations of the Federal government. Readers tend to find it easier to relate municipal accounting to municipal operations than to relate the accounting and the operations of more complex units. Persons who are familiar with accounting for state and local governmental units, and with accounting for business enterprises, appear to have little difficulty in understanding accounting and financial reporting practices recommended for use by Federal agencies and those recommended for public schools, colleges and universities, hospitals, and other nonprofit entities.

²Readers who are not familiar with basic accounting should study any contemporary Introductory Accounting text (several are available in programmed learning format) before attempting to understand the more technical portions of Chapters 2-20. Particular attention should be given to the discussion in the introductory text of financial statements and to the explanation of double entry methodology (often called "the accounting cycle").

It is generally conceded that management of any organization—nonbusiness as well as business—is facilitated by the preparation of budgets for operations and capital improvements. State laws usually require the preparation of a budget as a legal document to control the revenue raising and expenditure processes of state and local governments. Accordingly, Chapter 2 describes the budgeting process of state and local governments, particularly as it impacts upon the financial management, accounting, and reporting of these organizations.

Chapters 3 through 14 describe the application of generally accepted accounting principles to the activities of state and local governmental units. Chapter 15 is intended particularly for readers who have not studied the subject of internal control previously; it is concerned with planning and controlling cash—typically a critically important asset of any organization. Accounting for agencies of the Federal government is described in Chapter 16; Public School Accounting in Chapter 17; College and University Accounting, Chapter 18; Hospital Accounting, Chapter 19; Accounting for Voluntary Health and Welfare Organizations and Other Nonprofit Organizations, Chapter 20. Independent Verification of Reports of Financial and Operating Activities of Governmental and Nonprofit Entities, and the manner in which objectives of auditing nonbusiness entities differs from the objectives of auditing business enterprises are discussed in Chapter 21.

Many technical terms are introduced in Chapters 1 through 21. For the convenience of the reader a glossary is provided in Appendix 1. Accounting for investments is a topic which is of concern in many different contexts in all of the types of nonbusiness organizations discussed in this text. In order to avoid excessively repetitive detailed treatment in a number of chapters, the discussion in each chapter where the topic is of importance is limited to those aspects most relevant to the purposes of the chapter. A more complete and generalized treatment is presented in Appendix 2.

A BRIEF INTRODUCTION TO ACCOUNTING FOR NONBUSINESS ENTITIES

Fund Accounting

Local governmental units have only the resources allowed by laws of the superior jurisdiction; the legislative branch of a local governmental unit may choose not to utilize a resource authorized by state law, but it may *not* choose to utilize an unauthorized resource. Local governmental units may incur expenditures only for purposes, and in amounts, approved by the legislative branch in accord with procedures detailed in state laws. Whether the officials of a given local governmental unit agree that the constraints imposed by superior jurisdictions promote wise management of resources, or feel that wise management is hindered, is beside the point. The constraints are binding, the governmental official has no choice but to operate

within them; the accounting system must enable the officials to comply with the legal constraints. The need to demonstrate compliance with legal requirements led to the development of the fund accounting concept, which is so basic that the term “fund accounting” is often used to denote the kind of accounting recommended for state and local governmental units and by nonprofit entities.

The word *fund* has a special technical meaning in the nonbusiness sector. The National Council on Governmental Accounting defines the term as follows:

A fund is defined as a fiscal and accounting entity with a self-balancing set of accounts recording cash and other financial resources, together with all related liabilities and residual equities, or balances, and changes therein, which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions, or limitations.³

The dual meaning of “fund” should be noted. A *fund is an accounting entity; it is also a fiscal entity* created, in most instances, by operation of law. The term “law” is used in its most general sense. The accounting and financial reporting of state and local governmental units may be prescribed (or circumscribed) by state constitutions, state statutes, bond indentures, agreements with employees, provisions of grants from Federal or other governmental agencies, and agreements with individuals or private organizations which have donated assets to be used for specified purposes. Local governmental units are also bound by administrative regulations of agencies of higher jurisdictions, and by ordinances and resolutions enacted by the legislative component of the local unit. Public schools, colleges and universities, hospitals, voluntary health and welfare organizations, and other nonprofit organizations generally have fewer categories of legal restrictions than do governmental units, but do have grants and gifts restricted by donors, agreements with employees and creditors, and, in some cases, governmental appropriations, which indicate the desirability of fund accounting.

The types of funds recommended for use by state and local governments by the National Council on Governmental Accounting are classified in three categories: governmental funds, proprietary funds, and fiduciary funds. In the first group, *governmental funds*, are:

1. *General Funds.* General funds are funds established to account for resources devoted to financing the general services which the governmental unit performs for its citizens. These include general administration, protection of life and property, sanitation and similar broad services. The general fund is sometimes described as the one used to account for all financial transactions not properly accounted for in another fund. Some activities, such as governmentally supported libraries, are often of sufficient importance and mag-

³National Council on Governmental Accounting, *Governmental Accounting and Financial Reporting Principles, Statement 1* (Chicago: Municipal Finance Officers Association, 1979), p. 2.

nitude to have a special fund; when this is not true they become a function and responsibility of the general fund. Accounting and reporting for general funds is discussed in Chapters 3, 4, and 5 of this text.

2. *Special Revenue, or Special, Funds.* Funds of this class are created and operated to account for revenue designated by law for a particular purpose. For the specific purpose or function to which it is devoted, a special revenue fund is much in the nature of a general fund. Some of the governmental services for which special funds are frequently established are education, libraries, streets and bridges, welfare, etc. Accounting and reporting for special funds follows the principles and practices set forth in Chapters 3, 4, and 5.

3. *Capital Projects Funds.* The receipt and disbursement of all financial resources to be used for the acquisition of capital facilities other than those financed by special assessment funds, proprietary funds and trust funds is accounted for by capital projects funds. Capital projects funds are discussed in Chapter 6.

4. *Debt Service Funds.* A debt service fund is created to account for the resources devoted to the payment of interest and principal on long-term general obligation debt other than that payable from special assessments and that serviced by governmental enterprises. Chapter 7 is devoted to debt service funds.

5. *Special Assessment Funds.* Special assessment funds are designed to account for the construction, or purchase through contract, of public improvements—streets, sidewalks, and sewer systems, for example—which are financed in whole or in part by special levies against property owners adjudged to receive benefits from the improvements materially in excess of benefits received by the general body of taxpayers, and for the maintenance and upkeep of such assets. Chapter 8 presents the fundamentals of special assessment fund accounting.

The following two fund types are referred to as *proprietary funds*:

6. *Internal Service Funds.* Internal service funds are established by governmental units as a means of providing services to other funds or departments of the same unit, or to other governmental units, on a cost-reimbursement basis. Funds of this nature are discussed in Chapter 9.

7. *Enterprise Funds.* Internal service funds are established to provide services for governmental customers, but enterprise funds are operated to provide electric, water, gas, or other services to the general public. Except for ownership, they bear a close resemblance to investor-owned utility or other service enterprises. Enterprise funds are also used to account for activities for which the governmental body desires periodic computation of revenues earned, costs incurred, or net income. Chapter 10 presents accounting and reporting standards for enterprise funds.

The third category of funds recommended for use by state and local governmental units is *fiduciary funds*.

8. *Fiduciary Funds.* Fiduciary funds are used to account for transactions related to assets held by a governmental unit as a trustee or agent. In most cases the governmental unit does not have absolute title to the assets held; and in the remainder, they are owned with specific restrictions upon their use. Fiduciary funds are discussed in Chapter 11.