

ESSENTIALS OF
ACCOUNTING

for Governmental and
Not-for-Profit Organizations



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

Eighth Edition

Paul A. Copley,
Ph.D., CPA

*Hantzmon, Wiebel & Co.
Faculty Fellow
Director, School of Accounting
James Madison University*

John H. Engstrom
D.B.A., CPA, CGFM

*KPMG Professor of
Accounting, Emeritus
Northern Illinois University*



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ESSENTIALS OF ACCOUNTING FOR GOVERNMENTAL AND NOT-FOR-PROFIT ORGANIZATIONS

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In memory of Russ Barefield (Director, J.M. Tull School of Accounting, University of Georgia) and Patrick R. Delaney (Arthur Andersen Professor and Chair of the Department of Accountancy, Northern Illinois University).

Preface

Thank you for considering the eighth edition of *Essentials of Accounting for Governmental and Not-for-Profit Organizations*. Our purpose is to provide a text that may be adopted in a variety of government/not-for-profit (GNP) course formats. We have used this text with stand-alone, three semester-hour classes, with half-semester GNP courses, and as a module in advanced accounting classes. It is appropriate for accounting majors or as part of a public administration program. Concepts are well illustrated with journal entries and do not require specific accounting knowledge beyond that provided in most principles of accounting courses. The coverage is effective in preparing candidates for the CPA examination.

The focus of the text is on the preparation of external financial statements. Among the more challenging aspects of governmental reporting is the preparation of government-wide financial statements. Our approach is to record governmental activities using the modified accrual basis of accounting, which facilitates preparation of fund-basis statements. These are illustrated in Chapters 2 through 7. In Chapter 8, the fund-basis statements are converted to the accrual basis used in the government-wide financial statements through the use of worksheet journal entries. This approach has two advantages: (1) it is the approach most commonly applied in practice, and (2) it is an approach familiar to students who have studied the process of consolidation in their advanced accounting classes.

Chapter 10 is devoted to accounting and reporting by private not-for-profit organizations. This chapter provides essential coverage of private-sector not-for-profits and may be all that is desired in courses taught in half a semester or as modules in advanced accounting. Alternatively, for full-semester courses, detailed applications of not-for-profit accounting for specific industries are provided in Chapters 9, 11, and 12. Chapters 9 and 11 illustrate transactions and reporting requirements unique to public and private colleges and universities. Similarly, Chapter 12 illustrates typical transactions and alternative financial statement formats common among health care organizations. Chapter 13 examines auditing and tax issues specific to governmental and not-for-profit organizations and concludes with a discussion of performance evaluation, including ratio analysis and service efforts and accomplishments reporting.

The text is updated for recent GASB statements including accounting for other postemployment benefits, impairment of capital assets, and economic condition reporting. The eighth edition reflects changes in standards issued by the GASB, FASB, AICPA, and GAO. Additional features of the text include:

- An ongoing example integrated throughout Chapters 2 through 8 and 13.
- A continuous homework problem throughout Chapters 2 through 8 and 13.
- *Instructor's Guide*.
- *Suggested Quiz and Examination Questions and Problems*.
- Powerpoint slides.
- A textbook Web site.

- Excel financial statement templates for the continuous problem.
- An additional practice set.

We are indebted to members of the Governmental Accounting Standards Board for permission to use GASB materials and to the American Institute of Certified Public Accountants for permission to use their materials. We thank Sue Cullers, Tarleton State University; Liz Keating, Harvard University; Saleha Khumawala, University of Houston; and Lela Pumphrey, Idaho State University for reviewing the seventh edition and providing suggestions. We are also indebted to the many users of the text for their comments. Additional comments and suggestions are welcome and may be addressed to: copleypa@jmu.edu.

Paul A. Copley

John H. Engstrom

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Chapter One

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

If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary.
James Madison, fourth president of the United States and principal author of the U.S. Constitution

Learning Objectives

- Obtain an overview of financial reporting for nonbusiness entities.
- Distinguish between private and public sector organizations.
- Identify the sources of authoritative accounting standards for various public and private sector organizations.
- Define the 11 fund types used by state and local governments.

In its relatively short existence, the United States has grown to be the largest and most successful economy in history. Why then would a country founded on the principles of free markets and private investment rely on governments to provide many goods and services? The answer lies in understanding the incentives of a free enterprise economy. There are many services that simply cannot be priced in a way that naturally encourages commercial entrepreneurs to enter the marketplace. Commonly this is because the service is subject to free-riding. For example, public

safety and a clean environment benefit every citizen, whether or not they contribute to its cost. Since there is no practical means for businesses to sell this service, governments are called upon through the political process to provide those services that citizens demand. In other instances, free market incentives do not align with public interest. For example, society finds it desirable to provide a K–12 education to all its citizens, not just those with the ability to pay.¹

Although the majority of products and services are provided by either businesses or governments, in some circumstances private organizations are formed to provide goods or services without the intent of earning a profit from these activities. Examples include public charities, trade associations, and civic groups. Again, the goods or services they provide often cannot be priced in a way that encourages commercial entrepreneurship. For example, a public radio broadcast cannot be effectively restricted to only those individuals choosing to support the public radio station. While this explains why the services are not provided by businesses, why aren't governments called upon to provide them?

In some instances, obstacles exist that prevent government involvement. For example, the U.S. Constitution provides for separation of church and state. Therefore, any group that wishes to promote religious activities must do so through private organizations rather than through government. More commonly the reason is heterogeneous demand. Support for the arts may be important to a group of individuals but unless that group is sufficiently large to influence the political process, it is unlikely that elected officials will use government funds for that purpose. However, support for the arts could still be provided by forming a charitable foundation with no relationship to the government and having the foundation solicit donations from that segment of the public who finds the arts important.

The organizations introduced in the preceding paragraphs are the focus of this book: governmental and not-for-profit organizations. They are distinguished from commercial businesses by the absence of an identifiable individual or group of individuals who hold a legally enforceable residual claim to the net assets. Throughout the text a distinction will be made between **public** and **private** organizations. Public organizations are owned or controlled by governments. Private organizations are not owned or controlled by governments and include businesses as well as private not-for-profit organizations. **Not-for-profit organizations** lack a residual ownership claim and the intent is other than to provide goods and services at a profit.

Because significant resources are provided to governments and not-for-profit organizations, financial reporting by these organizations is important. To paraphrase the James Madison quotation provided at the beginning of the chapter, because humans (not angels) operate governments, controls are necessary. Financial reports that reflect the policies and actions of governmental managers are an effective means to control the actions of those entrusted with public resources. To be effective, external financial reports must be guided by a set of generally accepted accounting principles. The generally accepted accounting principles for governmental and private

¹ The branch of economics that studies the demand for government services is termed "public choice."

not-for-profit organizations are the subject of this book. The first nine chapters of the text deal with public sector organizations and Chapters 10, 11, and 12 deal primarily with private not-for-profit organizations. Chapter 13 discusses auditing and tax-related issues unique to governments and private not-for-profits and also evaluates performance of these entities.

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

Organisms evolve in response to characteristics of their environment. Similarly, accounting principles evolve over time as people find certain practices useful for decision making. Further, we expect organisms in different environments to evolve differently. Likewise, if the environments in which governments and not-for-profits operate differ in important ways from those of commercial enterprises, we would expect the accounting practices to evolve differently.

Consider first the operations of governmental entities. Listed below are some of the ways that the governmental environment differs from commercial enterprises and how those differences manifest in governmental accounting practices. The purpose here is to provide an understanding of why governmental accounting practices differ from business accounting practices. The actual accounting practices will be described in more detail in later chapters.

- **Lack of residual ownership claim:** The purpose of business reporting is to provide information to investors and creditors. While governments also have creditors, identifying the set of “investors” is more difficult. Citizens and businesses, both within the government’s jurisdiction and those considering relocation to the jurisdiction, are among the potential investors. In addition, governments receive considerable resources from other governments and grantors who may also be considered investors. Since this diverse set of resource providers has varying interests, the information needs of one group may not meet the needs of another. The result is that governments report far more disaggregated information than do commercial enterprises.

- **Nonexchange transactions:** Net income is a universally accepted measure of business performance. The calculation of net income begins with sales. A sale occurs when an independent party perceives that the product offered both provides value and is fairly priced. Net income then simply determines whether this measure of demand (sales) exceeds the cost of providing the product and is an accepted measure of performance for business organizations. On the other hand, governments derive many of their resources from taxes. Individuals and businesses pay taxes to avoid penalty, not voluntarily because they perceive government services to be of value and fairly priced. Because tax and other nonexchange revenues are not equivalent to sales, the excess of revenues over expenses cannot be interpreted as an effectiveness measure in the manner of business net income. Because net income was not viewed as a useful measure for evaluating government performance, governmental accounting practices developed with a focus on the sources and uses of expendable funds, rather than with a focus on income concepts such as capital maintenance.

- **Restricted resources:** While a business can use its resources as it deems appropriate, governments frequently receive resources that are restricted to a particular purpose. For example, a city may collect a telephone excise tax legally restricted to operating a 911 emergency service. In an effort to provide assurance that resources are used according to legal or donor restrictions, governments use **fund accounting**. A fund represents part of the activities of an organization that is separated from other activities in the accounting records to more easily demonstrate compliance with legal restrictions or limitations.

- **Formal and restrictive budgets:** While many businesses prepare budgets, these are for planning and control purposes and are rarely made available to creditors or investors. In contrast, governmental budgets often carry the authority of law, preventing public officials from spending outside their budgetary authority. The increased importance of budgets is reflected in the financial reports by a required report comparing budgeted and actual amounts.

For these and other reasons, the accounting practices of governmental organizations evolved differently from those of businesses.

As you will see in later chapters, the accounting practices of not-for-profit organizations more closely resemble those of commercial businesses. However, the not-for-profit environment shares some important characteristics with governments. Similar to governments, not-for-profits do not have residual owners. “Investors” in not-for-profits are diverse and include donors, volunteers, and members. In addition, as with governments, the excess of revenues over expenses is not an effective measure of organizational performance. Finally, like governments, not-for-profits receive resources with donor-imposed restrictions.

Further complicating this issue is the fact that we have three levels of government (federal, state, and local) and not-for-profits may be either publicly or privately owned. This is important because different standards-setting bodies have authority for establishing reporting standards for these groups. Illustration 1–1 summarizes the various organizational types and the bodies with primary standard-setting authority.

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. Government Accountability 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

ILLUSTRATION 1–1 Summary of Standards-Setting Organizations

| Reporting Organization | Standards Setting Board |
|-----------------------------|---|
| Federal government | Federal Accounting Standards Advisory Board (FASAB) |
| State and local governments | Governmental Accounting Standards Board (GASB) |
| Public not-for-profits | Governmental Accounting Standards Board (GASB) |
| Private not-for-profits | Financial Accounting Standards Board (FASB) |
| Investor-owned businesses | Financial Accounting Standards Board (FASB) |

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