
INTRODUCTION TO
FUND
ACCOUNTING

SECOND EDITION
EDWARD S. LYNN • JOAN W. NORVELLE

INTRODUCTION TO FUND ACCOUNTING

Second Edition

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Preface

Public administration majors need a knowledge of fund accounting. Until the first edition of this text was published there was no text designed to permit students with no prior knowledge of accounting to study fund accounting. Then, as now, the major texts in the field were designed for use by accounting majors who had studied accounting for business enterprises for two or more semesters.

The authors and other users of the first edition have found that, with the combination of the *Introduction* and a conventional fund accounting text,* public administration, home economics, and other nonbusiness majors have the tools for a thorough one-semester course. *Introduction* is General Fund oriented. We start our students in *Introduction*, then gradually add materials from the introductory chapters of the major text, then intermix assignments from *Introduction* and the General Fund chapters of the major text. By the time a third of a semester has passed, the students are ready to utilize the more sophisticated materials from the major text without the support of *Introduction*.

We want to thank those public administration students, graduate and undergraduate, who have proved feasible a fund accounting course for those who have had no prior accounting.

Many employees of governments and institutions begin work with no accounting background, then find they need to

*For example: Edward S. Lynn and Robert J. Freeman, *Fund Accounting: Theory and Practice*, 2nd ed. (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1983).

know what is going on in accounting in their offices. The same qualities that make this book a good introduction to fund accounting in a college course make it suitable for familiarization of municipal, state, and institutional personnel with what accounting in their environment is all about. Its wording is simple, its terminology is well defined, and its pace is suited to self-study. We expect that those who use it will find their interest stimulated and will want to go on with a more advanced accounting text.

Edward S. Lynn
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Characteristics of Fund Accounting

ACCOUNTING DEFINED

Accounting is the art of analyzing, recording, summarizing, evaluating, and interpreting an organization's financial activities and status, and communicating the results. Accounting is an information system for a specific entity. The entity concept is described in Chapter 3.

Accounting is frequently referred to as “the language of business,” and indeed it serves as a principal means of communication for the profit-seeking segment of the economy. But it is equally the language of the *not-for-profit* (NFP) or nonbusiness segment.

Accounting in the NFP segment is referred to as fund accounting. The fund concept is defined in Chapter 2. Fund accounting is a broader term than governmental accounting although the terms are sometimes used synonymously. Governments use fund accounting, but so do all of the other not-for-profit organizations.

TYPES OF NFP ORGANIZATIONS

The major types of NFP organizations and some examples are:

- **Governmental.** Federal, state, and local.
- **Educational.** Public and private schools, colleges, and universities.
- **Health and welfare.** Hospitals, nursing homes, and orphanages.
- **Religious.** Churches and church-related organizations.
- **Charitable.** Community-wide organizations and those having more restricted service objectives.
- **Foundations.** Private trusts and corporations.

This is a general classification scheme, and there is much overlap. For example, many charitable organizations are church-related; governments are deeply involved in education, health, and welfare activities; and foundations are usually organized with educational, religious, or charitable objectives.

Fund accounting texts are usually based on local government accounting, as this one is, because local governments are the most numerous users of fund

accounting. The principles of governmental accounting, once mastered, can easily be applied to state and federal governments as well as to other types of NFP entities. For a more detailed description of accounting for all types of NFP organizations and other topics in fund accounting, see Lynn and Freeman's *Fund Accounting: Theory and Practice*.¹

AUTHORITATIVE SOURCES OF NFP ACCOUNTING PRINCIPLES

The focus of this text is on accounting and financial reporting for local governments. The primary source for the principles of fund accounting and financial reporting for local governments is the National Council on Governmental Accounting (NCGA). The NCGA promulgates *Statements*² and *Interpretations* that are authoritative. Table 1.1 lists this and other bodies or organizations that have established principles of accounting or offered assistance in financial management for their constituencies in various references, journals, and newsletters.

TABLE 1.1: Authoritative Sources of NFP Accounting Principles

Type of Organization	Source
State and Local Government	National Council on Governmental Accounting
Federal Government	General Accounting Office
Hospitals	American Hospital Association Hospital Financial Management Association
Colleges and Universities	National Association of College and University Business Officers National Center for Education Statistics
Voluntary Health and Welfare Organizations	National Health Council National Assembly of National Voluntary Health and Social Welfare Organizations United Way of America

No list of authoritative sources for NFP organizations would be complete without reference to the audit guides of the American Institute of Certified Public Accountants (AICPA), which include *Hospital Audit Guide* (1972), *Audits of*

¹Edward S. Lynn and Robert J. Freeman, *Fund Accounting: Theory and Practice*, Second Edition (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1983).

²The first, a comprehensive statement of principles, is *Statement 1*, "Governmental Accounting and Financial Reporting Principles" (Chicago: The Municipal Finance Officers Association of the United States and Canada, 1979). Hereafter cited "*Statement 1*."

Colleges and Universities (1973), *Audits of State and Local Governmental Units* (1974), and *Audits of Voluntary Health and Welfare Organizations* (1974). The pronouncements of the various NFP standards-setting bodies were studied by AICPA committees in the course of preparing the audit guides. Originally, there were some conflicting views and alternative methods suggested; however, all substantive differences between the AICPA committees and the NFP standards-setting bodies have now been resolved, and both the audit guides and pronouncements have been amended to gain mutual agreement. This concurrence was a significant achievement.

Two other AICPA publications of particular interest in the NFP sector are Statement of Position 78–10 (SOP 78–10), *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations* and Statement of Position 80–2 (SOP 80–2), *Accounting and Financial Reporting by Governmental Units*. SOP 78–10 sets forth accounting and reporting practices for those types of NFP organizations that did not have separate standards-setting bodies or audit guides. SOP 80–2 amends the AICPA *Audits of State and Local Governmental Units* (ASLGU) to incorporate *Statement 1* and provides additional guidance to auditors of state and local governmental financial statements. Today this literature makes up the bulk of the authoritative references in the NFP sector, but a major change has occurred in the standards-setting process. In 1979, the Financial Accounting Standards Board (FASB) agreed to exercise responsibility for all “specialized” accounting and reporting principles and practices. “Specialized” refers to all NFP organizations except state and local governments—a final decision on the proper standards-setting body for state and local governments is pending.

The NCGA, until such time as another body is assigned the task, will be responsible for establishing accounting and reporting standards for state and local government. The Council consists of 21 members representing state and local government finance officers, certified public accountants, educators, and other financial executives who serve on a voluntary, part-time basis. The Council maintains liaison with the FASB, the AICPA, and other organizations concerned with state and local governmental accounting.

Although the FASB issued a Statement of Financial Accounting Concepts on “Objectives of Financial Reporting by Nonbusiness Organizations” in 1980, and some of its recent statements apply to both business and nonbusiness organizations, it has not yet had a major impact on NFP accounting and reporting standards. Thus, there continue to be several sources of authoritative pronouncements concerning NFP accounting and financial reporting; at this writing there has been no determination of the body that will set standards of state and local accounting and financial reporting in future years.

NCGA *Statements* are the final authority for accounting and reporting principles for state and local government. *Statement 1* was issued in 1979 and was formally

recognized as authoritative by the AICPA in its Statement of Position 80-2. A companion reference to *Statement 1* is the publication of the Municipal Finance Officers Association (MFOA) entitled *Governmental Accounting, Auditing, and Financial Reporting* (GAAFR 80).³ It is not an authoritative pronouncement, but was designed to be consistent with and illustrative of the principles of *Statement 1*. GAAFR 80 contains detailed illustrations of accounting and financial reporting for all types of funds and account groups, a glossary, and other materials.

The summarization in Table 1.2 of the authoritative literature for state and local governments is in chronological order and may aid in your study of this material.

TABLE 1.2: Chronology of Authoritative Literature for State and Local Governments

Date	Organization and Publication	Comments
1934	The National Committee on Municipal Accounting was organized under the auspices of the Municipal Finance Officers Association (MFOA) and very shortly published <i>Tentative Outlines—Principles of Municipal Accounting</i> .	The Committee's work was the first effort on a national scale to establish and promote standards and principles in governmental accounting.
1951	The National Committee on Governmental Accounting of the MFOA issued <i>Municipal Accounting and Auditing</i> .	This publication combined and revised the publications of the Committee (note name change) up to that time; sometimes referred to as the "Bible of municipal accounting."
1968	The National Committee on Governmental Accounting of the MFOA issued <i>Governmental Accounting, Auditing, and Financial Reporting</i> (GAAFR 68).	Often referred to as "the blue book." The 1968 Committee set forth what it considered to be the basic accounting and reporting principles applicable to state and local governments. This Committee (as well as its predecessor committees) was not a staff-supported permanent body which met regularly. GAAFR was neither endorsed nor rejected by the AICPA, but the pronouncements did constitute the most authoritative and widely accepted standards of municipal accounting and reporting principles.

³Municipal Finance Officers Association, *Governmental Accounting, Auditing, and Financial Reporting* (Chicago: MFOA, 1980). Richard J. Haas, primary author.

Date	Organization and Publication	Comments
1974	The American Institute of Certified Public Accountants (AICPA) issued <i>Audits of State and Local Governmental Units</i> (ASLGU).	Subsequently amended by AICPA Statement of Position 75-3 (<i>Accrual of Revenues and Expenditures by State and Local Governmental Units</i>) and Statement of Position 77-2 (<i>Accounting for Interfund Transfers of State and Local Governmental Units</i>). See the reference to Statement of Position 80-2 immediately below.
1979	The National Council on Governmental Accounting issued <i>Governmental Accounting and Financial Reporting Principles, Statement 1</i> , and <i>Grant, Entitlement, and Shared Revenue Accounting and Reporting by State and Local Government Units, Statement 2</i> .	<i>Statement 1</i> is the definitive reference for accounting and reporting principles for state and local government, and is recognized as authoritative by the AICPA in its Statement of Position 80-2 (<i>Accounting and Financial Reporting by Governmental Units</i>). Established generally accepted accounting principles (GAAP) for state and local governments—this concept is described further in Chapter 2. (Note name change of Committee to Council.)
1980	The MFOA both authored and published the 1980 edition of <i>Governmental Accounting, Auditing, and Financial Reporting</i> (GAAFR 80).	Note absence of NCGA authorship. Unlike GAAFR 68 and <i>Statement 1</i> , it neither establishes nor authoritatively interprets GAAP for state and local governmental units. It is intended, as stated in its introduction, “to provide government finance officers, elected officials, independent auditors, and others with detailed guidance to the effective application of <i>Statement 1</i> principles to the accounting and financial reporting activities of state and local governments.”
1983	Governmental Accounting Standards Board (GASB).	The Governmental Accounting Standards Board is now in the process of being formed. Its pronouncements will be authoritative as a part of generally accepted accounting principles.

LEGAL AND ADMINISTRATIVE CHARACTERISTICS OF NFP ORGANIZATIONS

All facets of an NFP organization's operations may be affected by legal or quasi-legal requirements imposed both externally (by federal or state statute, ruling, grant stipulation, or judicial decree) and internally (by charter, by-law, ordinance, trust agreement, donor stipulation, or contract). Furthermore, operational and administrative controls may be stricter than in private enterprise because of the need to assure compliance with legal and other requirements. The two most important types of legal and administrative control provisions affecting accounting in this environment are funds and budgets, both of which are discussed in Chapter 2.

Thus, managers of NFP organizations may have limited discretion compared with managers of business enterprises. For example, it may be difficult to:

1. Modify an organization's structure, no matter how archaic, awkward, or ineffective.
2. Attract qualified employees at prescribed pay rates, discharge or demote incompetent employees, or reward outstanding employees.
3. Acquire sufficient resources or use available resources as management deems most appropriate.
4. Improve the existing budgeting, accounting, reporting, or auditing arrangements.

The role and emphasis of financial accounting and reporting may be correspondingly altered, therefore, as compared with the profit-seeking enterprise environment. However, given the hardships listed above and the different environment for NFP organizations, sound financial management is still just as important for the NFP entity as for the business enterprise. Furthermore, because of the scope and diversity of its activities, proper management of the financial affairs of a city or town may be far more complex than that of a private business with comparable assets or annual expenditures.

Accounting is a service function and must evolve to meet the information demands of a given environment. In the NFP environment decisions concerning resource acquisition and allocation, managerial direction and control of resource utilization, and custodianship of resources have traditionally been framed in terms of social and political objectives and constraints rather than profitability. Legal and administrative requirements have been used as society's methods of directing its NFP institutions in achieving those objectives. NFP organization accounting and reporting have correspondingly evolved with a distinctive emphasis on control of and accountability for expendable resources.

CONTRASTING NFP ORGANIZATIONS WITH PROFIT-SEEKING ENTERPRISES

Governments and other not-for-profit organizations are different from profit-seeking organizations in many ways. Some of these are listed below:

1. The profit motive is not the basis for their inception or operation.
2. They are usually owned collectively by their constituents; that is, ownership is not normally evidenced by individually owned equity shares which may be sold or exchanged.
3. Those contributing financial resources to the organization do not necessarily receive a direct or proportionate share of its goods or services; for example, the welfare recipient probably did not pay the taxes from which his benefits are paid. The contributors do not expect to profit (for example, receive dividends) because of their contributions.
4. The objective of most not-for-profit organizations is to provide as many goods or as much service each year as financial and other resources permit.
5. NFP organizations typically operate on a year-to-year basis, raising such resources as they can and expending them in serving their clientele.
6. Governments have the unique power to force involuntary financial resource contributions through taxation—of property, sales, income, etc.—and all levels rely heavily upon this power. They may seek to increase the amount of resources made available to them each year—and most do—but the objective is to enable them to provide services, not to increase their wealth.

In sum, while private businesses seek to increase their wealth for the benefit of their owners, NFP organizations seek to expend their available financial resources for the benefit of their clientele. Financial management in the NFP environment thus typically focuses on acquiring and using financial resources rather than on net income.

Even though not-for-profit entities have organizational characteristics and objectives that differ from those of business enterprises, they are also similar in many ways. For example:

1. They are integral parts of the same economic system and utilize similar resources in accomplishing their purposes.
2. Both must acquire and convert scarce resources into their respective goods or services.
3. Financial management processes are essentially similar in both and each must have a viable information system—of which the accounting system is an integral compo-

ment — if its managers and other interested persons or groups are to receive relevant and timely data for planning, directing, controlling, and evaluating the use of its scarce resources.

4. Inasmuch as their resources are relatively scarce — whether donated, received from consumers, acquired from investors or creditors, or secured through taxation — least-cost analysis and other control and evaluation techniques are essential to assuring that resources are utilized effectively and efficiently.
5. In some cases, both produce similar products; both governments and private enterprise may own and operate transportation systems, sanitation services, and electric or gas utilities.

In addition to organizational similarities, there are also many similarities in the accounting procedures for profit-seeking and not-for-profit entities. The basic mechanics of the record-keeping process are the same for both. Many of the terms are the same or similar, but not all of the terminology is interchangeable. In this text we provide definitions suitable to the fund accounting context and do not attempt to define the terms for profit-seeking enterprises, nor to contrast the definitions where they differ.

QUESTIONS

1. Define accounting.
2. Distinguish between fund and governmental accounting.
3. List the major types of NFP organizations and give an example of each type.
4. List at least one governing body for the following types of NFP entities: state and local government, federal government, hospitals, colleges and universities, and voluntary health and welfare organizations.
5. List the NFP sectors for which the AICPA has prepared audit guides.
6. What do the following initials stand for: NFP, NCGA, AICPA, SOP, FASB, MFOA, GAAFR, and ASLGU?
7. Describe the role of the NCGA in standards-setting.
8. What is the definitive reference for accounting and reporting principles for state and local government?
9. Describe the purpose of the 1980 edition of GAAFR.
10. List four difficulties that may be encountered more frequently by managers of NFP organizations than by managers of profit-seeking entities.
11. List five ways in which NFP organizations differ from profit-seeking entities.
12. List five ways in which NFP and profit-seeking entities are similar.

Principles of Fund Accounting and Reporting

NCGA *Statement 1* lists twelve basic principles of accounting and reporting applicable to governmental units. Some of these principles and reporting concepts are discussed below (Principles 1, 2, 3, 4, 8, 9, 10, and 11); for more details on these principles and those not discussed (Principles 5, 6, 7, and 12), please refer to *Statement 1* itself or to more advanced fund accounting texts such as Lynn and Freeman's *Fund Accounting*.

FINANCIAL REPORTING

When the activities of a governmental fund for a period of time (a reporting period) have been recorded, the data need to be summarized for the purposes of:

1. Reporting that activities have complied with applicable laws (e.g., appropriations, regulations, etc.).
2. Reporting the financial position of the governmental entity at the end of the reporting period.
3. Reporting the changes (e.g., revenues and expenditures) in the expendable resources of the entity.

Chapter 7 is devoted to a discussion of the general purpose financial statements of the General Fund.

When reports for all the funds of a governmental unit have been prepared, there remains the problem of presenting the financial position and results of operation of the government as a whole. That topic is also beyond the scope of this book but is covered in *Statement 1* (Principle 12).

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES AND LEGAL COMPLIANCE

Principle 1 states that:

A governmental accounting system must make it possible both: (a) to present fairly and with full disclosure the financial position and results of financial operations of the funds

and account groups of the governmental unit in conformity with generally accepted accounting principles; and (b) to determine and demonstrate compliance with finance-related legal and contractual provisions.⁴

Generally accepted accounting principles (GAAP) are a set of standards of quality—a set of guides to action in the preparation of general purpose financial statements. One dictionary of accounting gives the following definition of GAAP:

The set of standards and conventions that guide accountants in the preparation of financial statements. Certified public accountants, in expressing opinions on financial statements, are required to indicate whether the statements were prepared in accordance with generally accepted accounting principles.⁵

In instances where certain finance-related legal provisions conflict with GAAP (for example, a city may require cash basis budgets and financial statements, whereas GAAP requires use of accrual and modified accrual bases of accounting), the accounting system must provide data for both legal compliance and GAAP reports. This requirement does not necessitate two accounting systems. Rather, the accounts will be kept on one basis and the system will also provide the additional data needed to convert the accounts to the other basis.

GAAP statements are necessary to assure proper reporting and a reasonable degree of comparability among the statements of governments across the nation. Preparation of statements in conformity with GAAP assures that the financial reports of all state and local governments, regardless of their legal provisions and customs, contain the same types of financial statements and disclosures for the same categories and types of funds and account groups and are based on the same measurement and classification criteria.

FUND ACCOUNTING

The significance of the fund concept cannot be over-emphasized. *Statement 1* devotes three of its twelve principles to the subject of the fund: Principle 2 requires the use of funds and defines the term “fund”; Principle 3 lists and defines the types of funds recommended for state and local governments; and Principle 4 states the need to limit the number of fund entities employed in order to avoid undue accounting, reporting, and analytical complexities.

⁴*Statement 1*, p. 4.

⁵Ralph Estes, *Dictionary of Accounting* (Cambridge, Massachusetts: The MIT Press, 1981), p. 58.