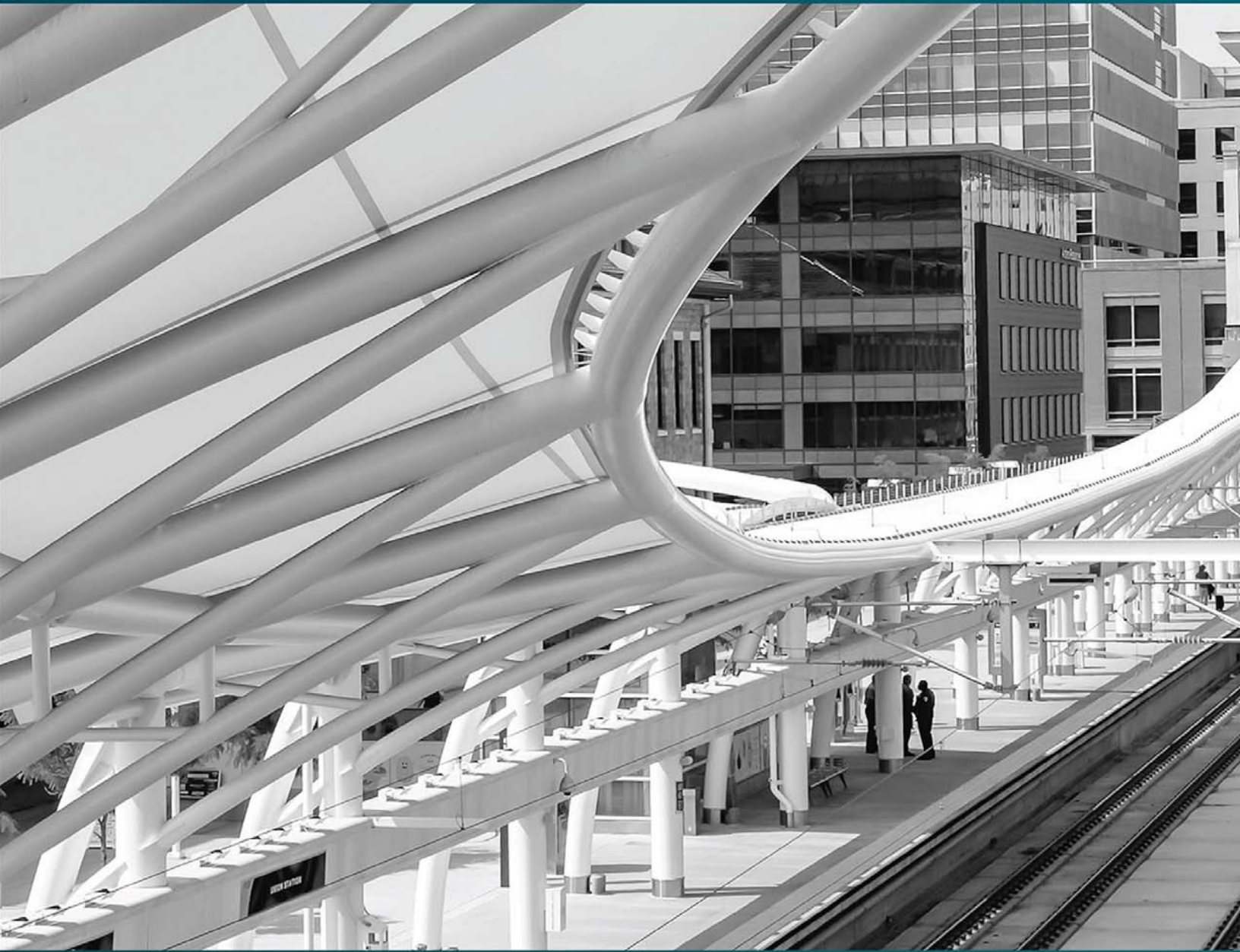


EIGHTEENTH EDITION

# ACCOUNTING FOR GOVERNMENTAL & NONPROFIT ENTITIES



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Education

Jacqueline L. **Reck** | Suzanne L. **Lowensohn** | Daniel G. **Neely**

# Accounting for Governmental & Nonprofit Entities



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Eighteenth Edition

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ACCOUNTING FOR GOVERNMENTAL & NONPROFIT ENTITIES, EIGHTEENTH EDITION

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Dr. Reck worked for state government for several years before joining academia. Currently, she is active in several professional associations. In addition to teaching government and not-for-profit accounting, Dr. Reck serves on the Governmental Accounting Standards Advisory Council and the Financial Reporting Model Task Force and presents continuing professional education workshops and sessions. She has provided workshops on government and not-for-profit accounting for local accounting firms and the state auditor general's staff. Dr. Reck has received several teaching and research awards and has chaired or served on several doctoral dissertation committees.

Dr. Reck has published articles in *Journal of Accounting and Public Policy*; *Journal of Governmental and Nonprofit Accounting*; *Research in Governmental and Nonprofit Accounting*; *Journal of Public Budgeting, Accounting and Financial Management*; and the *Journal of Information Systems*, among others. She joined as an author on the 14th edition.

## Suzanne L. Lowensohn

Is an assistant professor of Accounting at the University of Vermont. She received BS and MAcc degrees from the University of South Florida and her PhD from the University of Miami. She is a certified public accountant (Florida) and a chartered global management accountant.

Dr. Lowensohn has served on the Governmental Accounting Standards Board Intangible Issues Task Force and Comprehensive Implementation Guide Advisory Committee, on the Government Finance Officers Association Special Review Executive Committee, on the Colorado Society of Certified Public Accountants Governmental Issues Committee, on the AICPA FARS Content Subcommittee, and as president of the Government and Nonprofit Section of the American Accounting Association. Prior to joining academia, she worked for KPMG and performed numerous governmental audits.

Professor Lowensohn has published articles in *Contemporary Accounting Research*; *Journal of Accounting and Public Policy*; *Journal of Governmental and Nonprofit Accounting*; *Research in Governmental and Nonprofit Accounting*; *Issues in Accounting Education*; and *Journal of Public Budgeting, Accounting and Financial Management*, among others. She joined as an author on the 16th edition.

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Is an associate professor of Accounting at the University of Wisconsin–Milwaukee. He received BBA and MPA degrees from the University of Texas at Austin and his PhD from the University of Houston. He is a certified public accountant (Texas).

Dr. Neely worked in public accounting for several years before joining academia. Currently, he is active in professional associations and nonprofit organizations. In addition to teaching not-for-profit accounting, Dr. Neely serves on the *Journal of Governmental and Nonprofit Accounting* Editorial Board. He has served on the FASB NFP Financial Statements Project Resource Group and the FASB NFP Other Financial Communications Resource Group.

Professor Neely has published articles in *Contemporary Accounting Research*; *Journal of Accounting and Public Policy*; *Journal of Governmental and Nonprofit Accounting*; *Accounting Horizons*; *Issues in Accounting Education*; *Journal of Accounting Education*; *Nonprofit Voluntary Sector Quarterly*; and *Journal of Public Budgeting, Accounting and Financial Management*, among others. He joined as an author on the 18th edition.

# Preface

For more than 60 years, *Accounting for Governmental & Nonprofit Entities* has led the market in governmental accounting. It is a comprehensive government and not-for-profit accounting text, written for students who will be auditing and working in public and not-for-profit sector entities. Originally published in 1951 and written by Professor R. M. Mikesell, this book—and the many subsequent editions revised by Professors Leon Hay, Earl Wilson, Susan Kattelus, Jacqueline Reck, Suzanne Lowensohn, and Daniel Neely—have given generations of instructors and students a comprehensive knowledge of the specialized accounting and financial reporting practices of government and not-for-profit organizations, as well as an understanding of how those organizations can better meet the information needs of a diverse set of financial statement users and decision makers. The vision of the early authors continues to be reflected in this 18th edition, and their strategy of providing a large and innovative set of instructional support materials prepared and tested in the classroom by the authors continues to be a guiding principle today. The current author team brings to this edition their extensive experience teaching government and not-for-profit courses as well as insights gained from their professional experience, scholarly writing, and professional activities. The result is a relevant and accurate text that includes the most effective instructional tools.

## ORGANIZATION AND CONTENT

The 18th edition of *Accounting for Governmental & Nonprofit Entities* is separated into three parts: Part One covers state and local governments (Chapters 2 through 9), Part Two focuses on accountability for public funds (Chapters 10 through 12), and Part Three examines not-for-profit organizations (Chapters 13 through 16) and the federal government (Chapter 17). Chapter 1 continues to form a broad foundation for the more detailed material in Chapters 2 through 17. The order of the chapters is the same as the last edition, with one exception. Chapters 13 and 14 were reversed so that a general discussion of not-for-profit organizations precedes accounting for such organizations. The chapters are ordered to facilitate a variety of courses and formats used by adopters of the text. For example, a course focused on state and local governments may cover Chapter 1 and Parts One and Two, while a course focused on not-for-profit organizations may cover Chapter 1 and Parts Two and Three. Part Two is a bridge between the public and not-for-profit sectors that includes accountability topics (e.g., financial analysis, auditing, and budgeting) applicable to all types of entities that receive public funds.

## KEY CHANGES IN THIS EDITION

With the 18th edition, we are pleased to continue to expand options available under McGraw-Hill's Connect and LearnSmart educational technology systems. Connect is a digital teaching and learning platform for homework completion and review that helps improve student performance over a variety of critical outcomes while aiding instructor grading and assessment efficiency. LearnSmart is an adaptive study tool that helps identify specific topics and learning objectives individual students need to study.



As always, readers can count on this edition to include authoritative changes from the Governmental Accounting Standards Board, Financial Accounting Standards Board, Federal Accounting Standards Advisory Board, American Institute of Certified Public Accountants, Office of Management and Budget, Internal Revenue Service, and Government Accountability Office. Update bulletins will be provided periodically on the text website as new authoritative statements are issued.

Since publication of the 17th edition, **important** changes affecting accounting, financial reporting, and auditing for government and not-for-profit organizations have occurred, which include

- Governmental Accounting Standards Board standards (particularly *Statement Nos. 76, 84, and 87*) have been issued, and these describe new GAAP hierarchy as well as significant changes to accounting and reporting fiduciary funds and leases.
- The Financial Accounting Standards Board issued Accounting Standards Update 2016-14, which modified net assets classification, certain financial statement presentations, and note disclosures of not-for-profit organizations.

Each of the changes in this abbreviated list has been incorporated into the text.

Several notable improvements have been made in this edition of the text. The discussion of the conceptual framework was moved from Chapter 9 to Chapter 2 at the request of some of our users. To improve the flow, discussion and journal entries related to budget amendments and the closing process have been added to Chapter 3. Chapter 4 includes new coverage of deferred inflows of resources. Chapter 8 has extensive modifications based upon GASB *Statement No. 84* changes. Chapter 9 contains a reorganized and expanded discussion on component units. Coverage of auditor independence under generally accepted government auditing standards has been enhanced in Chapter 11. As mentioned earlier, Chapters 13 and 14 were rearranged so that a general discussion of not-for-profit organizations precedes accounting for such organizations. Chapter 14 reflects important changes to net assets classification and includes revised discussions of special events, investments, and acquisitions. Chapters 15 and 16 include new illustrations demonstrating the calculation of financial health indicators for colleges and universities, and hospitals, respectively. Finally, learning objectives are linked to all end-of-chapter material in the text as well as in the instructor's manual.

This edition continues to feature two comprehensive and effective computerized practice sets, the City of Bingham and the City of Smithville. As with the prior edition, a short version of the City of Smithville practice set is available for those instructors who wish a less comprehensive case. Both practice sets are available within Connect.

## INNOVATIVE PEDAGOGY

For state and local government accounting, the authors have found that *dual-track* accounting is an effective approach in showing the juxtaposition of government-wide and fund financial statements in GASB's integrated model of basic financial statements. It allows students to see that each transaction has an effect on the fund financial statements (that are designed to show fiscal compliance with the annual budget), on the government-wide financial statements (that demonstrate accountability for operational performance of the government as a whole), or both. This approach better serves students who will design and use accounting information systems to allow information

to be captured once and used for several purposes. Accounting for federal agencies as well as nongovernmental, not-for-profit entities closely parallels this approach as traditional fund accounting may be appropriate for keeping track of resources with restricted purposes, but citizens and donors also need to see the larger picture provided by the entity as a whole.

Governments will continue to prepare fund-based statements throughout the year and convert to accrual-based government-wide statements at the end of the year until they invest in information systems that can deliver real-time information for decision making. We want students to think beyond being transaction-bookkeepers and aspire to design and use the systems that will make government-wide financial information available when managers and citizens need it. The City of Bingham and City of Smithville Continuous Computerized Problems are teaching tools that develop these skills and perspective. The authors feel so strongly that this general ledger software tool helps students understand the material that we again provide it with the text. Students have enthusiastically told us that they like “learning by doing” and that these continuous computerized problems helped them to understand the concepts in the book.

## TARGET AUDIENCE

The text continues to be best suited for senior and graduate accounting majors who plan to sit for the certified public accountant (CPA) exam and then audit government or not-for-profit entities. Public administration and other students who plan to provide financial management or consulting services to government and not-for-profit entities report that the text provides a more comprehensive set of competencies than traditional public budgeting texts. Students in not-for-profit management education programs find that the coverage of accounting, financial reporting, auditing, taxation, and information systems for both government and not-for-profit entities provides the exposure they need to work across disciplines and sectors. Finally, students preparing for the certified government financial manager (CGFM) or the certified public finance officer (CPFO) exam also will find Chapters 1 through 12 useful. We encourage all students who use this book to consider the challenges and rewards of careers in public service—in federal, state, and local governments as well as not-for-profit organizations.

## ADDITIONAL INSTRUCTOR AND STUDENT RESOURCES

The Connect Instructor Library is a repository for additional resources to improve student engagement in and out of class. You can select and use any asset that enhances your lecture. The following ancillary materials are prepared by the authors to ensure consistency and accuracy and are available in the Instructor Resources within the Connect Library, and via the Additional Student Resources within the eBook. The Connect Instructor Library includes

- Instructor’s Guide and Solutions Manual.
- PowerPoint lecture presentations.
- Test bank (including TestGen).

TestGen is a complete, state-of-the-art test generator and editing application software that allows instructors to quickly and easily select test items from McGraw-Hill’s test

bank content. The instructors can then organize, edit, and customize questions and answers to rapidly generate tests for paper **or online administration**.

- The City of Bingham and City of Smithville Continuous Computerized Problems—general ledger practice sets, downloadable from Connect.
- The City of Bingham and City of Smithville Instructor’s Version software, providing guidance for instructors, solution data files, and solution page image (.pdf) files for all required financial statements, schedules, and reports.

## ROGER CPA



McGraw-Hill Education has partnered with Roger CPA Review, a global leader in CPA Exam preparation, to provide students a smooth transition from the accounting classroom to successful completion of the CPA Exam. While many aspiring accountants wait until they have completed their academic studies to begin preparing for the CPA Exam, research shows that those who become familiar with exam content earlier in the process have a stronger chance of successfully passing the CPA Exam. Accordingly, students using these McGraw-Hill materials will have access to sample CPA Exam Multiple-Choice questions and Task-based Simulations from Roger CPA Review, with expert-written explanations and solutions. All questions are either directly from the AICPA or are modeled on AICPA questions that appear in the exam. Task-based Simulations are delivered via the Roger CPA Review platform, which mirrors the look, feel and functionality of the actual exam. McGraw-Hill Education and Roger CPA Review are dedicated to supporting every accounting student along their journey, ultimately helping them achieve career success in the accounting profession. For more information about the full Roger CPA Review program, exam requirements and exam content, visit [www.rogercpareview.com](http://www.rogercpareview.com).

# The Dual-Track Accounting Approach

The GASB reporting model requires government-wide, accrual-based financial statements to provide information that goes beyond the familiar fund accounting information. Analysts increasingly use government-wide “big picture” information in performance analysis, and some council members find that, relative to fund accounting information, accrual-based statements are better suited to demonstrate accountability for interperiod equity. For example, these statements provide the information necessary to explore critical questions such as, Has the government shifted the liability for current services to future generations? However, to date, governmental accounting software vendors have not provided governments with systems that can directly produce government-wide financial statements on the required accrual basis, particularly on an interim basis, such as monthly.

The dual-track approach helps students understand how two different sets of accounting records are used to collect financial data as transactions occur. One set of records collects information using the short-term measurement focus and near-cash basis of accounting traditionally used in governmental fund accounting. This set of records includes a chart of accounts, general journal, general ledger, trial balances, and financial statements for each fund. The other set of records collects the same underlying information using a long-term measurement focus similar to that used by business; that is, the accrual

basis of accounting. The second set of records assists in preparing statements for governmental activities and business-type activities. Each time a transaction is presented, we illustrate or explain what, if any, effect it will have on the fund and governmental activities record.

The text does illustrate the reclassification approach in Chapter 9 because that approach is used in practice by most governments. Governments that continue to release only fund financial information throughout the year and must then convert (or reclassify) the data to government-wide information for the purposes of the financial statement preparation and year-end audit are not as accountable or transparent as governments that make GAAP-based information available throughout the year.

Governments, even small ones, are complex entities and there is no easy approach to learning the external governmental financial model. But the authors believe that the dual-track approach is conceptually superior to the reclassification approach in that it gives students the tools to understand “why” and “how” financial statements are prepared and used. A greater conceptual understanding of governmental financial statements also makes it easier for students to understand the reclassification approach when it is encountered. The dual-track pedagogy can help students see the short- and long-term effects of the decisions made by government managers and oversight bodies from the perspective of all stakeholders.

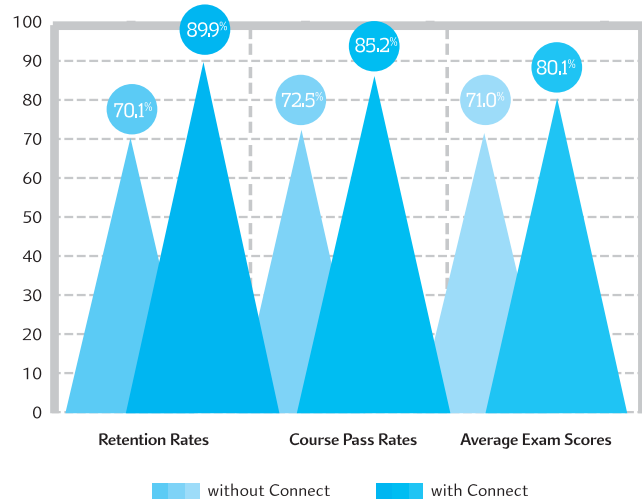
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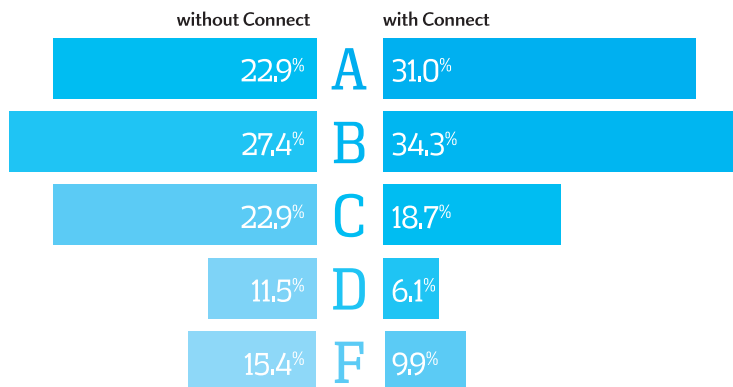
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- Connect offers comprehensive service, support, and training throughout every phase of your implementation.
- If you're looking for some guidance on how to use Connect, or want to learn tips and tricks from super users, you can find tutorials as you work. Our Digital Faculty Consultants and Student Ambassadors offer insight into how to achieve the results you want with Connect.

# Connect Features

## Connect End-of-Chapter Material

Connect helps students learn more efficiently by providing feedback and practice material when they need it, where they need it. Connect grades homework automatically and gives immediate feedback on any questions students may have missed. The extensive assignable, gradable end-of-chapter content includes a new multi-tab design for easier navigation for select exercises. A selection of auto-graded static and algorithmic exercises is available for each chapter within Connect.

The City of Castleton's General Fund had the following post-closing trial balance at June 30, 2019, the end of its fiscal year:

	Debits	Credits
Cash	\$ 438,000	
Taxes Receivable-Delinquent	591,000	
Allowance for Uncollectible Delinquent Taxes		\$ 197,000
Interest and Penalties Receivable	27,000	
Allowance for Uncollectible Interest and Penalties		11,960
Inventory of Supplies	16,900	
Vouchers Payable		156,500
Due to Federal Government		67,490
Deferred Inflows of Resources-Unavailable		419,000
Revenues		419,000
Fund Balance-Nonspendable-Inventory of Supplies		16,900
Fund Balance-Unassigned		204,130
	<u>\$1,072,980</u>	<u>\$1,072,980</u>

- Record the effect of the following transactions on the General Fund and governmental activities for the year ended June 30, 2020.
- Record in general journal form entries to close the budgetary and operating statement accounts in the General Fund only. Do not close the governmental activities accounts.
- Prepare a General Fund balance sheet as of June 30, 2020.
- Prepare a statement of revenues, expenditures, and changes in fund balance for the year ended June 30, 2020. Do not prepare the government-wide financial statements.

Complete this question by entering your answers in the tabs below.

Required A   Required B   Required C   Required D

Prepare a General Fund balance sheet as of June 30, 2020.

CITY OF CASTLETON		
General Fund Balance Sheet		
As of June 30, 2020		
Assets		
Cash		

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## Assurance of Learning Ready

Many educational institutions today are focused on the notion of *assurance of learning*, an important element of some accreditation standards. *Accounting for Governmental & Nonprofit Entities* is designed specifically to support your assurance of learning initiatives with a simple, yet powerful solution.

Each test bank question for *Accounting for Governmental & Nonprofit Entities* maps to a specific chapter learning objective listed in the text. You can use Connect to easily query for learning outcomes/objectives that directly relate to the learning objectives for your course. You then can use the reporting features of Connect to aggregate student results in a similar fashion, making the collection and presentation of assurance of learning data simple and easy.

## AACSB Statement

McGraw-Hill Education is a proud corporate member of AACSB International. Understanding the importance and value of AACSB accreditation, *Accounting for Governmental & Nonprofit Entities* recognizes the curricula guidelines detailed in the AACSB standards for business accreditation by connecting selected questions in the test bank to the eight general knowledge and skill guidelines in the AACSB standards.

The statements contained in *Accounting for Governmental & Nonprofit Entities* are provided only as a guide for the users of this textbook. The AACSB leaves content coverage and assessment within the purview of individual schools, the mission of the school, and the faculty. While *Accounting for Governmental & Nonprofit Entities* and the teaching package make no claim of any specific AACSB qualification or evaluation, within the Test Bank to accompany *Accounting for Governmental & Nonprofit Entities* we have labeled selected questions according to the eight general knowledge and skill areas.



# City of Bingham and City of Smithville Continuous Computerized Problems

**Note: The City of Bingham and City of Smithville computerized problems can be found within Connect, in the Instructor Library and in the Additional Student Resources for students.**

A great way to understand the GASB financial reporting model is to be actively engaged in learning through these “hands-on” continuous problems for small governmental entities. The City of Bingham and City of Smithville web supplement is general ledger software in which students record transactions in the appropriate general journals of each city. Transaction analysis is the first and most important step in the accounting cycle of any organization. After journal entries have been recorded, the software conveniently posts changes to all accounts in general and to subsidiary ledgers. From this point, students can preview trial balances, export them to a Microsoft Excel file, and then prepare financial statements from those data.

This instructional supplement substantially aids students’ learning by requiring them to decide whether each transaction has an effect on the *fund financial statements*, the *government-wide financial statements*, or both. The City of Bingham and City of Smithville are built on the *dual-track approach* described in a subsequent section and in the textbook. Students can apply the conceptual framework that connects the government-wide financial statements (that report on the flow of total economic resources of the government using the accrual basis of accounting) and the fund financial statements (that report on the flow of current financial resources using the modified accrual or near-cash basis of accounting).

## STUDENTS

Several examples are provided here to show how the software facilitates learning. When a government

sends out property tax bills for the year, this transaction is recorded in the General Fund general journal because it impacts the governmental funds statement of revenues, expenditures, and changes in fund balance and in the governmental activities general journal because it has an impact on the government-wide statement of activities. Within each practice set, you can easily toggle among the journals for each fund and governmental activity. Drop-down menus make it easy to decide which revenue account should be increased or decreased, as the chart of accounts is embedded in the software. Journal entries must balance before one can proceed. When the government records its budget or encumbers items related to purchase orders, however, these journal entries affect only the governmental funds. Budgetary account titles are available for selection in the governmental funds general journals but not in the governmental activities general journal because funds, not governmental activities, capture information to show compliance with the short-term, legally approved budget. Conversely, depreciation expense of general capital assets is recorded only in the general journal of governmental activities because the accrual basis of accounting captures and matches the cost of using up the utility of capital assets with the time period in which the assets generate revenues.

## INSTRUCTORS

This software can be used in several ways. You can project it each day as part of the classroom experience and discuss transactions that are keyed to the chapter under discussion. Depending on your

objectives, you can require a small set of the transactions be recorded for each fund or governmental activity or you can assign either of the full problems as a semester-long case. Regardless of how you choose to use the cases, we recommend that students work on the City of Bingham or City of Smithville problem as they are studying the related chapter in

the text and turn in each chapter as they go along. You may find that small student work groups provide an efficient way for students to learn from each other.

We continue to be encouraged by our students' positive reaction as they *learn by doing* the City of Bingham and City of Smithville Continuous Computerized Problems.

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Although we are extremely careful in checking the text and end-of-chapter material, it is possible that errors and ambiguities remain in this edition. As readers encounter such, we urge them to let us know, so that corrections can be made. We also invite every user of this edition who has suggestions or comments about the material in the chapters to share them with one of the authors, either by regular mail or e-mail. The authors will continue the service of issuing Update Bulletins to adopters of this text that describe changes after the book is in print. These bulletins can be found in the Instructor Resources tab in the Connect Library.

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# Accounting for Governmental & Nonprofit Entities

# Chapter One



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## Introduction to Accounting and Financial Reporting for Government and Not-for-Profit Entities

### Learning Objectives

**After studying this chapter, you should be able to:**

- 1-1 Identify and explain the characteristics that distinguish government and not-for-profit entities from for-profit entities.
- 1-2 Identify the authoritative bodies responsible for setting financial reporting standards for (1) state and local governments, (2) the federal government, and (3) not-for-profit organizations.
- 1-3 Contrast and compare the objectives of financial reporting for (1) state and local governments, (2) the federal government, and (3) not-for-profit organizations.
- 1-4 Explain the minimum requirements for general purpose external financial reporting for state and local governments and how they relate to comprehensive annual financial reports.
- 1-5 Identify and describe the required financial statements for the federal government.
- 1-6 Identify and describe the required financial statements for not-for-profit organizations.

### WELCOME TO GOVERNMENT AND NOT-FOR-PROFIT ACCOUNTING

**Welcome to the new world of accounting for government and not-for-profit organizations!** Initially, you will likely find it challenging to understand the many new terms and concepts introduced. Additionally, if you are like most readers, you will question at the outset why government and not-for-profit organizations use accounting and financial reporting practices that are different from those used by for-profit entities.

As you read this first chapter of the text, the reasons for the differences between government and not-for-profit accounting and for-profit accounting should become apparent. Specifically, government and not-for-profit organizations serve entirely different purposes in society than do business entities. Because such organizations are largely financed by taxpayers, donors, and others who do not expect benefits proportional to the resources they provide, management has a special duty to be accountable for how resources are used in providing services. Thus, the need for managers to be accountable to citizens, creditors, oversight bodies, and others has played a central role in shaping the accounting and reporting practices of government and not-for-profit organizations.

This first chapter will give you a basic conceptual understanding of the unique characteristics of government and not-for-profit organizations and how their accounting and financial reporting concepts and practices differ from those of for-profit organizations. By the time you finish subsequent chapters assigned for your course, you should have an in-depth practical knowledge of government and not-for-profit accounting and financial reporting.

## DISTINGUISHING GOVERNMENT AND NOT-FOR-PROFIT ORGANIZATIONS

### LO 1-1

Identify and explain the characteristics that distinguish government and not-for-profit entities from for-profit entities.

### What Are Government and Not-for-Profit Organizations?

Government and not-for-profit organizations are vast in number and range of services provided. In the United States, governments exist at the federal, state, and local levels and serve a wide variety of functions. The most recent census of governments reports that there are 90,056 local governments, in addition to the federal government and 50 state governments. These 90,056 local governments consist of 3,031 counties, 19,519 municipalities, 16,360 towns and townships, 12,880 independent school districts, and 38,266 other special district governments that derive their power from state governments.<sup>1</sup>

States, counties, municipalities (for example, cities, towns, and villages), and townships are **general purpose governments**—governments that provide a wide range of services to their residents (such as police and fire protection; sanitation; construction and maintenance of streets, roads, and bridges; and culture and recreation). Independent school districts, public colleges and universities, and special districts are **special purpose governments**—governments that provide only a single function or a limited number of functions (such as education, drainage and flood control, irrigation, soil and water conservation, fire protection, and water supply). Similar to general purpose governments, special purpose governments are provided the power by state laws to levy and collect taxes and to raise revenues from nontax sources to finance the services they provide.

Not-for-profit organizations also exist in many forms and serve many different functions in society. These include private colleges and universities, various kinds of community service and health care organizations, certain libraries and museums, professional and trade associations, fraternal and social organizations, and religious organizations. According to the NCCS Business Master file of April 2016, as of 2014 there are nearly 1.6 million not-for-profit organizations receiving tax-exempt status in the United States.<sup>2</sup>

<sup>1</sup> U.S. Department of Commerce, Bureau of the Census, *Government Organizations Summary Report: 2012*, [http://www2.census.gov/govs/cog/g12\\_org.pdf](http://www2.census.gov/govs/cog/g12_org.pdf).

<sup>2</sup> The National Center for Charitable Statistics, <http://nccs.urban.org/statistics/quickfacts.cfm>.

## Distinguishing Characteristics of Government and Not-for-Profit Organizations

Government and not-for-profit organizations differ in important ways from business organizations. An understanding of how these organizations differ from business organizations is essential to understanding the unique accounting and financial reporting principles that have evolved for government and not-for-profit organizations.

In its *Statement of Financial Accounting Concepts No. 4*, the **Financial Accounting Standards Board (FASB)** noted the following characteristics that it felt distinguished government and not-for-profit organizations from business organizations:

- a. 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.
- b. Operating purposes that are other than to provide goods or services at a profit or profit equivalent.
- c. 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.<sup>3</sup>

The **Governmental Accounting Standards Board (GASB)** distinguishes government entities in the United States from both not-for-profit and business entities 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 government 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 federal government. In the United States, higher levels of government encourage or dictate activities of lower-level governments. Higher levels of government partially or wholly finance some activities using 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 involuntary contributors of revenue to governments, which effectively have monopoly power in most instances. As involuntary contributors of revenue, taxpayers often have little choice over the level of services they receive. The lack of a competitive market and the disconnect between the revenues provided by taxpayers and the cost for the level of service received means that unlike for-profit organizations, a “net income” figure cannot be used to assess government performance. Because there is no one “net income” figure that can be used to assess overall government efficiency and effectiveness, there is a great need for public accountability in financial reporting.<sup>4</sup>

<sup>3</sup> Financial Accounting Standards Board, *Statement of Financial Accounting Concepts No. 4*, “Objectives of Financial Reporting by Nonbusiness Organizations” (Norwalk, CT, 1980 as amended), par. 6. In 1985 the FASB replaced the term *nonbusiness* with the term *not-for-profit*. Other organizations use the term *nonprofit* as a synonym for *not-for-profit*. The term *not-for-profit* is predominantly used in this text.

<sup>4</sup> Governmental Accounting Standards Board, *Concepts Statement No. 1*, par. 18. *Codification of Governmental Accounting and Financial Reporting Standards as of June 30, 2017* (Norwalk, CT, 2017), Appendix B.



## SOURCES OF FINANCIAL REPORTING STANDARDS

### LO 1-2

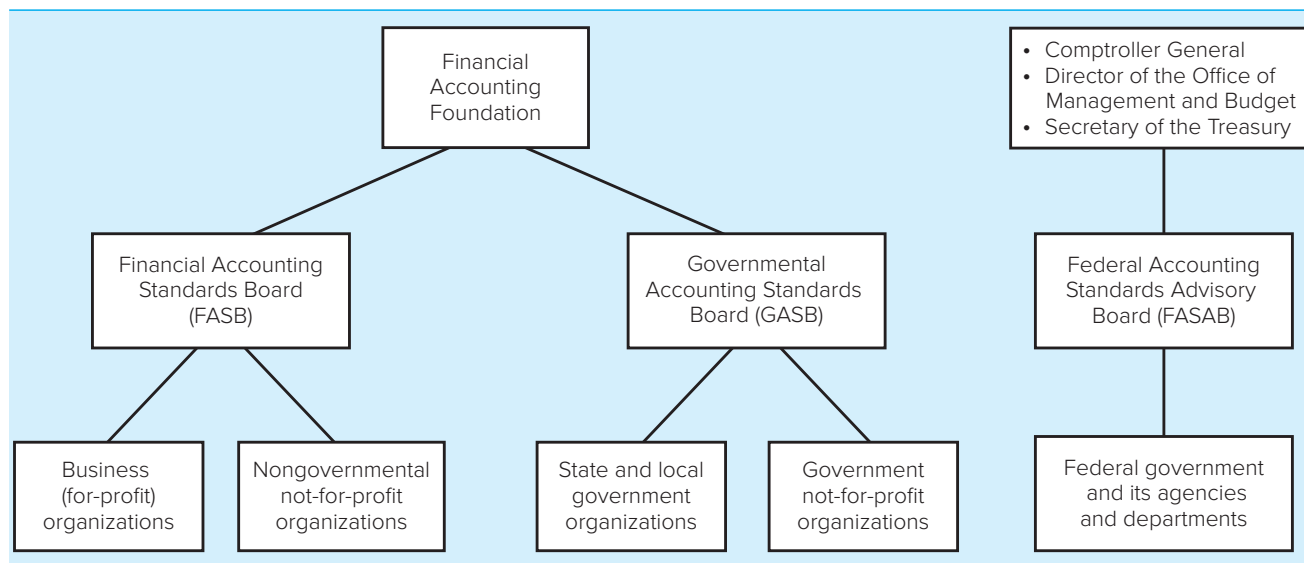
Identify the authoritative bodies responsible for setting financial reporting standards for (1) state and local governments, (2) the federal government, and (3) not-for-profit organizations.

As shown in Illustration 1–1, Rule 203 of the American Institute of Certified Public Accountants (AICPA) Code of Professional Conduct formally designates the GASB, FASB, and FASAB as the authoritative bodies to establish **generally accepted accounting principles (GAAP)** for state and local governments, nongovernmental not-for-profit organizations, and the federal government, respectively. In practice, the “authority to establish accounting principles” means the “authority to establish accounting and financial reporting standards.”

Authority to establish accounting and reporting standards for not-for-profit organizations is split between the FASB and the GASB because a sizable number of not-for-profit organizations are governmental in nature, particularly public colleges and universities and government hospitals. Governmental not-for-profit organizations follow standards established by the GASB. The FASB is responsible for setting accounting and reporting standards for not-for-profit organizations that are independent of governments.

The GASB and the FASB are parallel bodies under the oversight of the Financial Accounting Foundation, which appoints the members of the two boards and supports the boards’ operations. The federal Sarbanes-Oxley Act mandates an assessed fee on corporate security offerings to support the FASB, while the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010) required the establishment of an accounting support fee to fund the GASB. In February 2012 the Financial Industry Regulatory Authority (FINRA) established such a fee.<sup>5</sup> The fee is collected from each firm that reports municipal securities trades to the Municipal Securities Rule-Making Board.

**ILLUSTRATION 1-1** Primary Sources of Accounting and Financial Reporting Standards for Businesses, Governments, and Not-for-Profit Organizations



<sup>5</sup> Financial Industry Regulatory Authority, *Regulatory Notice 13-17*, “GASB Accounting Support Fee,” April 2013.

Because of the method 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 boards in the private sector.” Before the creation of the GASB and the FASB, financial reporting standards were set by groups sponsored by professional organizations: The forerunners of the GASB (formed in 1984) were the National Council on Governmental Accounting (1973–84), the National Committee on Governmental Accounting (1948–73), and the National Committee on Municipal Accounting (1934–41). The forerunners of the FASB (formed in 1973) were the Accounting Principles Board (1959–73) and the Committee on Accounting Procedure (1938–59) of the American Institute of Certified Public Accountants.

Federal statutes assign responsibility for establishing and maintaining a sound financial structure for the federal government to three officials: the Comptroller General, the Director of the Office of Management and Budget, and the Secretary of the Treasury. In 1990, these three officials created the **Federal Accounting Standards Advisory Board (FASAB)** to recommend accounting principles and standards for the federal government and its agencies. It is understood that, to the maximum extent possible, federal accounting and financial reporting standards should be consistent with those established by the GASB and, where applicable, by the FASB.

## OBJECTIVES OF FINANCIAL REPORTING

### LO 1-3

Contrast and compare the objectives of financial reporting for (1) state and local governments, (2) the federal government, and (3) not-for-profit organizations.

As indicated earlier, due to the nature of government, there is a great need for public accountability. The need for public accountability led the GASB to state that “**Accountability** is the cornerstone of all financial reporting in government.”<sup>6</sup> Accountability requires governments to justify the raising and use of public resources, such as taxes. Government financial reports can provide citizens with the information needed to help with the public debate about the sources and uses of public resources.

Illustration 1–2 shows several ways that state and local government financial reporting is used in making economic, social, and political decisions and assessing accountability. Closely related to the concept of accountability as the cornerstone of government financial reporting is the concept the GASB refers to as interperiod equity. **Interperiod equity** can most simply be defined as ensuring that the government “lives within its means.” The GASB believes that interperiod equity is an important part of government accountability.<sup>7</sup> As such, financial reporting should provide information that assists users in evaluating whether the current period’s resources are sufficient to support the current period’s services. When the cost of the current period services is greater than the resources available, the excess costs become the burden of future taxpayers who have not received the benefit of the services.

Accountability is also the foundation for the financial reporting objectives the FASAB has established for the federal government. The FASAB’s *Statement of Accounting and Reporting Concepts Statement No. 1* identifies four objectives of federal financial reporting (see Illustration 1–2) focused on evaluating budgetary integrity, operating performance, stewardship, and adequacy of systems and controls. Budgetary integrity relates to being publicly accountable for complying with laws and regulations related to the raising and spending of taxes and other resources received by the federal government during a fiscal year. Financial reporting also should help users assess the

<sup>6</sup> GASB, *Codification*, Appendix B, *Concepts Statement No. 1*, par. 56.

<sup>7</sup> *Ibid.*, par. 61.

### ILLUSTRATION 1-2 Comparison of Financial Reporting Objectives—State and Local Governments, Federal Government, and Not-for-Profit Organizations

State and Local Governments <sup>a</sup>	Federal Government <sup>b</sup>	Not-for-Profit Organizations <sup>c</sup>
<p>Financial reporting is used in making economic, social, and political decisions and in assessing accountability primarily by</p> <ul style="list-style-type: none"> <li>• Comparing actual financial results with the legally adopted budget.</li> <li>• Assessing financial condition and results of operations.</li> <li>• Assisting in determining compliance with finance-related laws, rules, and regulations.</li> <li>• Assisting in evaluating efficiency and effectiveness.</li> </ul>	<p>Financial reporting should help to achieve accountability and is intended to assist report users in evaluating</p> <ul style="list-style-type: none"> <li>• Budgetary integrity.</li> <li>• Operating performance.</li> <li>• Stewardship.</li> <li>• Adequacy of systems and controls.</li> </ul>	<p>Financial reporting should provide information useful in</p> <ul style="list-style-type: none"> <li>• Making resource allocation decisions.</li> <li>• Assessing services and ability to provide services.</li> <li>• Assessing management stewardship and performance.</li> <li>• Assessing economic resources, obligations, net resources, and changes in them.</li> </ul>

<sup>a</sup> Source: GASB, *Concepts Statement No. 1*, par. 32.

<sup>b</sup> Source: FASAB, *Statement of Federal Accounting Concepts No. 1*, par. 134.

<sup>c</sup> Source: FASB, *Concepts Statement No. 4*, pars. 33–42.

operating performance of the federal government. In addition to information on the cost of providing services, it is important to be able to evaluate the efficiency and effectiveness with which the government is managing its assets and liabilities. Stewardship relates to providing information on the financial position of the government. Financial reporting should assist in evaluating the government's operating performance and its investments for the period to determine whether the financial condition of the federal government has improved or deteriorated. Finally, federal financial reporting should help users in determining whether adequate internal and administrative control systems are in place.

Unlike the FASB and the GASB, which focus their standards on *external* financial reporting, the FASAB and its sponsors in the federal government are concerned with *both* internal and external financial reporting. Accordingly, the FASAB has identified four major groups of users of federal financial reports: citizens, Congress, executives, and program managers. Given the broad role the FASAB has been assigned, its standards focus on cost accounting and performance measures, as well as on financial accounting and reporting.

Financial reports of not-for-profit organizations—voluntary health and welfare organizations, private colleges and universities, private health care institutions, religious organizations, and others—have similar uses. However, as Illustration 1-2 shows, the reporting objectives for not-for-profit organizations emphasize decision usefulness over financial accountability needs. The FASB *Statement of Financial Accounting Concepts No. 4* indicates that not-for-profit and business enterprises are similar in many ways, thus the emphasis on decision usefulness in assisting users with decisions regarding the allocation of scarce resources to a not-for-profit's objectives. A significant component of the decision on where to allocate scarce resources is the services the not-for-profit organization provides and its ability to continue to provide those services. To ensure ongoing service, resource providers and others are interested in management's stewardship, that is, its custody and safekeeping of the not-for-profit's assets and their efficient and effective use.

Note that the objectives of financial reporting for governments and not-for-profit organizations stress the need for the public to understand and evaluate the financial activities and management of these organizations. Readers will recognize 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. Because each of us is significantly affected by government and not-for-profit organizations, it is important that we be able to read intelligently the financial reports of these organizations. In order to make informed decisions as citizens, taxpayers, creditors, and donors, readers should make the effort to learn the accounting and financial reporting standards developed by the authoritative bodies. The standards are further explained and illustrated throughout the remainder of the text.

## OVERVIEW OF FINANCIAL REPORTING FOR STATE AND LOCAL GOVERNMENTS, THE FEDERAL GOVERNMENT, AND NOT-FOR-PROFIT ORGANIZATIONS

### LO 1-4

Explain the minimum requirements for general purpose external financial reporting for state and local governments and how they relate to comprehensive annual financial reports.

### Financial Reporting of State and Local Governments

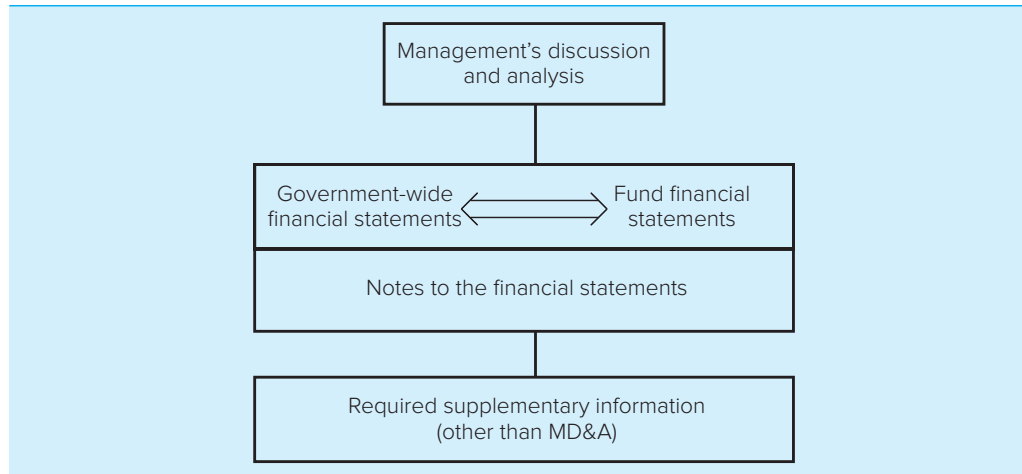
Like the FASB, the GASB continues to develop concepts statements that communicate the framework within which the Board strives to establish consistent financial reporting standards for entities within its jurisdiction. The GASB, as well as the FASB, is concerned with establishing standards for financial reporting to *external* users—those who lack the authority to prescribe the information they want and who must rely on the information management communicates to them. The Board does not intend to set standards for reporting to managers and administrators or others deemed to have the ability to enforce their demands for information.

#### *General Purpose External Financial Reporting*

Illustration 1–3 displays the minimum requirements for general purpose external financial reporting under the government financial reporting model specified by the GASB.<sup>8</sup> Central to the model is the **management's discussion and analysis (MD&A)**. The MD&A is **required supplementary information (RSI)** designed to communicate in narrative, easily readable form the purpose of the basic financial statements and the government's current financial position and results of financial activities compared with those of the prior year.

As shown in Illustration 1–3, the GASB prescribes two categories of **basic financial statements**: government-wide and fund. **Government-wide financial statements** are intended to provide an aggregated overview of a government's net position and changes in net position. You will notice that the GASB uses the term *net position* rather than the FASB term *net assets*; however, the terms are substantially the same. The government-wide financial statements report on the government as a whole and assist in assessing **operational accountability**—whether the government has used its resources efficiently and effectively in meeting operating objectives. The GASB concluded that reporting on operational accountability is best achieved by using essentially the same basis of accounting and measurement focus used by business organizations: the accrual basis and flow of economic resources measurement focus.

<sup>8</sup> GASB Codification, Sec. 2200.102.

**ILLUSTRATION 1-3** Minimum Requirements for General Purpose External Financial Reporting

Source: GASB Codification, Sec. 2200.103.

**Fund financial statements**, the other category of basic financial statements, provide more detailed financial information about the government. Certain funds, referred to as *governmental funds*, focus on the short-term flow of current financial resources rather than on the flow of economic resources.<sup>9</sup> The focus on current financial resources makes it easier for users assessing **fiscal accountability**, which relates to ensuring the government is complying with the public's decisions concerning the raising and spending of resources generally within a budgetary period of one year. Because of the short-term focus, governmental funds use a modified accrual basis of accounting rather than the accrual basis. Under **modified accrual**, revenues are recognized in the period they are measurable and available for spending and expenditures (not expenses) are recognized when they create an obligation to be paid from current financial resources. The characteristics and roles of the government-wide and fund financial statements are summarized in Illustration 1-4.

Other funds, referred to as *proprietary* and *fiduciary funds*, account for the business-type and certain fiduciary (trust and custodial) activities of the government. These funds follow accounting and reporting principles similar to those of business organizations.

As shown in Illustration 1-3, the notes to the financial statements are considered integral to the financial statements. In addition, governments are required to disclose certain RSI other than MD&A. These additional information disclosures are discussed in several of the following chapters.

### ***Comprehensive Annual Financial Report***

Serious users of government financial information need more detail than is found in the MD&A, basic financial statements, and RSI (other than MD&A). For state and local governments, much of that detail is found in the government's **comprehensive annual financial report (CAFR)**. Although governments are not required to prepare a CAFR, most do so as a matter of public record and to provide additional financial details beyond the minimum requirements shown in Illustration 1-3. As such, the GASB provides standards for the content of a CAFR in its annually updated publication

<sup>9</sup> The definition of *fund* is given in Chapter 2. For now, you can view a fund as a separate set of accounts used to account for resources segregated for particular purposes.

**ILLUSTRATION 1-4 Dual Roles of Government Financial Statements in Assessing Accountability**

	<b>Operational Accountability</b>	<b>Fiscal Accountability</b>
Statements	Government-wide financial statements (governmental and business-type activities) and those of proprietary funds and fiduciary funds	Governmental fund financial statements
Measurement focus	Flow of economic resources	Flow of current financial resources
Basis of accounting	Accrual basis (revenues and expenses are recognized when exchange of economic resources occurs or per GASB recognition rules for nonexchange transactions, such as taxes, contributions, and grants)	Modified accrual basis (revenues are recognized when resources are measurable and available for current spending; expenditures are recognized when an obligation to spend current financial resources is incurred)

*Codification of Governmental Accounting and Financial Reporting Standards.* A CAFR prepared in conformity with these standards should contain the following sections.<sup>10</sup>

*Introductory Section*<sup>11</sup> The introductory section typically includes items such as a title page and contents page, a letter of transmittal, a description of the government, and other items deemed appropriate by management. The letter of transmittal may be literally that—a letter from the chief financial officer addressed to the chief executive and governing body of the government—or it may be a narrative over the signature of the chief executive. In either event, the letter or narrative material should cite legal and policy requirements for the report.

*Financial Section* The financial section of a comprehensive annual financial report should include (1) an auditor’s report, (2) management’s discussion and analysis (MD&A), (3) basic financial statements and related notes, (4) required supplementary information (other than MD&A), and (5) other supplementary information, such as combining statements and individual fund statements and schedules. Items (2), (3), and (4) represent the minimum requirements for general purpose external financial reporting, as depicted in Illustration 1–3. As you will recognize, a CAFR provides additional supplementary financial information beyond the minimum amount required by generally accepted accounting principles.

Laws regarding the audit of governments vary from state to state. Some states have laws requiring that all state agencies and all local governments be audited by an audit agency of the state government. In most states, however, local governments are audited by independent public accounting firms. In still other states, some local governments are audited by the state audit agency and some by independent public accounting firms. In any event, the auditor’s opinion should accompany the financial statements reproduced in the report.

The financial section should contain sufficient information to disclose fully and present fairly the financial position and results of financial operations during the fiscal year. Laws of higher jurisdictions, actions of the legislative branch of the government

<sup>10</sup> GASB *Codification*, Sec. 2200.104–212.

<sup>11</sup> For a view of the introductory section, as well as the other sections of the CAFR, you may wish to look at the City and County of Denver, Colorado’s CAFR at [https://www.denvergov.org/content/dam/denvergov/Portals/344/documents/CAFR/2016\\_CAFR.pdf](https://www.denvergov.org/content/dam/denvergov/Portals/344/documents/CAFR/2016_CAFR.pdf). Portions of Denver’s CAFR for 2016 are included for illustrative purposes in various places in this text.