MICHAEL H. GRANOF | SALEHA B. KHUMAWALA | THAD D. CALABRESE | DANIEL L. SMITH

Government and Not-for-Profit Accounting

Concepts and Practices

Seventh Edition

Wiley Binder Version

WILEY

Government and Not-for-Profit Accounting

Concepts and Practices

Government and Not-for-Profit Accounting

SEVENTH EDITION

Concepts and Practices

Michael H. Granof
University of Texas, Austin

Saleha B. Khumawala
University of Houston

Thad D. Calabrese
New York University

Daniel L. Smith
New York University

WILEY

VICE PRESIDENT & DIRECTOR	George Hoffman
ACQUISITIONS EDITOR	Emily McGee
ASSOCIATE DEVELOPMENT EDITOR	Courtney Luzzi
MARKET SOLUTIONS PROGRAM ASSISTANT	Elisa Wong
SENIOR DIRECTOR	Don Fowley
PROJECT MANAGER	Gladys Soto
PROJECT SPECIALIST	Nichole Urban
PROJECT ASSISTANT	Anna Melhorn
ASSISTANT MARKETING MANAGER	Puja Katariwala
ASSOCIATE DIRECTOR	Kevin Holm
SENIOR CONTENT SPECIALIST	Nicole Repasky
PRODUCTION EDITOR	Rajeshkumar Nallusamy
COVER PHOTO CREDIT	© Sergey Kamshylin/Shutterstock; Polryaz/Shutterstock

This book was set in 10/12 TimesLTStd-Roman by SPi Global and printed and bound by Courier Kendalville

This book is printed on acid free paper. ∞

ISBN: 978-1-118-98327-0 (BRV)
ISBN: 978-1-119-17498-1 (EVALC)

Library of Congress Cataloging in Publication Data:

Names: Granof, Michael H. | Khumawala, Saleha B. | Calabrese, Thad D. | Smith, Daniel L.
Title: Government and not-for-profit accounting : concepts and practices / Michael H. Granof, Saleha B. Khumawala, Thad D. Calabrese and Daniel L. Smith.
Description: Seventh edition. | New York : Wiley, 2015. | Revised edition of Government and not-for-profit accounting, 2013. | Includes index.
Identifiers: LCCN 2015037545 | ISBN 9781118983270 (loose-leaf)
Subjects: LCSH: Finance, Public—United States—Accounting. | Finance, Public—Accounting—Standards—United States. | Nonprofit organizations—United States—Accounting. | Nonprofit organizations—Accounting—Standards—United States. | BISAC: BUSINESS & ECONOMICS / Accounting / Governmental.
Classification: LCC HJ9801 .G7 2015 | DDC 657/.835—dc23 LC record available at http://lccn.loc.gov/2015037545

Printing identification and country of origin will either be included on this page and/or the end of the book. In addition, if the ISBN on this page and the back cover do not match, the ISBN on the back cover should be considered the correct ISBN.

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

Michael H. Granof
In Memory of
My mother, Diana S. Granof (a teacher)
My father, David H. Granof (a CPA)

Saleha B. Khumawala
To my husband Basheer and
children Naaz and Mubeen

Thad D. Calabrese
To my wife Abby and children
Benjamin, Noah, and Ethan

Daniel L. Smith
To my wife Tara and
daughter Madison

Preface

The objectives of this, the seventh edition of *Government and Not-for-Profit Accounting: Concepts and Practices*, remain unchanged from those of the previous editions. Above all, the text aims to make students aware of the dynamism of government and not-for-profit accounting and of the intellectual challenges that it presents.

Government and not-for-profit accounting has changed dramatically in the past few decades. For certain, the nature of governments and not-for-profit organizations and the transactions in which they engage will continue to evolve further in the future. Therefore, so too must the corresponding accounting.

For the most part, the accounting issues faced by governments and not-for-profit organizations are far less tractable than those encountered by businesses. Businesses have the luxury of directing attention to profits—a metric that is relatively easy to define—inasmuch as the overriding objective of businesses is to earn a profit. Governments and not-for-profit entities, by contrast, have broader, much less clear-cut goals. They must determine not only how to measure their performance but also what to measure. Hence, the accounting profession is almost certain to be dealing with fundamental questions throughout the professional careers of today's students, and the pace of rapid change will continue unabated.

Obviously, we intend for this text to inform students of current accounting and reporting standards and practices—those with which they might need to be familiar in their first jobs. More important, however, we want to ensure that they are aware of the reasons behind them, their strengths and limitations and possible alternatives. We are more concerned that students are prepared for their last jobs rather than their first. The text aspires to lay the intellectual foundation so that the students of today can become the leaders of tomorrow—the members of the standard-setting boards, the partners of CPA firms, the executives of government and not-for-profit organizations, and the members of legislative and governing boards.

Courses in government and not-for-profit accounting are just one element of an accounting program and, indeed, of a college education. Therefore, we expect that this text will lead not only to an awareness of the issues of government and not-for-profit accounting, but also to a greater understanding of those in other areas of accounting. Almost all issues addressed in this text—for example, revenue and expense recognition, asset and liability valuation, the scope of the reporting entity, reporting cash flows—have counterparts in business accounting. By emphasizing concepts rather than rules and procedures, we hope that students will gain insight into how and why the issues may have been resolved either similarly or differently in the business sector.

Moreover, we trust that this text will contribute to students' ability to read, write, and "think critically." To that end we have made a special point of designing end-of-chapter problems that challenge students not only to apply concepts that are presented in the text, but also to justify the approach they have taken and to consider other possible methodologies.

Needless to say, many students will use this text to prepare for the CPA exam. We have endeavored to cover all topics that are likely to be tested on the exam—an admittedly difficult goal, however, now that the American Institute of Certified Public Accountants (AICPA) does not publish past exams. We have also included approximately 20 multiple-choice questions in most chapters as well as several other "CPA-type" questions. In addition, this text will be useful to students preparing for the Certified Government Financial Manager exam (CGFM) and other professional certification exams in which matters relating to government and not-for-profits are tested.

The need to update this text was made especially compelling by Governmental Accounting Standards Board (GASB) pronouncements that were either issued or had to be implemented since publication of the sixth edition. Most notably, Statement No. 67, *Financial Reporting for Pension Plans,* and Statement No. 68, *Accounting and Financial Reporting for Pensions,* had to be implemented for years beginning June 2013 and June 2014, respectively. Then in 2015 the GASB issued Statement No. 74, *Financial Reporting for Postemployment Benefit Plans Other than Pension Plans,* and Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other than Pensions*. Statements No. 74 and No. 75 deal mainly with postemployment health care benefits and must be implemented for years beginning June 2016 and June 2017, respectively. Collectively, these four pronouncements will have consequences that reach far beyond the form and content of financial statements. Many state and local governments face severe fiscal crises, and a key underlying cause is underfunded pensions and health care retirement plans. The new GASB pronouncements will not only require many governments to increase the measure of their pension and health care plan shortfalls, but also to report either new or significantly larger liabilities on their balance sheets and expenses on their statements of activities. Thus, they are likely to have major policy implications as governments struggle to cope with obligations that previously either went understated or, in some cases, unreported. Already, in fact, we have witnessed several governments "reforming" their pension and health care plans as a direct consequence of the new, more rigorous accounting and reporting requirements. Owing to the importance of these pronouncements, this text addresses them, in Chapter 10, in detail.

For years beginning in June 2015, governments must begin implementing Statement No. 72, *Fair Value Measurement and Application*. This statement, discussed in Chapter 7, made significant changes to the way certain investments are measured and reported.

Beginning in June 2013, Statement No. 70, *Accounting and Financial Reporting for Nonexchange Financial Guarantees,* also became required as part of governments' financial reporting. The reporting of loan guarantees falls under this new standard, and is covered in Chapter 8 of the text. Statement No. 77, *Tax Abatement Disclosures*, was adopted in 2015 and future financial statements will require disclosures about governments' tax abatement programs that reduce tax revenues in the future. This new standard is discussed in Chapter 11.

We have also, of course, revised the text to take into account other significant GASB statements, applicable Financial Accounting Standards Board (FASB) updates to standards, AICPA Audit and Accounting Guides, and publications of both the Office of Management and Budget as well as the Government Accountability Office that were actually issued, or we thought likely to be issued, since the publication of the sixth edition. For example, shortly before this text went to press, the FASB proposed noteworthy changes to the not-for-profit reporting model. We have added language in Chapters 12 and 14 to make students aware of these potentially significant changes. Both the GASB and FASB were also considering changes to reporting in capital leases at the time of this text's production. We included language in Chapter 8 to inform users how the standards described here might be different in the near future.

This edition, like previous editions, includes illustrations of actual financial statements, primarily from Charlotte, North Carolina, so that students can observe how information discussed in the text are actually presented to financial statement users. We also continue in this edition to include three or four "Questions for Research, Analysis, and Discussion" to most of the chapters pertaining to state and local governments. Many of these questions were drawn from technical inquiries submitted to the Governmental Accounting Standards Board or the Government Finance Officers Association. These are intended to enrich the typical government and not-for-profit accounting course. Students are, in effect, called on to address the types of issues that are commonly faced by government accountants and their auditors. For most of these questions students will have to look beyond the text to the standards themselves and to the various interpretative pronouncements and implementation guides published by the GASB. For others, they will have to exercise their own good judgment. For many of the questions, there are no single correct answers. We are most grateful to David Bean (GASB's Director of Research and Technical Activities) and Stephen Gauthier (GFOA's Director of Technical Services Center) for providing actual questions that were submitted to their organizations and for providing ideas for others. Instructors with whom we spoke found these questions to serve as the basis for spirited class discussions. Hence, we have retained them for this edition.

OTHER SPECIAL FEATURES

CONTINUING PROBLEM

Each chapter dealing with state and local accounting principles includes a "continuing problem," which asks students to select a city, county, or state with a population over 100,000, review its comprehensive annual financial report (CAFR), and answer questions about it. The questions are applicable to the reports of any major municipal government. However, recognizing the advantages of having all students in a class work from the same report, instructors may want to require their students to download the 2014 CAFR of City of Austin either from the website of the text or that of Austin comptroller's office (https://assets.austintexas.gov/financeonline/downloads/cafr/cafr2014.pdf). The solutions manual contains the "answers" to the continuing problem based on the Austin CAFR for fiscal year 2014.

COMPUTERIZED ACCOUNTING PRACTICE SETS—KEY FEATURE OF THIS EDITION

PRACTICE SETS

To provide an opportunity for students to get a taste of how accounting is practiced in the "real world," this edition of the text is supplemented by two "practice sets," one dealing with governments, the other with not-for-profit organizations. Each, however, is much more than a conventional bookkeeping exercise. They are built on state-of-the-art computerized fund accounting and reporting programs designed by OneNFP, a firm whose products are widely used in practice.

The practice sets enable students to form a new government or not-for-profit organization from scratch, enter and post a relatively few summary transactions, and prepare complete sets of financial statements (both fund and government-wide for governments). The main goal of the practice sets is to show students how the accounting and recording process fits together and to give the students a sense of accomplishment as they see their individual journal entries leading to a complete set of financial statements.

Unlike the software used in practice sets in the previous edition, the OneNFP software in this edition is cloud-based. Accordingly, students no longer have to download a program to their own individual computers and are thereby unlikely to face problems resulting from different computing platforms. Moreover, the students can now be assured that they will be using the most current version of the software. Because the software is subject to updating, the screenshots provided in the practice set instructions may differ slightly from what the students actually see on their computers. We don't believe that the difference should affect the ability of the students to complete the projects.

We have tried to make the recording process as blunder-proof as possible, thereby minimizing the sense of frustration that results when students inevitably make careless recording errors and have to spend an inordinate amount of time locating and correcting them. Accordingly, we give the students a comprehensive set of detailed instructions, including numerous screenshots of what should appear on their computer monitors as well as on their printed output. These instructions and chapter assignments related to the practice sets can be found at the textbook's companion website.

We are especially grateful to Brandon Taylor, and Jessica Betterly of OneNFP for arranging for us to use the company's software program, and to their colleagues, who ably assisted in adapting it as a practice set.

OTHER ACKNOWLEDGMENTS

We are especially grateful for the helpful comments of Professor Teresa P. Gordon (emeritus) of the University of Idaho, Penelope S. Wardlow, coauthor of *Core Concepts of Government and Not-for-Profit Accounting*, and our very own students, whose insights and ideas have found their way into this edition and have unquestionably improved it. We appreciate the help of Jobin Babu, Melissa Sia Clark and Esther Rehawi, who helped us with the computerized practice set and to prepare several tables in the text.

Additional thanks go to the following faculty who offered their helpful feedback and comments during the seventh edition review process: Karen Andrea Shastri (University of Pittsburg); Diane Belger (University of Colorado, Colorado Springs); Ann Selk (University of Wisconsin–Green Bay); David P. Mest (Seton Hall University); Michael Newman (University of Houston); Patricia A. Johnson (Canisius College); Larita J. Killian (Indiana University at Columbus); Lisa Forbes (Union College); David Jordan (Loyola University, Chicago); John Lord (San Francisco State University). We are also appreciative of Gladys Soto, project manager, Nichole Urban, project specialist and Rajeshkumar Nallusamy, production editor for their major support in bringing the text book to fruition. Finally, we are deeply indebted to our families for their substantial contribution through love, encouragement, and unwavering support without which this book would not be possible.

S.B.K.
Houston, Texas

M.H.G.
Austin, Texas

T.D.C.
New York, New York

D.L.S.
New York, New York

Contents

The Government and Not-for-Profit Environment

LEARNING OBJECTIVES

After studying this chapter you should understand:

- The characteristics that distinguish governments and not-for-profit organizations from businesses, and the accounting and reporting implications of these characteristics
- Why other characteristics of governments and not-for-profit entities may affect accounting and reporting practices
- The overall purpose of financial reporting in the government and not-for-profit sectors
- The information requirements of the primary users of the financial reports of governments and not-for-profit entities
- The specific objectives of financial reporting, as established by the Governmental Accounting Standards Board (for state and local governments), the Financial Accounting Standards Board (for not-for-profits), and the Federal Accounting Standards Advisory Board (for the federal government), and the obstacles to achieving these objectives within a set of financial statements prepared on a single basis of accounting
- How differences in accounting principles affect financial reporting and thus can have economic consequences
- The institutional arrangements for establishing accounting standards for these entities

Governments and not-for-profit organizations have much in common with businesses. However, the differences between the two environments are sufficiently pronounced that business schools have established a separate course in governmental and not-for-profit accounting apart from the usual accounting courses—financial accounting, managerial accounting, auditing, and information systems.

Every accounting issue or problem that affects governments and not-for-profit entities has a counterpart in the business sector. But the distinctions between accounting for governments and not-for-profits and accounting for businesses are so marked that the two disciplines warrant specialized textbooks, separate statements of concepts, and separate accounting principles and practices. As we shall see in this text, some of these differences may be justified by substantive distinctions in the two operating environments. Others are the result of long-standing differences in the traditions, composition, and perspectives of the standard-setting boards—the Governmental Accounting Standards Board (GASB), for state and local governments; the Federal Accounting Standards Advisory Board (FASAB),

for the federal government; and the Financial Accounting Standards Board (FASB), for the private sector, including private (nongovernmental) not-for-profits.

This chapter is divided into eight sections. The first examines the ways in which governments and not-for-profits differ from businesses, and why they require unique accounting principles and practices. The second points out the characteristics of governments and not-for-profits that might *not* distinguish them from businesses, but nevertheless do have significant implications for accounting and reporting. The third contrasts governments and not-for-profits, emphasizing that although they have much in common, they also differ significantly. The next four sections provide an overview of financial reporting for governments and not-for-profits—highlighting key user groups, their information needs, and the resultant objectives of financial reporting—and address the question of whether differences in accounting practices really matter. The last section spotlights the GASB, the FASB, and the FASAB.

In this text we use the term *not-for-profit* rather than the equally acceptable term *nonprofit*. Not-for-profit differentiates entities that don't intend to earn a profit from those that simply fail to do so.

HOW DO GOVERNMENTS AND NOT-FOR-PROFITS COMPARE WITH BUSINESSES?

Governments and not-for-profits differ from businesses in ways that have significant implications for financial reporting. For the most part, governments and not-for-profits provide services targeted at groups of constituents either advocating a political or social cause or carrying out research or other activities for the betterment of society. The objectives of governments and not-for-profits cannot generally be expressed in dollars and cents, are often ambiguous, and are not easily quantifiable. Moreover, governments and not-for-profits have relationships with the parties providing their resources that are unlike those of businesses.

DIFFERENT MISSIONS

As implied by the designation *not-for-profits*, the goal of governments and similar organizations is something other than earning profit. A key objective of financial reporting is to provide information about an entity's financial performance during a specified period. The main objective of a typical business is to earn a profit—to ensure that over the life of the enterprise, its owners get a return greater than the amount invested. Accordingly, financial statements that focus on net income are consistent with the entity's main objective. Specifically, an income statement is a report on how well the entity achieved its goals. To be sure, businesses may have objectives that go beyond "the bottom line." They may seek to promote the welfare of their executives and employees, improve the communities in which they are located, and produce goods that will enhance the quality of life. Financial accounting and reporting, however, are concerned almost exclusively with the goal of maximizing either profits or some variant of it, such as cash flows.

The financial reports of governments and not-for-profits can provide information about an organization's inflows (**revenues**) and outflows (**expenditures**) of cash and other resources. As a general rule, an excess of expenditures over revenues, particularly for an extended period of time, signals financial distress or poor managerial performance. However, an excess of revenues over expenditures is not necessarily commendable. An excess of revenues over expenditures may be achieved, for example, merely by reducing the services provided to constituents, which may be at odds with the entity's objectives.

If the financial statements of a government or not-for-profit incorporate only monetary measures, such as dollars and cents, they cannot possibly provide the information necessary to assess the organization's performance. For an organization to report properly on its accomplishments, it must augment its financial statements to include nonfinancial data that relate to its objectives. A school, for example, might include statistics on student achievement, such as test scores or graduation rates. A center for the homeless might present data on the number of people fed or adequately housed.

BUDGETS, NOT THE MARKETPLACE, GOVERN

Governments and not-for-profits are governed mainly by their budgets, not by the marketplace. These organizations control or strongly influence both their revenues and expenditures through the budgetary process. The revenues of a government may be determined by legislative action, and if they are, the government may not be subject to the forces of competition faced by businesses. Those of the not-for-profits, although they cannot be established by legal mandate, may be obtained from contributions, dues, tuition, or user charges—none of which are comparable to the sales revenue of a business.[1]

EXPENDITURES MAY DRIVE REVENUES

Governments and many not-for-profits establish the level of services that they will provide, calculate their cost, and then set tax rates and other fees to generate the revenues required to pay for them. Colleges and universities, unlike businesses, do not set tuition charges at the highest level that the market will bear. Instead, they calculate operating costs; estimate contributions, endowment revenues, and other sources of funds; and then set tuition charges at the rate necessary to cover the shortfall. Similarly, fraternities and sororities calculate their expenditures for housing, food, and social activities, and then set dues and other fees accordingly. In sum, expenditures drive revenues.

Although governments and not-for-profits do not participate in competitive markets, they cannot simply raise revenues without regard to their services or increase taxes without limit. Governments may be constrained by political forces. Universities may have to restrict tuition rates to approximately those of peer schools. Further, some not-for-profits, such as the United Way or organizations that fund medical research, base their expenditures exclusively on their revenues. The more funds they raise, the more they spend.

THE BUDGET, NOT THE ANNUAL REPORT, IS THE MOST SIGNIFICANT FINANCIAL DOCUMENT

For businesses, the annual report is the most significant financial document. A major company's announcement of annual earnings (the preview of the annual report) makes front-page news. By contrast, its annual budget is nothing more than an internal document, seldom made available to investors or the general public.

A government or not-for-profit's release of its annual report is customarily ignored by both organizational insiders and outsiders. Seldom does the report contain surprises, for if revenues and expenditures were markedly different from what were initially budgeted, the entity probably was required to amend the budget during the year.

For governments and not-for-profits, the **budget** takes center stage—properly so, because the budget is the culmination of the political process. It encapsulates almost all the decisions of consequence made by the organization. It determines which constituents give to the entity and which receive; which activities are supported and which are assessed.

Because it is so important, the budget, unlike the annual report, is a source of constituent concern and controversy. Government budget hearings often draw standing-room-only crowds

[1] Although market mechanisms are widely thought of as providing a more efficient distribution of goods and services, they can operate only when there can be no "free riders"—parties who are able to obtain the goods or services without paying for them. Many government services, such as police protection, cannot practically be provided only to paying customers. Hence we must resort to nonmarket mechanisms to allocate resources. See Richard A. Musgrave and Peggy B. Musgrave, *Public Finance in Theory and Practice*, 5th ed. (New York: McGraw–Hill, 1989), Chapter 3, "The Theory of Social Goods," for a discussion of this concept from the perspective of economists.

to the legislative chambers. The budget debates of religious organizations such as churches and synagogues are frequently marked by fervor more intense than that found in the congregants' worship services.

A government's budget may be backed by the force of law. State and local government officials are ordinarily prohibited from spending more than what was budgeted. Indeed, they can go to jail for severe violations of budgetary mandates. The budget is not a document to be taken casually. In light of the significance of the budget relative to the annual report, it is ironic that the standard-setting agencies focus exclusively on the annual report. Except insofar as governments—such as states—establish rules for cities or other governments within their jurisdiction, or parent not-for-profits—such as national fraternities—set guidelines for local affiliates, budgetary practices are within the discretion of the individual entity. Neither the GASB nor the FASB or FASAB has been granted the kind of statutory authority over budgets that it has over annual reports. As a consequence—which shall be made evident in discussions to follow—annual reports are in fact better than budgets at capturing the economic substance of the transactions and are far less subject to preparer efforts to artificially boost revenues or reduce expenditures.

BUDGETS DRIVE ACCOUNTING AND FINANCIAL REPORTING

Constituents of an organization want information on the extent of adherence to the budget. They want assurance that the organization has not spent more than what was authorized. They want to know whether revenue and expenditure estimates were reliable. The accounting system and the resultant financial reports must be designed to provide that information.

In addition, managers need an accounting system that provides them with ongoing data about whether they are on target to meet budget projections. Even more critically, they need a system that either prevents them from overspending or sets off warning signals when they are about to do so. The budget is a control device, but it requires the support of a complementary accounting and reporting system. Finally, auditors and other parties concerned with the organization's performance require a basis on which to evaluate accomplishments. As will be discussed in subsequent chapters, state-of-the-art budgets establish that basis by indicating not only how much will be spent on a particular activity, but also what the activity will achieve.

A postperiod assessment can then focus not only on whether the entity met its revenue and expenditure projections but also, equally important, on whether it attained what was expected of it. Evaluators can then assess organizational efficiency by comparing inputs (such as dollar expenditures) with outcomes (results). The accounting system should be fashioned to facilitate this comparison, ensuring that the organization reports and categorizes both revenues and expenditures in a way that is consistent with the budget. Currently, few governments and not-for-profits have established budgetary and accounting systems to measure and report adequately on the nonmonetary aspects of their performance. However, accounting standard-setting authorities have recognized the importance of performance measures and have taken steps to encourage the entities under their purview to provide them.[2]

NEED TO ENSURE INTERPERIOD EQUITY

Most governments are required by law, and most not-for-profits are expected by policy, to balance their operating budgets. Balanced operating budgets ensure that, in any particular period, revenues cover expenditures and that, as a group, the entity's constituents pay for what they receive. If organizations fail to balance their budgets—and borrow to cover operating deficits—then the cost of benefits enjoyed by the citizens of today must be borne by those of tomorrow.

The concept that constituents pay for the services that they receive and do not shift the burdens to their children has traditionally been labeled as **intergenerational equity**. In recent

[2] GASB Issued Suggested Guidelines for Voluntary Reporting, SEA Performance Information (June 2010). The federal government passed the *Government Performance and Results Act of 1993*.

years, to emphasize that entities should not transfer the costs even to future years, to say nothing of future generations, the term **interperiod equity** has been accepted as more appropriate.

To maintain interperiod equity, the accounting systems of governments and not-for-profits must provide information about whether this objective is being attained. Table 1-1 compares fiscal practices that promote interperiod equity with those that do not.

The concept of interperiod equity does not suggest that governments should never borrow. The prohibition against debt applies only to operating, not capital, expenditures. A government-constructed highway or university-purchased lab equipment will produce benefits over more than one year. It is only fair, therefore, that they be paid for by incorporating debt service costs into the taxes or tuition charges of the citizens or students who will benefit from them.

IN PRACTICE WHY IS STATE AND LOCAL GOVERNMENT ACCOUNTING IMPORTANT?

- There are over 90,000 state and local governments in the United States.
- State and local governments received $1.4 trillion in tax revenues in 2012, an 8.2% increase over 2007.*
- Expenditures for state and local governments increased 18.2% to $3.2 trillion from 2007 to 2012. Public welfare and education were the largest expenditures for state governments in 2012 at $433.3 billion and $271.1 billion, respectively.
- Total debt outstanding for state and local governments increased 22.2 percent, from $2.4 trillion in 2007 to $2.9 trillion in 2012.
- Education, the single largest functional category for all governments, employed 11.0 million people, or 49.8 percent of the total number of federal, state, and local government employees.

Source*: *2012 State & Local Government Finance Summary Report, U.S. Census Bureau, U.S. Department of Commerce 2012 Census of Governments: Employment Summary Report* ***http://www2.census.gov/govs/apes/2012_summary_report.pdf*

TABLE 1-1 Fiscal Practices that Promote or Undermine Interperiod Equity

Promote	Undermine
1. Setting aside resources for employee pensions during the years in which the employees provide their services.	1. Paying the pensions of retired employees out of current operating funds.
2. Issuing conventional 30-year bonds to finance the purchase of a new building that is expected to have a useful life of 30 years; repaying the bonds, along with appropriate amounts of interest, over the 30-year period.	2. Financing the purchase of the new building with 30-year zero-coupon bonds that permit the entire amount of principal and interest to be paid upon maturity of the bonds; making no provision to set aside resources for payment of principal and interest on the bonds until the year they mature.
3. Paying the current-year costs of an administrative staff out of current operating funds.	3. Issuing 30-year bonds to finance the current-year operating costs of an administrative staff.
4. Charging payments of wages and salaries made in the first week of the current fiscal year to the previous fiscal year, that in which the employees actually provided their services.	4. Charging wages and salaries applicable to services provided in the last week of the current fiscal year to the following fiscal year, that in which the payments were made.
5. Charging the cost of supplies as expenditures in the year in which they were used rather than when they were purchased.	5. Charging the cost of supplies as expenditures in the year they were purchased, irrespective of the year in which they were used.
6. Recognizing interest on investments in the year in which it is earned, irrespective of when it is received.	6. Recognizing interest in the year in which it is received, irrespective of when it is earned.
7. Setting aside funds each year to pay for an anticipated 20-year renovation of a college dormitory.	7. Paying for an anticipated 20-year renovation of a college dormitory out of current funds in the year the work is performed.

REVENUE NOT INDICATIVE OF DEMAND FOR GOODS OR SERVICES

For competitive businesses, revenues signal customer demand for goods and services. Holding prices constant, the greater the revenues, the greater the demand—an indication that the entity is satisfying a societal need.

In a government or not-for-profit, revenues may not be linked to constituent demand or satisfaction. An increase in tax revenues, for example, tells nothing about the amount or quality of service provided. Therefore, a conventional statement of revenues and expenditures cannot supply information on demand for services. Supplementary information is required.

NO DIRECT LINK BETWEEN REVENUES AND EXPENSES

Just as the revenues of governments and not-for-profits may not be directly linked to customer demand, they may also be unrelated to expenditures. The revenues from donations of a not-for-profit entity may increase from one year to the next, but the change may be unaccompanied by a corresponding increase in the quantity, quality, or cost of services provided. Thus, the *matching concept*—financial accounting's central notion that expenditures must be paired with corresponding revenues—may have a different meaning for governments and not-for-profits than for businesses. Businesses attempt to match the costs of specific goods or services with the revenues that they generate. Governments and not-for-profits, however, can sometimes do no more than associate overall revenues with the broad categories of expenditures they are intended to cover.

CAPITAL ASSETS MAY NEITHER PRODUCE REVENUES NOR SAVE COSTS

Unlike businesses, both governments and not-for-profits make significant investments in assets that neither produce revenues nor reduce expenditures. Therefore, the conventional business practices used to value assets may not be applicable.

According to financial theory, the economic value of an asset is the present or discounted value of the cash inflows that it will generate or the cash outflows that it will enable the entity to avoid. Hence, conventional capital budgeting models specify that in evaluating a potential asset acquisition, the business should compare the present value of the asset's expected cash outflows with its inflows.

Many capital assets of governments and not-for-profits cannot be associated with revenues or savings. The highway or bridge being considered by a state or local government will not yield cash benefits—at least not directly to the government. The proposed college library may enrich the intellectual life of the community, but not the college's coffers. In fact, some governments and not-for-profit "assets," such as historical monuments and heritage sites, may be more properly interpreted as liabilities. Inasmuch as they have to be maintained and serviced, they will consume, rather than provide, resources.

RESOURCES MAY BE RESTRICTED

In contrast to the resources of businesses, many of the assets of government and not-for-profit entities are restricted to particular activities or purposes. As shown in Figure 1-1, for example, a sizable share of one government's revenues may be from other governments and, more than likely, restricted for specific purposes. The federal government may give a state or local government a grant for construction of low-income housing, in which case the award can be used only for low-income housing and not for any other purposes, irrespective of how worthy they might be.

Taxes and membership dues may also be restricted. A city's hotel tax may be dedicated to financing a local convention center or to promoting tourism. A state's gasoline tax may be targeted by law at highway construction and maintenance. A portion of a not-for-profit cemetery association's fees may have to be set aside for the acquisition of new land.

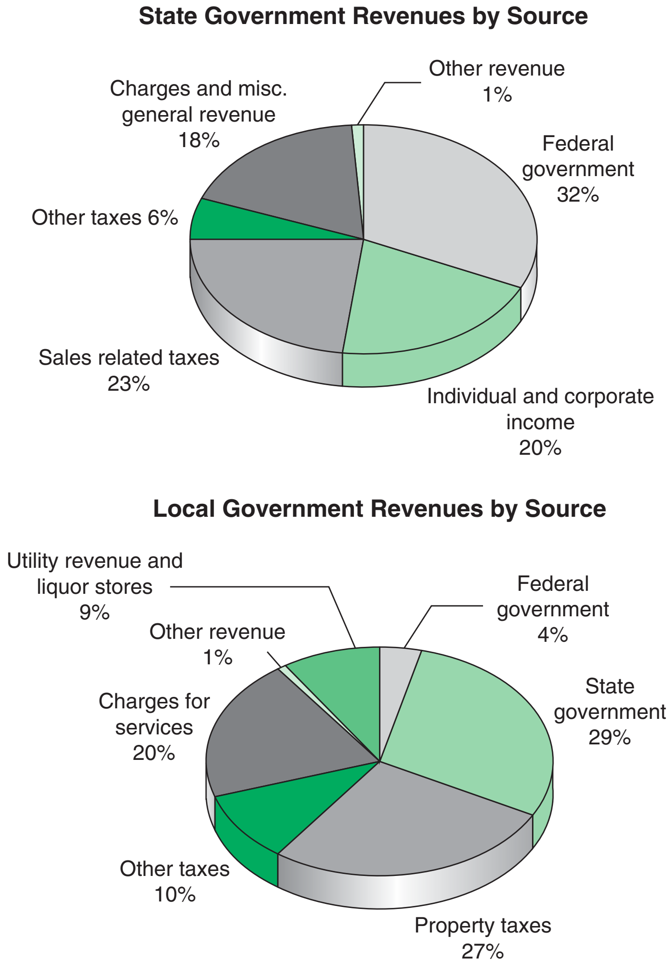


FIGURE 1-1 State and Local Government Revenues by Sources
Source: State and Local Government Finances by Level of Government and by State: 2012, U.S. Census Bureau

Both governments and not-for-profits need to assure the parties providing the restricted funds that the money is used properly. At the same time, they must show in their financial reports that the restricted resources are unavailable for purposes other than those specified. Therefore, the financial statements must either segregate the restricted from the unrestricted resources or disclose by some other means that some resources can be used only for specific purposes.

As with budgetary mandates, slipups regarding restrictions carry serious consequences. At the very least, they may cause the organization to forfeit past and future awards. Therefore, as with budgets, the organization must design its accounting system so that management is prevented from inadvertently misspending restricted resources. To this end, governments and not-for-profits employ a system of accounting known as **fund accounting**, which is discussed in Chapter 2.

NO DISTINCT OWNERSHIP INTERESTS

Neither governments nor not-for-profits have defined ownership interests like those of businesses. Typically, these entities cannot be sold or transferred. Should they be dissolved, they involve no stockholders or bondholders who are entitled to receive residual resources.

The most obvious financial reporting implication of this distinction is that the mathematical difference between assets and liabilities cannot sensibly be termed *owners' equity*. Some other term is required.

More substantively, however, the distinction suggests that the financial statements of governments and not-for-profits must be prepared from the perspective of parties other than stockholders. (The main groups of statement users will be identified later in this chapter.) Similarly, for certain entities the distinction implies that there may be less interest in the market values of their resources. Governments do not typically sell their highways and sewers, and few statement users are interested in their market values. Libraries and museums may be able to sell their collections, but may have to use the funds to acquire similar assets. The market values may be of concern only if the entire institution were to be closed and its assets liquidated. Yet, at the same time, market values may be relevant indicators of whether assets are being put to their optimum use. For example, a city might be better off selling an office building located downtown and using the proceeds to acquire property in outlying neighborhoods.

LESS DISTINCTION BETWEEN INTERNAL AND EXTERNAL ACCOUNTING AND REPORTING

In the government and not-for-profit arena, the line between external and internal accounting and reporting is less clear-cut than in the business sector. First, in the business sector, external reports focus on profits. Nevertheless, even in businesses, few organizational units are profit centers in which management controls all the key factors that affect profits. Therefore, internal reports present data on other measures of performance, such as total fixed costs or per-unit variable costs.

In the government and not-for-profit arenas, profit is no more an appropriate measure of performance for external parties than it is for internal departments. The relevant performance measures must be drawn from the organizations' unique goals and objectives and are unlikely to be the same for all user groups.

Second, in business the budget is an internal document, seldom made available to external parties. In governments and not-for-profits, it stands as the key fiscal document that is as important to taxpayers, bondholders, and other constituencies as it is to managers.

Third, the distinction between internal and external parties in governments and not-for-profits is more ambiguous than it is in business. Taxpayers and organizational members, for example, cannot be categorized neatly as either insiders or outsiders. Although they are not paid employees (and thus, not traditional "insiders"), they may nevertheless have the ultimate say (through either direct vote or elected officers) on organizational policies.

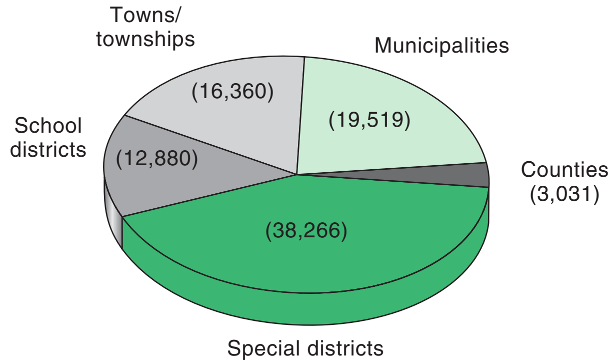
WHAT OTHER CHARACTERISTICS OF GOVERNMENTS AND NOT-FOR-PROFITS HAVE ACCOUNTING IMPLICATIONS?

Governments and not-for-profits have additional characteristics that do not necessarily distinguish them from businesses but have significant accounting and reporting implications.

MANY DIFFERENT TYPES OF GOVERNMENTS AND NOT-FOR PROFITS

Approximately 90,000 local governments currently exist in the United States (Figure 1-2). In common usage, a **municipality** is a village, town, or city. Government specialists, however, use the term to refer also to any other nonfederal government, including school districts, public authorities, and even states.

The number of municipalities may be surprisingly large, but consider how many separate governments have jurisdiction over a typical neighborhood. The neighborhood may be part of a town, several of which constitute a township. The township may be part of a county, which, in turn, may be a subdivision of a state. Further, the neighborhood school may be administered



Total = 90,056

- The average number of local government units per state is 1,801, but Illinois has 6,963, whereas Hawaii has only 21.
- Nine states account for slightly less than half of all local government units in the nation.

FIGURE 1-2 Composition of the Local U.S. Government Units
Source: U.S. Census Bureau. 2012. *Census of Governments: Organization components. There are 90,056 Local Governments in the United States*. http://www2.census.gov/govs/cog/g12_org.pdf

by an independent school district. The local hospital may be governed by a hospital district, the water and sewage system by a utility authority, and the bus system by a transportation authority. The community college may be financed by a community college district, and the nearby airport may be managed by an independent airport authority.

Each category of government will likely differ from others in the services it provides, the type of assets it controls, its taxing and borrowing authority, and the parties to which it is accountable. Moreover, even governments in the same category may vary in the services they provide. New York and Dallas are among the nation's ten largest cities. But New York operates its own school system, whereas Dallas's schools are under the control of an independent school district. San Antonio—Texas's third-largest city—provides electric service to its residents, whereas in Houston—the state's largest city—the citizens receive their power from a privately owned utility.

As shown in Table 1-2, not-for-profits are also many in number: over one million in the United States. These entities constitute what is sometimes referred to as the **independent, or third, sector**. Their diversity limits the suitability of a common accounting model (i.e., set of accounting and reporting principles) for any single, or even for any particular type of, government or not-for-profit entity. Assuming that comparability among entities is a desirable characteristic of financial reporting, standard-setting authorities face a policy question. To what extent should they adopt common standards for all governments and not-for-profits, as opposed to common standards only for entities of the same type? When entities are similar, common standards may promote comparability. When the entities are not, common standards may, like ill-fitting clothes, distort reality. As will be discussed in succeeding chapters, rule-making authorities have issued one set of common principles for all not-for-profits and a separate set for all state and local governments.

SHORT-TERM FOCUS OF MANAGERS AND ELECTED OFFICIALS

U.S. managers of both corporations and public enterprises have been accused of sacrificing the long-term welfare of their organizations for short-term benefits—sometimes for their organizations and other times only for themselves. This failing is said to be especially pronounced in governments.

Government officials typically face election (at the national level) every even-numbered year. In the periods preceding an election, they have powerful incentives both to avoid unpopular