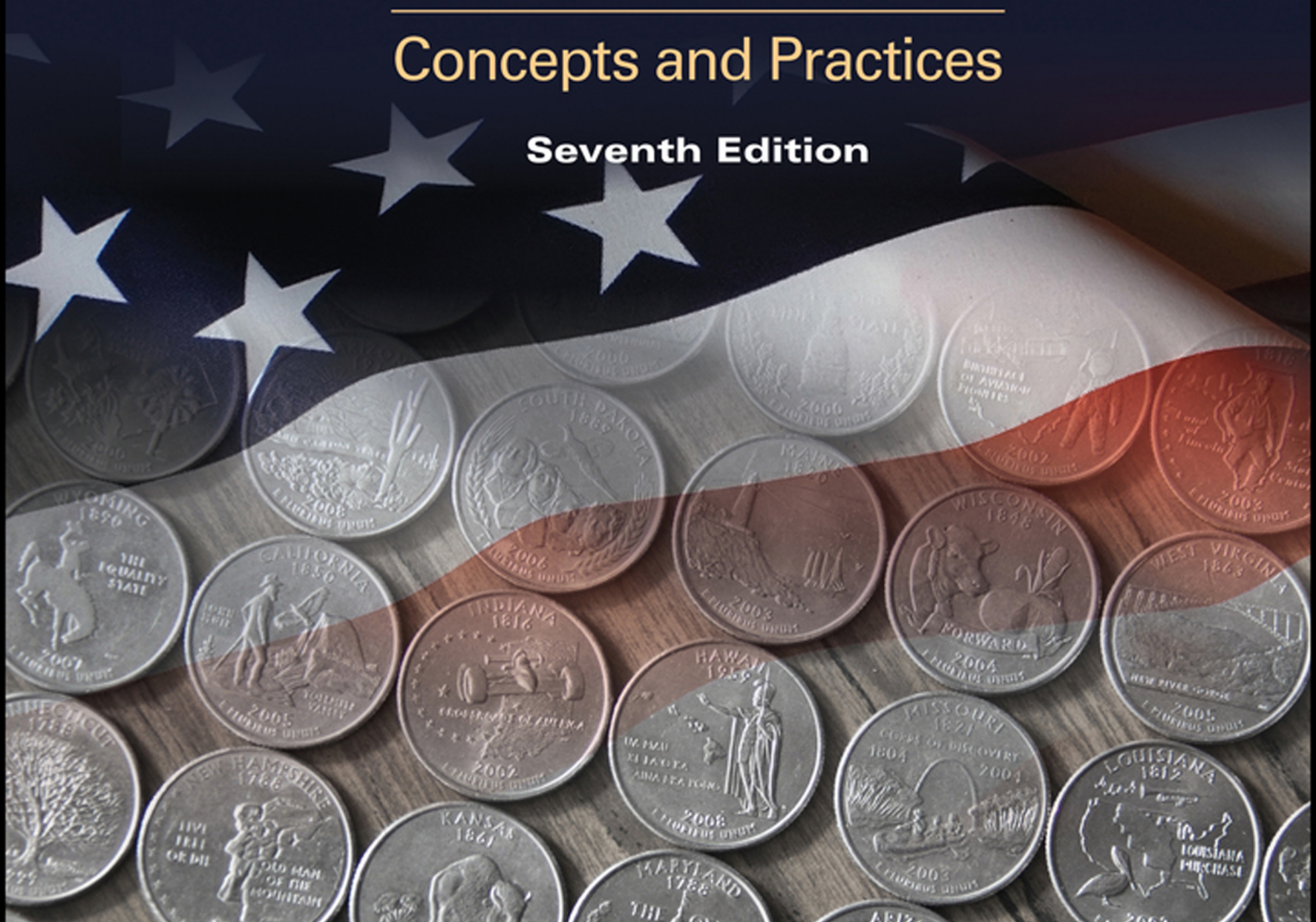


MICHAEL H. GRANOF | SALEHA B. KHUMAWALA | THAD D. CALABRESE | DANIEL L. SMITH

Government and Not-for-Profit Accounting

Concepts and Practices

Seventh Edition



Wiley Binder Version

WILEY

Government and Not-for-Profit Accounting

Concepts and Practices

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SEVENTH
EDITION

Concepts and Practices

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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.

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.

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Contents

Preface

vi

1 The Government and Not-for-Profit Environment

1

How Do Governments and Not-For-Profits Compare With Businesses? 2

■ In Practice: Why is State and Local Government Accounting Important? 5

What Other Characteristics of Governments and Not-For-Profits Have Accounting Implications? 8

How Do Governments Compare With Not-For-Profits? 11

What Are the Overall Purposes of Financial Reporting? 12

Who Are the Users, and What are the Uses of Financial Reports? 13

What Are the Specific Objectives of Financial Reporting as Set Forth by The GASB and FASB? 16

■ Example: Clash among Reporting Objectives 17

Do Differences in Accounting Principles Really Matter? 20

■ In Practice: Will Accounting Changes Make a Difference? 21

Who Establishes Generally Accepted Accounting Principles? 21

■ In Practice: Assessing the Profitability of a Football Program 22

■ In Practice: Governments and Not-For-Profits May Also Be Aggressive in Their Accounting 23

Summary 26

Key Terms in This Chapter 26

Questions For Review and Discussion 26

Exercises 27

Continuing Problem 30

Problems 30

Questions For Research, Analysis, And Discussion 36

2 Fund Accounting

37

What Is a Fund? 37

What Are the Key Elements of Government Financial Statements? 38

What Characterizes Funds? 39

■ Example: Fund Accounting in a School District	44
How Can Funds Be Combined and Consolidated?	46
What Are the Main Types of a Government's Funds?	57
What's Notable about Each Type of Governmental Fund?	58
What's Notable about Each Type of Proprietary Fund?	61
What's Notable about Each Type of Fiduciary Fund?	63
What Is Included in a Government's Comprehensive Annual Financial Report (CAFR)?	69
■ Example: Government-Wide Statement of Activities	71
How Do the Funds and Annual Reports of Not-For-Profits Differ from Those of Governments?	73
Summary	75
Key Terms in This Chapter	77
Exercise for Review and Self-Study	77
Questions for Review and Discussion	78
Exercises	79
Continuing Problem	84
Problems	84
Questions for Research, Analysis, and Discussion	93
Solution to Exercise for Review and Self-Study	93

3**Issues of Budgeting and Control****97**

What Are the Key Purposes of Budgets?	98
Why Is More Than One Type of Budget Necessary?	98
How Are Expenditures and Revenues Classified?	100
Why Are Performance Budgets Necessary?	101
What Are the Key Phases for the Budget Cycle?	104
■ In Practice: Budgeting and Legislative Constraints	106
On What Basis of Accounting Are Budgets Prepared?	108
■ In Practice: States Balance Their Budgets the Painless Way	109
■ In Practice: The Cost of GAAP	109
■ In Practice: Balancing the Budget by Selling Assets to Yourself	110
What Cautions Must Be Taken in Budget-to-Actual Comparisons?	110
How Does Budgeting in Not-For-Profit Organizations Compare with That in Governments?	114
How do Budgets Enhance Control?	114
What are the Distinctive Ways Governments Record their Budgets?	116
■ Example: Budgetary Entries	117
How Does Encumbrance Accounting Prevent Overspending?	119
■ Example: The Encumbrance Cycle—Year 1	120

- Example: The Encumbrance Cycle—Year 2 122
- Example: Impact of Encumbrances on Fund Balance 123
- Are Budgetary and Encumbrance Entries Really Needed? 125
- Summary 126
- Key Terms in This Chapter 126
- Exercise for Review and Self-Study 127
- Questions for Review and Discussion 127
- Exercises 128
- Continuing Problem 134
- Problems 134
- Questions for Research, Analysis, and Discussion 144
- Solution to Exercise for Review and Self-Study 145

4 Recognizing Revenues in Governmental Funds

147

- Why and How Do Governments Use the Modified Accrual Basis? 148
- What Are the Main Types of Nonexchange Revenues and the Limitations on How and When They Can Be Used? 151
- How Should Property Taxes and Other Imposed Nonexchange Revenues Be Accounted For? 152
 - In Practice: Housing Woes Raise New Problems for Accountants and Auditors 152
 - Example: Property Taxes 154
 - Example: Fines 157
- How Should Sales Taxes and Other Derived Tax Revenues Be Accounted For? 158
 - Example: Sales Taxes 159
 - Example: Sales Taxes Collected by State 160
 - Example: Income Taxes 161
- How Should Grants and Similar Government-Mandated and Voluntary Nonexchange Revenues Be Accounted For? 163
 - Example: Unrestricted Grant with Time requirement 164
 - Example: Grant with Purpose Restriction 164
 - Example: Reimbursement (Eligibility Requirement) Grant 164
 - Example: Unrestricted Grant with Contingency Eligibility Requirement 165
 - Example: Endowment Gift 165
 - Example: Pledges 165
 - Example: Payments in Lieu of Taxes 165
 - Example: Donations of Land for Differing Purposes 166
 - Example: On-Behalf Payments 169
- How Should Sales of Capital Assets Be Accounted For? 169
 - Example: Sales of Capital Assets 170

How Should Licenses, Permits, and Other Exchange Transactions Be Accounted For?	171
■ Example: License Fees	171
How Should Governments Report Revenues in Their Government-Wide Statements?	172
Summary	172
Key Terms in This Chapter	174
Exercise for Review and Self-Study	174
Questions for Review and Discussion	174
Exercises	175
Continuing Problem	180
Problems	181
Questions for Research, Analysis, and Discussion	189
Solution to Exercise for Review and Self-Study	189

5 Recognizing Expenditures in Governmental Funds

192

How Is The Accrual Concept Modified for Expenditures?	193
How Should Wages and Salaries Be Accounted For?	194
■ In Practice: Tax Expenditures That Are Actually Reductions in Revenue	194
■ Example: Wages and Salaries	194
How Should Compensated Absences Be Accounted For?	195
■ In Practice: Changing the Pay Date by One Day	196
■ Example: Vacation Leave	196
■ Example: Sick Leave	197
■ Example: Sabbatical Leave	198
How Should Pensions and Other Postemployment Benefits Be Accounted for?	199
■ Example: Pension Expenditure	200
How Should Claims and Judgments Be Accounted For?	200
■ Example: Claims and Judgments	201
How Should the Acquisition and Use of Materials and Supplies Be Accounted For?	202
■ Example: Supplies	202
How Should Prepayments Be Accounted For?	204
■ Example: Prepayments	204
How Should Capital Assets Be Accounted For?	205
■ Example: Capital Assets	206
■ Example: Installment Notes	207
■ Example: Capital Leases	208
How Should Interest and Principal on Long-Term Debt Be Accounted For?	209
■ Example: Long-term Debt	209
■ In Practice: California Schoolchildren May Pay for Their Own Education	211

How Should Nonexchange Expenditures be Accounted for?	212
■ Example: Unrestricted Grant with Time Requirement	212
■ Example: Grant with Purpose Restriction	213
■ Example: Reimbursement (Eligibility Requirement) Grant	213
How Should Interfund Transactions Be Accounted For?	214
■ Example: Interfund Transfer	214
■ Example: Interfund Purchase/Sale	215
What Constitutes other Financing Sources and Uses?	216
How Should Revenues, Expenditures, and Other Financing Sources and Uses be Reported?	217
What Is the Significance of the Current Financial Governmental Fund Statements? An Overview	217
Summary	218
Key Terms in This Chapter	218
Exercise for Review and Self-Study	219
Questions for Review and Discussion	220
Exercises	221
Continuing Problem	227
Problems	228
Questions for Research, Analysis, and Discussion	236
Solution to Exercise for Review and Self-Study	237

6 Accounting for Capital Projects and Debt Service

240

How do Governments Account for Capital Projects Funds?	241
■ Example: Bond Issue Costs	243
■ Example: Bond Premiums and Discounts	243
■ Comprehensive Example: Main Types of Transactions Accounted for in Capital Projects Funds	244
How do Governments Account for Resources Dedicated to Debt Service?	247
■ Comprehensive Example: Main Types of Transactions Accounted for in Debt Service Funds	249
How Do Governments Handle Special Assessments?	252
■ In Practice: Use and Abuse of Special Assessments	253
Accounting for Special Assessments in Proprietary Funds	255
■ In Practice: What We Might Learn From “Net Investment in Capital Assets”	257
How Can Governments Benefit from Debt Refundings?	258
■ Example: Debt Refundings	259
■ Example: In-Substance Defeasance	260
Summary	262
Key Terms in This Chapter	263
Exercise for Review and Self-Study	263
Questions for Review and Discussion	264

Exercises	264
Continuing Problem	270
Problems	270
Questions for Research, Analysis, and Discussion	280
Solution to Exercise for Review and Self-Study	281

7 Capital Assets and Investments in Marketable Securities **285**

What Accounting Practices Do Governments Follow for General Capital Assets?	286
■ Example: Trade-Ins	289
Why and How Should Governments Report Infrastructure?	290
■ In Practice: Nation's Infrastructure Earns a Cumulative Grade of D+	291
■ In Practice: Fair Values May (Or May Not) Facilitate Sales Decisions	296
How Should Governments Account for Assets That Are Impaired?	297
■ Example: Restoration Approach	297
■ Example: Service Units approach	298
■ Example: Deflated Depreciated Replacement Cost Approach	299
What Issues Are the Critical Issues With Respect to Marketable Securities and Other Investments?	299
■ Example: Investment Income	303
■ In Practice: Some Governments May Make Suboptimal Investment Decisions in Order to Avoid Financial Statement Volatility	304
■ Example: Interest Income	304
■ In Practice: One Common-Type Derivative	306
■ In Practice: Investment Debacles	306
■ In Practice: Common sense Investment Practices	308
Summary	308
Key Terms in this Chapter	309
Exercise for Review and Self-Study	309
Questions for Review and Discussion	310
Exercises	310
Continuing Problem	314
Problems	315
Questions for Research, Analysis, and Discussion	324
Solution to Exercise for Review and Self-Study	324

8 Long-Term Obligations **326**

Why is Information on Long-Term Debt Important to Statement Users?	327
Can Governments and Not-For-Profits Go Bankrupt?	327
■ In Practice: It is Not So Easy to Declare Municipal Bankruptcy	328

How Do Governments Account for Long-Term Obligations?	329
■ Example: Accounting for Bonds in Government-Wide Statements	331
■ In Practice: Valuing a Lottery Prize	332
What Constitutes A Government's Long-Term Debt?	332
■ Example: Demand Bonds	334
■ Example: Bond Anticipation Notes	335
■ Example: Tax Anticipation Notes	335
■ Example: Capital Leases	338
■ Example: Overlapping Debt	341
■ In Practice: 49Ers Score Big in The Financial Arena	343
■ In Practice: Tobacco Bonds are Both Risky and Inconsistent with Government Policies	344
What Other Information Do Users Want to Know About Outstanding Debt?	344
■ Example: Debt Margin	346
What are Bond Ratings, and Why are They Important?	347
Summary	349
Key Terms in this Chapter	349
Exercise for Review and Self-Study	349
Questions for Review and Discussion	350
Exercises	350
Continuing Problem	356
Problems	356
Questions for Research, Analysis, and Discussion	363
Solution to Exercise for Review and Self-Study	364

9**Business-Type Activities****365**

What Types of Funds Involve Business-Type Activities?	366
Why Do Governments and Not-For-Profits Engage in Business-Type Activities?	366
Should Business-Type Activities be Accounted for Differently than Governmental Activities?	367
What are the Three Basic Statements of Proprietary Fund Accounting?	369
What Accounting Issues are Unique to Enterprise Funds of Governments?	373
■ Example: Revenue Bond Proceeds as Restricted Assets	377
■ Example: Landfill Costs in an Enterprise Fund	379
■ Example: Pollution Remediation Costs in an Enterprise Fund	382
What are Internal Service Funds, and How are they Accounted For?	382
■ Example: Internal Service Fund Accounting	385
■ In Practice: Full-Cost Pricing May Encourage Dysfunctional Decisions	387
What Special Problems are Created when An Internal Service Fund or the General Fund Accounts for "Self-Insurance"?	389

■ Example: Insurance Premiums	390
■ Example: Self-Insurance in a General Fund	391
How are Proprietary Funds Reported?	392
■ Example: Eliminating Interfund Balances and Transactions	393
■ In Practice: Want to Own a Bridge?	395
What do Users Want to Know about Revenue Debt?	396
Summary	397
Key Terms in this Chapter	398
Exercise for Review and Self-Study	398
Questions for Review and Discussion	399
Exercises	402
Continuing Problem	407
Problems	407
Questions for Research, Analysis, and Discussion	416
Solution to Exercise for Review and Self-Study	417

10 Pensions and Other Fiduciary Activities

419

Why is Pension Accounting so Important?	420
■ In Practice: Funded Status of State Defined Benefit Plans—Ten Best and Ten Worst	421
How do Defined Contribution Plans Differ From Defined Benefit Plans?	421
■ In Practice: Defined Benefit Plans are More Efficient than Defined Contribution Plans	422
■ In Practice: Can Defined Benefit Plans be Saved?	423
What are the Distinctions Among Single, Agent Multiple-Employer, and Cost-Sharing Plans?	424
What is the Relationship Between an Employer and its Pension Plan?	424
What is the Underlying Rationale for the Gasb Approach?	425
How Should the Employer Measure its Pension Obligation?	425
How is the Discount Rate Determined?	426
How Should the Pension Expense in Full Accrual Statements be Determined?	427
■ Example: The Pension Expense	429
How Should the Pension Expenditure in Governmental Funds be Determined?	432
What Special Problems do Multiple-Employer Cost-Sharing Plans Pose?	432
How Should the Pension Plan be Accounted For?	433
What Types of Disclosures are Required?	435
How Should Postemployment Benefits other than Pensions (Opeb) be Accounted For?	436
What are Fiduciary Funds?	437
What Is An Endowment?	437
What are Permanent Funds and How are they Distinguished from Fiduciary Funds?	438
Should Investment Income be Reported in an Expendable or A Nonexpendable Fund?	439
■ Example: Expendable Investment Income	440

How are The Assets Held in Fiduciary Funds Accounted For?	440
■ Example: Recognizing Declines in Fair Value	441
Should Investment Gains be Considered Net Additions to Principal or Expendable Income?	442
■ Example: Investment Gains	442
■ Example: Investment Losses	443
■ In Practice: Disconnect Between FASB and Legal Provisions	445
How can Institutions Protect Against Inflation, Yet Reap the Benefits of Current Income?	446
■ Example: Fixed Rate of Return Approach	446
How are the Main Types of Transactions Recorded in Nonexpendable Trust Funds?	447
■ Example: Recording Transactions in a Permanent Fund	447
What Accounting Issues do Agency Funds Present?	452
■ Example: Agency Funds	452
What Accounting Issues do Investment Trust Funds Present?	454
Summary	456
Key Terms in this Chapter	457
Exercise for Review and Self-Study	457
Questions for Review and Discussion	459
Exercises	460
Continuing Problem	464
Problems	465
Questions for Research, Analysis, and Discussion	472
Solution to Exercise for Review and Self-Study	472

11**Issues of Reporting, Disclosure, and Financial Analysis****474**

How Can a Government Prepare Government-Wide Statements from Fund Statements?	474
Why is the Reporting Entity an Issue for Governments?	476
■ Example: The Reporting Entity	476
What Criteria Have Been Established for Government Reporting Entities?	477
■ Example: Financially Accountable Component Units	478
■ Example: Fiscal Dependency	479
■ Example: Blended Component Units	480
■ Example: A Closely Affiliated Organization	484
■ Example: Application of Current Standards	484
What Other Elements Make Up the Comprehensive Annual Financial Report?	486
What Are the Reporting Requirements for Special-Purpose Governments?	490
How Can A Government's Fiscal Condition be Assessed?	492
■ In Practice: Balanced Budget Requirements Don't Always Result in Balanced Budgets	501
Drawing Conclusions	510

Summary	510
Key Terms in This Chapter	511
Exercise for Review and Self-Study	511
Questions for Review and Discussion	512
Exercises	513
Continuing Problem	519
Problems	519
Questions for Research, Analysis, and Discussion	525
Solution to Exercise for Review and Self-Study	525

12 Not-for-Profit Organizations

528

Who's In Charge?	528
What Should be the Form and Content of Financial Statements?	529
■ Example: Reporting Revenues and Expenses	533
What Are the Main Types of Contributions, and How Should Pledges be Accounted for?	539
■ In Practice: Even the Very Wealthy Sometimes Renege on their Contributions	543
■ Example: Pledges	543
When Should Use-Restricted (Purpose-Restricted) Contributions Be Recognized?	545
■ Example: Use-Restricted Contributions	545
■ In Practice: A Gift With Strings Attached	546
Should Contributions of Services be Recognized?	546
■ Example: Service Contributions	547
Should Receipts of Collection Items Be Recognized As Revenues?	547
■ In Practice: Examples of Contributed Services	548
When Should Conditional Promises be Recognized?	548
■ In Practice: When a Contribution is Not A Contribution	549
■ Example: Conditional Promises	549
How Should "Pass-Through" Contributions be Accounted for?	550
■ Example: A Federated Fund-Raising Organization	550
■ Example: A Foundation That Transfers Assets to a Specified Organization	550
■ Example: A Foundation That Supports a Related Organization	550
When Should Gains and Losses on Investments be Recognized?	552
■ Example: Investment Gains	552
What Are Split Interest Agreements, And How Should They Be Accounted For?	553
How Should Depreciation be Reported?	554
■ Example: Depreciation	554
What Issues Does a Not-For-Profit Face in Establishing its Reporting Entity?	555
■ Comprehensive Example: Museum of American Culture	556

How Should the Costs of Fund-Raising Activities be Determined?	564
■ Example: Allocating Charitable Costs	565
How can a Not-For-Profit's Fiscal Condition be Assessed?	567
■ In Practice: Not-For Profits, Like Corporations, Tainted by Scandals	569
Summary	570
Key Terms in this Chapter	571
Exercise for Review and Self-Study	571
Questions for Review and Discussion	575
Exercises	575
Problems	581
Solution to Exercise for Review and Self-Study	586

13 Colleges and Universities

587

What Unique Issues do Colleges and Universities Face?	587
Accounting for Revenues and Expenses	596
■ In Practice: Which Set of Standards Do We Follow?	597
■ In Practice: Trying to Go Private	598
■ In Practice: How Should a University Classify a Gift that May Not Be a Gift?	598
■ Example: Tuition and Fee Revenues	599
Other Issues	600
■ Example: Grants	601
■ Example: Student Loans	602
■ In Practice: How Auxiliary Enterprises Can Be Misused	603
■ Comprehensive Example: Mars University	603
Evaluating the Fiscal Wherewithal of Colleges and Universities	608
Summary	610
Key Terms in this Chapter	610
Exercise for Review and Self-Study	610
Questions for Review and Discussion	613
Exercises	614
Problems	618
Solution to Exercise for Review and Self-Study	624

14 Health Care Providers

626

■ In Practice: Hospitals Face Economic Challenges While Also Implementing Policy Changes	627
What Unique Issues do Health Care Providers Face?	628
What are the Key Differences Between Private Not-For-Profit and Government Health Care Providers?	629

What Are The Basic Financial Statements?	629
How Are Key Revenues and Expenses Recognized?	634
■ Example: Patient Care Revenues	634
■ Example: Capitation Fee Revenues	635
■ Example: Charity Care	636
■ Example: Malpractice Claims	637
■ Example: Retrospective Premiums	638
■ Comprehensive Example: Medical Center Hospital	638
How can The Fiscal Wherewithal of Health care Organizations be Evaluated?	643
■ In Practice: Financial Problems Not Caused By Single Issue	645
Possible Future Changes	645
Summary	646
Key Terms in this Chapter	646
Exercise for Review and Self-Study	646
Questions for Review and Discussion	647
Exercises	648
Problems	654
Solution to Exercise for Review and Self-Study	660

15 Managing for Results

661

What Role do Accountants Play in the Management Cycle of Governments and Not-For-Profits?	662
How Can the Limits of Traditional Budgets Be Overcome?	663
What are the Characteristics of Sound Operational Objectives?	665
What are the Perils of Establishing Operational Objectives?	667
■ In Practice: A Classic Case of Reliance on Misspecified Objectives (Two Perspectives of the Vietnam War)	668
How Do Program Budgets Relate Expenditures to Operational Objectives?	669
How Should Service Efforts and Accomplishments Be Reported?	675
How Are Capital Expenditures Planned and Budgeted Within A Framework of Operational Objectives?	681
■ Example: Benefits Are Cash Savings	683
■ Example: Choosing among Options with Similar Benefits	684
■ In Practice: September 11 Victim Compensation Fund	686
Summary	688
Key Terms in this Chapter	688
Exercise for Review and Self-Study	689
Questions for Review and Discussion	689
Exercises	690
Problems	693
Solution to Exercise for Review and Self-Study	700

16 Auditing Governments and Not-for-Profit Organizations**702**

- How do Audits of Governments and Not-For-Profits Differ from Those of Businesses? 703
- How has the Yellow Book Influenced Governmental and Not-For-Profit Auditing? 703
- What Types Of Audits Do Governments Conduct? 704
- What Levels of Standards are Applicable to all Engagements? 705
- What are the Key Differences Between Government and Nongovernment Financial Audit Standards? 708
- In Practice: To Whom Should a City Auditor Report? 708
- In Practice: The Auditors' Dilemma 710
- How Have the Single-Audit Act and other Pronouncements Influenced Auditing? 711
- What Approach do Auditors Take in Performing Single Audits? 712
- What Reports Result from Single Audits? 716
- What are Performance Audits? 718
- In Practice: Targeting Seemingly Trivial Activities 721
- Example: Evidence Gathering 724
- In Practice: Findings Must Relate to Program Objectives 725
- Example: Ethical Dilemma 728
- Summary 729
- Key Terms in this Chapter 730
- Exercise for Review and Self-Study 731
- Questions for Review and Discussion 731
- Exercises 732
- Problems 735
- Cases in Ethics 740
- Solution to Exercise for Review and Self-Study 742

17 Federal Government Accounting**744**

- Which Agencies Are Responsible For Federal Accounting And Reporting? 746
- What Constitutes The Federal Budget? 751
- What Constitutes the Federal Government Reporting Entity? 752
- What are the Form and Content of Government-Wide Federal Statements? 754
- What Types of Accounts are Maintained by Federal Entities? 759
- What Statements are Required of Federal Agencies? 762
- What are other key Features of the FASAB Model? 770
- Example: Subsidized loan 777
- Example: loan Guarantees 778
- What Additional Steps Has The Federal Government Taken To Improve Its Fiscal Management? 779
- What are the key International Trends in Governmental Accounting? 779
- Summary 781

Key Terms in this Chapter	782
Exercise For Review And Self-Study	783
Questions for Review and Discussion	783
Exercises	784
Problems	788
Solution to Exercise for Review and Self-Study	796

Glossary	797
Value Tables	816
Index	825

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.

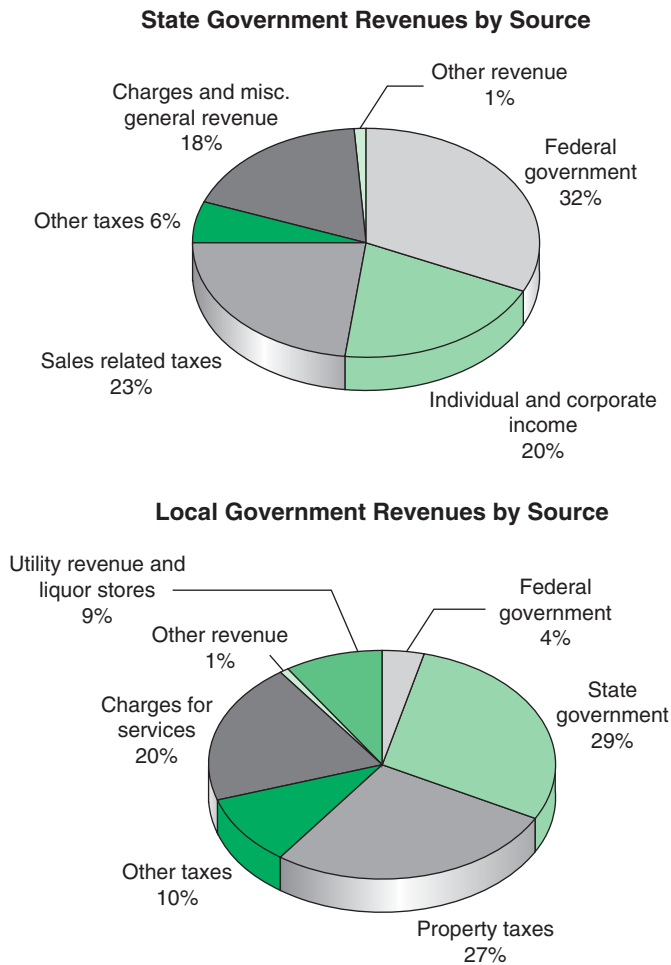


FIGURE 1-1 State and Local Government Revenues by Sources
Source: State and Local Government Finances by Level of Government and by State: 2012, U.S. Census Bureau

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 mispending 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.

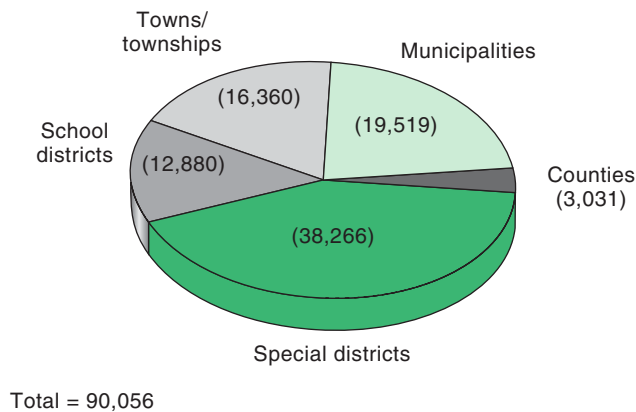
WHAT OTHER CHARACTERISTICS OF GOVERNMENTS AND NOT-FOR-PROFITS HAVE ACCOUNTING IMPLICATIONS?

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



- 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