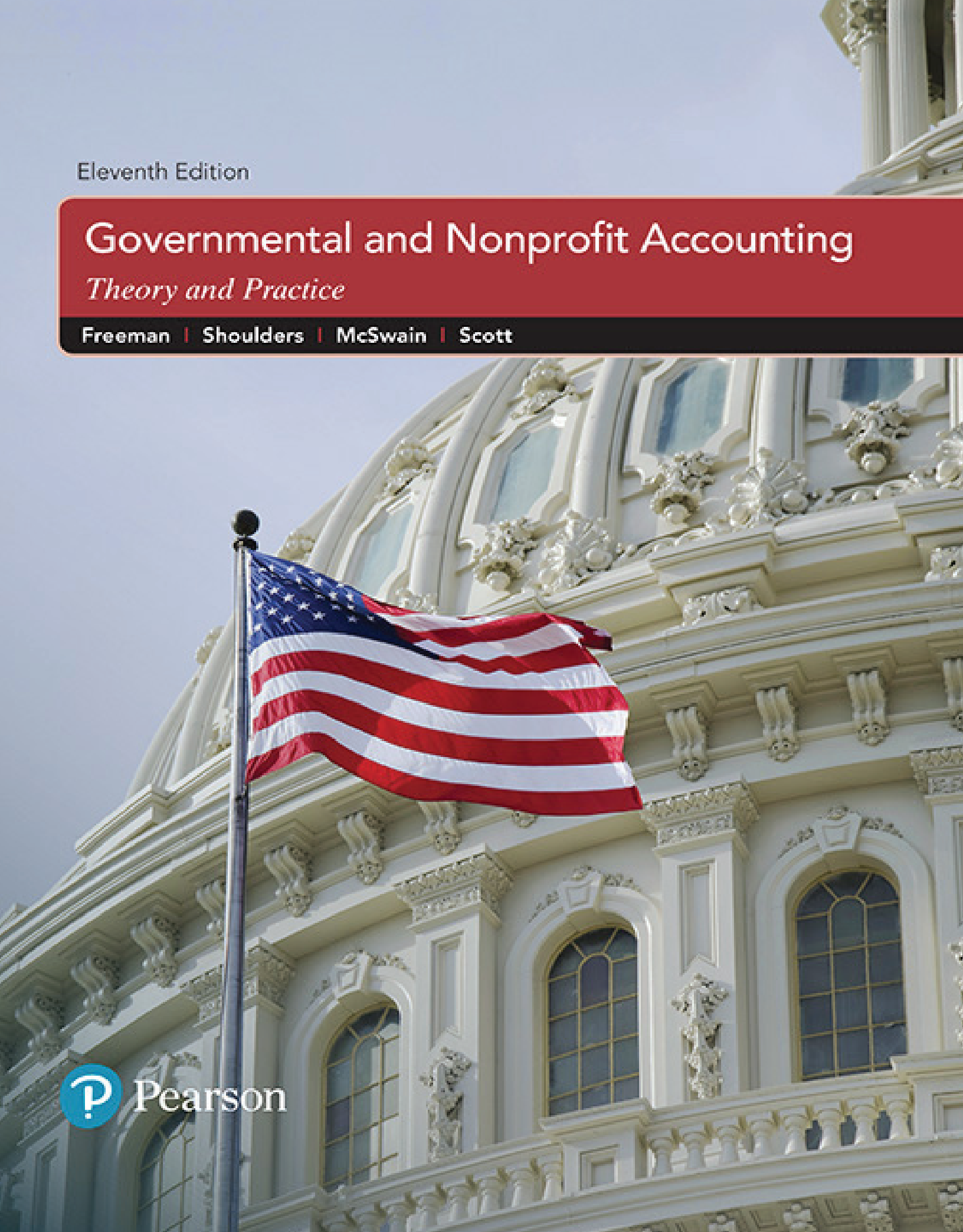


Eleventh Edition

Governmental and Nonprofit Accounting

Theory and Practice

Freeman | Shoulders | McSwain | Scott



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GOVERNMENTAL AND NONPROFIT ACCOUNTING

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Preface

The 11th edition of *Governmental and Nonprofit Accounting* continues a 75+ year tradition as a comprehensive, practice-relevant, up-to-date textbook covering state and local government, federal government, and not-for-profit organization accounting, financial reporting, and auditing. This new edition is in keeping with our philosophy that what students learn in the accounting classroom should correlate highly with what they must understand and apply on the CPA examination and as professional accountants.

Governmental accounting, financial reporting, and auditing have experienced enormous changes recently, accelerating the trend of past years. In just the 10-month period from June of 2015 through March of 2016, the Governmental Accounting Standards Board (GASB) issued 10 Statements of Governmental Accounting Standards. Still other GASB standards became effective for the first time during that period, as did significant changes in Single Audit guidance. These changes have had significant impacts on government accounting, financial reporting, and auditing. Changes include a new hierarchy of generally accepted accounting principles (GAAP), up-to-date fair value guidance, and new standards for accounting for and reporting postemployment benefits—including both pensions and other postemployment benefits. Also, in August 2016, the Financial Accounting Standards Board (FASB) adopted *Accounting Standards Update 2016-14*, “Not-for-Profit Entities” (Topic 958), making major changes in not-for-profit organization financial statements. ***Governmental and Nonprofit Accounting: Theory and Practice, 11th edition***, is updated for all of these and other relevant changes in accounting standards through the beginning of 2017.

EYES-OF-THE-LEARNER–MOTIVATED CHANGES

Changes to this edition will allow students to master content more efficiently. By continuing to use the feedback from adopters and students, we have examined the text “through the eyes of the learner.” New features include:

- **The order of** Chapter 3, “Budgeting, Budgetary Accounting, and Budgetary Reporting,” and Chapter 4, “General and Special Revenue Funds,” have been reworded so that budgeting is covered before General Fund accounting and reporting. This change allows budgetary accounting and reporting to be fully integrated with accounting for actual revenues and expenditures when initially discussed and illustrated.
- **An appendix has been added** to Chapter 14, “Financial Reporting: Deriving Government-Wide Financial Statements and Required Reconciliations.” It provides journal entries consistent with completing the two-worksheet-based conversion of governmental funds data to government-wide governmental activities data. The appendix was added because many students find that seeing the entries improves their understanding of the conversion. The one-worksheet conversion continues to be provided in a second appendix, as in recent editions.
- Chapter 20, “Auditing Governments and Not-for-Profit Organizations,” has been reorganized and rewritten to facilitate understanding the audit requirements, processes, and responsibilities under recent revisions of Government Auditing Standards (GAS) and Single Audit requirements.

STANDARDS-DRIVEN CHANGES

As should be expected, most of the modifications in the content of this 11th edition are necessary because of the numerous changes in government and nonprofit

organization accounting standards and in auditing guidance. Changes required by this new guidance include the following:

- Chapter 1, “Governmental and Nonprofit Accounting: Environment and Characteristics,” is updated for the new government GAAP hierarchy established by GASB *Statement No. 76*, “The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments.” Both the authoritative levels of the hierarchy and the guidance for addressing transactions and events not covered in the authoritative literature are discussed.
- Chapter 5, “Revenue Accounting—Governmental Funds,” is updated for the provisions of GASB *Statement No. 72*, “Fair Value Measurement and Application.” This coverage includes the new definitions of both *fair value* and *investments*, the applicability of fair value, fair value measurement guidance, and the requirement to disclose the levels of inputs (reliability) of the measurements. In addition, GASB *Statement No. 77*, “Tax Abatement Disclosures,” is addressed in this chapter.
- Chapter 6, “Expenditure Accounting—Governmental Funds,” is updated for the provisions of (1) GASB *Statement No. 68*, “Accounting and Financial Reporting for Pensions—An Amendment of GASB *Statement No. 27*,” (2) GASB *Statement No. 75*, “Accounting and Financial Reporting for Postemployment Benefit Plans Other Than Pensions,” and (3) GASB *Statement No. 82*, “Pension Issues—An Amendment of GASB *Statements No. 67, No. 68, and No. 73*.”
- Chapter 9, “General Capital Assets; General Long-Term Liabilities; Permanent Funds: Introduction to Interfund-GCA-GLTL Accounting,” discusses and illustrates accounting for net pension liabilities and related deferred outflows of resources and deferred inflows of resources. The computation of pension expense for governmental activities is demonstrated as well. Other postemployment benefits (OPEB) also are incorporated briefly. The chapter is updated for the GASB *Statement No. 72* requirement to use acquisition costs for donated capital assets and certain other transactions.
- Chapter 10, “Enterprise Funds,” includes the impact of the new pension and OPEB standards on Enterprise Funds.
- Chapter 12, “Trust and Agency (Fiduciary) Funds: Summary of Interfund-GCA-GLTL Accounting,” is updated for the pertinent provisions of the new pension and OPEB standards—particularly pension plan and OPEB plan reporting. These standards include:
 - GASB *Statement No. 67*, “Financial Reporting for Pension Plans—An Amendment of GASB *Statement No. 25*”
 - GASB *Statement No. 73*, “Accounting and Financial Reporting for Pensions and Related Assets That Are Not within the Scope of GASB *Statement 68*, and Amendments to Certain Provisions of GASB *Statements 67 and 68*” (This standard supersedes GASB *Statements No. 25 and No. 27*.)
 - GASB *Statement No. 74*, “Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans” (This standard supersedes GASB *Statement No. 43*.)
 - GASB *Statement No. 82*, “Pension Issues—An Amendment of GASB *Statements No. 67, No. 68, and No. 73*”
- Chapter 13, “Financial Reporting: The Basic Financial Statements and Required Supplementary Information,” discusses and illustrates the government-wide statement of net position, including presentation of pension-related deferred outflows of resources and deferred inflows of resources as well as net pension liabilities.
- Chapter 14, “Financial Reporting: Deriving Government-Wide Financial Statements and Required Reconciliations,” expands the coverage of the two-worksheet approach with a new appendix, including related journal entries, and incorporates new deferred items that must be included in the conversion.
- Chapter 15, “Financial Reporting: The Comprehensive Annual Financial Report and the Financial Reporting Entity,” incorporates the new blending requirements adopted in *Statement No. 80*, “Blending Requirements for Certain Component Units—An Amendment of GASB *Statement No. 14*.”
- Chapter 16, “Non-SLG Not-for-Profit Organizations,” has been revised to reflect the changes in not-for-profit financial statements required by the FASB’s *Accounting Standards Update 2016-14*, “Not-for-Profit Entities (Topic 958): Presentation of Financial Statement of Not-for-Profit Entities.”
- Chapter 17, “Accounting for Colleges and Universities,” has been revised to incorporate both GASB *Statement No. 81*, “Irrevocable Split-Interest Agreements,” and FASB *Accounting Standards Update 2016-14*.

- Chapter 18, “Accounting for Health Care Organizations,” has been updated for FASB *Accounting Standards Update 2016-14*.
- Chapter 20, “Auditing Governments and Not-for-Profit Organizations,” incorporates recent changes in auditing guidance and audit reports. In particular, it is updated for the most recent state and local government audit guide and for the new “Uniform Guidance” that applies to Single Audits of governments and not-for-profit entities.

CUSTOMIZATION FRIENDLY DESIGN

As in the past, the text design allows professors to tailor their courses to their students’ needs and priorities. Therefore, the breadth of topics is wider than is covered in the typical government and not-for-profit accounting course. Chapters that tend to be among the ones omitted are constructed to permit their omission without harming the flow of a course.

LEARNING FRIENDLY

The 11th edition also continues to incorporate the building block approach to the learning process consistent with the following philosophy:

- Mastering governmental and not-for-profit accounting concepts, principles, and practices involves progressing through many different phases of knowledge and understanding.
- Learning efficiency and effectiveness requires this progression to follow a logical sequence.
- Logical sequencing keeps the next concept to be learned accessible from the base provided by the concepts learned already. (Students learn more in less time when taken through the right steps.)
- Efficiently achieving more advanced levels of learning and knowledge requires attaining any prerequisite knowledge first.
- Having this base of prior knowledge and understanding facilitates learning the new information and ideas.

This approach should guide both the ordering of chapters and the sequencing of material within a chapter. The learning process should take full advantage of the business accounting background the learner likely brings into the course.

OTHER POINTS OF DISTINCTION

Other key features of the text, in addition to the learner orientation, flow from our teaching philosophies and goals, including:

- Integrating the *computerized Harvey City Comprehensive Case* throughout Chapters 4 to 15 to simulate the experience of accounting and reporting for a small city
- Correlation with professional practice, enhanced by:
 - Using a practice-relevant, conversion worksheet approach to develop government-wide financial statement data
 - Integrating practice examples for teaching purposes throughout the state and local government accounting, reporting, and auditing chapters
 - Incorporating case problems developed from actual state and local government financial reports in the end-of-chapter materials

INSTRUCTOR SUPPLEMENTS

Supplements for this new edition of *Governmental and Nonprofit Accounting* are available for download by instructors only at www.pearsonhighered.com. Resources

include an Instructor's Manual, Solutions Manual, Excel solution templates for the Harvey City Comprehensive Case and for selected problems, Test Item File, and a PowerPoint presentation.

ACKNOWLEDGMENTS

We are grateful for the excellent input provided by numerous adopters and other individuals that led to improvements in the 11th edition of the text.

A few individuals have provided particularly significant input to help us enhance the chapters. We offer special thanks to:

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AUTHORSHIP CHANGES

As anyone familiar with this text will likely have noticed before even opening the book, we have the bittersweet misfortune of wishing two good friends and colleagues well as they end their time as co-authors of the text.

Greg Allison continues to make monumental contributions to the governmental accounting profession and education in his roles at the University of North Carolina at Chapel Hill. The demands on his time continue to be immense. He recently contributed to the development of an online Masters of Accounting program at the university in addition to his work with the School of Government, the North Carolina Local Government Commission, and governments throughout the state and beyond. Greg has made valuable contributions to the text in the more than 10 years he has served as a co-author.

G. Robert Smith, Jr., better known to us all as Smitty, has retired after a long and successful career during which he made valuable contributions not only to the universities and students he served but to the governmental accounting profession as well. Smitty held leadership roles in the Government and Not-for-Profit Section of the American Accounting Association, including serving as its president. He also served on the Governmental Accounting Standards Advisory Council, participated in multiple roles with the AICPA, and regularly provided continuing professional education for CPAs and government officials. Smitty accomplished all this even during the time that he was serving as the accounting department head at Middle Tennessee State University. One of the contributions to this text that has left its mark and that we value greatly is Smitty's introduction of the two-worksheet approach to converting fund financial statement information into government-wide financial statement information. This is an effective approach for helping students (and practitioners) understand the conversion process. We wish Smitty the very best in his Tennessee mountain retirement.

The other side of authorship changes is we get the benefit of the ideas, experience, and efforts of our new colleagues. Two outstanding professionals have joined us to carry the load left by the departures of Greg and Smitty.

Dwayne McSwain, currently a member of the accounting faculty at Sam Houston State University, is a well-known and well-respected member of the governmental accounting and auditing specialists within academe. He has had extensive

experience in both governmental accounting roles and as a public school district finance director before entering the professorial ranks. Dwayne also co-authored a significant practitioner guide for several years. This extensive background and his publishing experience make Dwayne a valuable addition to our authorship team.

Robert Scott, the chief financial officer and assistant city manager of the city of Carrollton, Texas, is among the most talented and respected CPAs in government today. He has been recognized as the outstanding CPA in government by the AICPA (2008) and serves on its State and Local Government Expert Panel. Bob has served the Government Finance Officers Association (GFOA) in many capacities, including as a member of its Executive Board, and is an outstanding continuing professional education instructor who has authored or co-authored well-regarded continuing education courses. Bob, like Dwayne, is a valuable addition to the author team. Both have made meaningful contributions to this edition.

MOST IMPORTANTLY

Finally, we can never adequately express our love and appreciation to our families. They stand by us in all that we do, including the revision of this text. Clearly, their help and support multiply what we are able to accomplish. Most importantly, they enrich our lives in countless ways and are continuous sources of joy and blessings.

About the Authors

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Robert J. Freeman, Ph.D., CPA, is the Distinguished Professor of Accounting Emeritus at Texas Tech University. He served on the Governmental Accounting Standards Board from 1990 to 2000 and on its predecessor, the National Council on Governmental Accounting, from 1974 to 1980. Dr. Freeman has received the Enduring Lifetime Contributions Award from the American Accounting Association Government and Nonprofit Section, the Louisiana Tech University Tower Medallion Award, and the AICPA Elijah Watt Sells Silver Medal Award.

Prior to joining the Texas Tech faculty, Dr. Freeman was on the faculties of the University of Alabama and Louisiana Tech University, and served as national director of State and Local Government Activities at Arthur Young & Company. The extensive governmental accounting, financial reporting, and auditing seminars that he has offered each summer for the past 35 years have been attended by over 20,000 participants, including some of today's leaders whose first introduction to governmental accounting and financial reporting was in his 3-day Governmental Accounting and Financial Reporting seminar.

Dr. Freeman has contributed numerous articles to professional journals, including *The Journal of Accountancy*, *Accounting Horizons*, *The Government Accountants Journal*, *Government Finance Review*, *The International Journal of Governmental Auditing*, and *The Journal of Public Budgeting, Accounting & Financial Management*. He has served on the editorial boards of *The Journal of Accountancy*, *Research in Governmental Accounting*, *The Journal of Accounting and Public Policy*, and *The Journal of Public Budgeting, Accounting & Financial Management*. Also, Dr. Freeman and Dr. Shoulders were co-authors of multiple editions of Practitioners Publishing Company's three-volume practice guide, *Preparing Governmental Financial Statements*.

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In addition to being the recipient of the Cornelius E. Tierney/Ernst & Young Research Award from the Association of Government Accountants, Dr. Shoulders has been recognized twice by the AICPA as an Outstanding Discussion Leader. He prepares and teaches continuing education courses and seminars on governmental accounting and auditing across the country and is a past president of the Roanoke Area Chapter of the Virginia Society of CPAs. Dr. Shoulders has conducted research for the GASB on the financial reporting entity and has served on GASB task forces on other projects.

Dr. Shoulders coauthors several continuing education courses and for many years authored the government and not-for-profit sections of the ExamMatrix CPA Review. His articles have appeared in such journals as *Issues in Accounting Education*, *The Journal of Accountancy*, *Government Finance Review*, and *The Journal of Government Financial Management*. He received his bachelor's degree from Campbellsville University, his master's degree from the University of Missouri-Columbia, and his Ph.D. from Texas Tech University.

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Dr. McSwain's research has been published in *Internal Auditing*, *Journal of Accounting Literature*, *Journal of Government Financial Management*, and *The CPA Journal*, among others. He is a member of the American Accounting Association, American Institute of CPAs, Association of Government Accountants, Government Finance Officers Association, and the Texas Society of CPAs. Dr. McSwain has been teaching governmental and nonprofit accounting since 1999. He has more than 14 years of governmental accounting experience in practice, working as a staff auditor, payroll specialist, internal auditor, finance director, and accounting information systems specialist in Texas school districts.

In addition to co-authoring several academic and practitioner articles related to governmental and nonprofit accounting, Dr. McSwain co-authored annual updates to *Applying Government Accounting Principles* for 8 years. He received his associate's degree from Gaston College, his bachelor's degree from the University of North Carolina at Charlotte, his master's degree from Tarleton State University, and his Ph.D. from the University of Texas at Arlington.

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Robert Scott is the chief financial officer/assistant city manager for the city of Carrollton, Texas. He earned a master's degree in Accounting and a bachelor of science degree in Political Science from Texas Tech University. Today, he combines his extensive knowledge of governmental accounting with practical knowledge of what works in practice.

Mr. Scott began his career in public accounting and has served both as a Practice Fellow at the Governmental Accounting Standards Board (GASB) and as a representative to the Governmental Accounting Standards Advisory Committee. He serves as a reviewer during revisions of Governmental Accounting, Auditing, and Financial Reporting (the "Blue Book"), is a past chair of GFOA's Committee for Accounting, Auditing and Financial Reporting (CAAFR), and has served on the GFOA's Executive Board. Mr. Scott serves on the AICPA State and Local Government Expert Panel, and in 2008 the AICPA named him the Outstanding CPA in Local Government.

Governmental and Nonprofit Accounting

Environment and Characteristics

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- 1.1 Describe the key unique characteristics and major types of government and nonprofit (G&NP) organizations.
- 1.2 Describe the objectives of G&NP accounting and financial reporting.
- 1.3 Identify the authoritative sources of financial reporting standards for various types of G&NP organizations and the level of authority (hierarchy) of various pronouncements and guides.
- 1.4 Summarize the key distinguishing characteristics, concepts, and objectives of G&NP accounting and financial reporting.
- 1.5 Explain the key characteristics of state and local government financial reporting.

Accounting and financial reporting for governments and nonprofit (G&NP) organizations, as well as G&NP auditing, are based on distinctive concepts, standards, and procedures that accommodate their environments and the needs of their financial and audit report users. This book focuses on the most important of these concepts, standards, and procedures applicable to (1) state and local governments, including counties, cities, and school districts, as well as townships, villages, special districts, and public authorities; (2) the federal government; and (3) not-for-profit and governmental universities, hospitals, voluntary health and welfare organizations, and other not-for-profit (or nonprofit) organizations. Financial management and accountability considerations peculiar to G&NP organizations are emphasized throughout, and auditing G&NP organizations is discussed in the final chapter.

This chapter introduces the characteristics and types of G&NP organizations and the objectives and nature of G&NP accounting and financial reporting. Additionally, it discusses and illustrates how to distinguish government and non-government organizations; identifies the various authoritative sources of G&NP accounting principles and reporting standards, including their relative authoritativeness; and introduces the state and local government (SLG) accounting and

financial reporting environment, concepts, objectives, and distinctive features. The latter includes funds, legally enacted budgets and appropriations, and budgetary control.

CHARACTERISTICS AND TYPES OF G&NP ORGANIZATIONS

Learning Objective 1.1

Governments and other nonprofit organizations are unique in the following ways:

- They do not attempt to earn a profit, and most are exempt from income taxes. Thus, typical business accounting, including income tax accounting, usually is not appropriate.
- They are owned collectively by their constituents; because ownership is not evidenced by equity shares that can be sold or traded, residents who are dissatisfied with their government must await a change in its elected governing body or move elsewhere.
- Those contributing financial resources to the organizations do not necessarily receive a direct or proportionate share of their services. For example, homeowners pay property taxes to finance public schools even if they do not have children in school.
- Their major policy decisions, and perhaps some operating decisions, typically are made by majority vote of an elected or appointed governing body (e.g., a state legislature, a city council, or a hospital board of directors) whose members serve part time, receive modest or no compensation, and have diverse backgrounds, philosophies, capabilities, and interests.
- Decisions usually must be made “in the sunshine” — that is, in meetings open to the public, including the news media — and most have “open records” laws that make their accounting and other records open to the public.

A G&NP organization exists because a community or society decides to provide certain goods or services to its group as a whole. Often, these goods or services are provided regardless of whether costs incurred will be recovered through charges for the goods or services or whether those paying for the goods or services are those benefiting from them. Indeed, many G&NP services could not be provided profitably through private enterprise. In addition, the community or society may consider these services so vital to the public well-being that they should be supervised by its elected or appointed representatives.

The major types of government and nonprofit organizations may be classified as:

1. **Governmental:** federal, state, county, municipal, township, and village, as well as other local governmental authorities and special districts
2. **Educational:** kindergartens, elementary, and secondary schools; vocational and technical schools; and colleges and universities
3. **Health and welfare:** hospitals, nursing homes, child protection agencies, the American Red Cross, and United Service Organizations (USO)
4. **Religious:** Young Men’s Christian Association (YMCA), Young Women’s Christian Association (YWCA), Salvation Army, and other church-related organizations
5. **Charitable:** United Way, Community Chest, and similar fund-raising agencies; related charitable agencies; and other charitable organizations
6. **Foundations:** private trusts and corporations organized for educational, religious, or charitable purposes

This general classification scheme has much overlap among the classifications. Many charitable organizations are operated by churches, for example, and governments are deeply involved in education, health, and welfare activities.

G&NP Sector Significance

Governments and other nonprofit organizations have experienced dramatic growth in recent years and are major economic, political, and social forces in our society. Indeed, the G&NP sector now accounts for more than one-third of all expenditures in the U.S. economy. During the Great Recession, government spending temporarily

grew to over 40 percent of the total gross domestic product. The total value of financial and human resources devoted to this sector is gigantic, both absolutely and relatively.

Sound financial management—including thoughtful budgeting, proper accounting, meaningful financial reporting, and timely audits by qualified auditors—is at least as important in the G&NP sector as in the private business sector. Furthermore, because of the scope and diversity of its activities, proper management of the financial affairs of a city or town, for example, may be far more complex than that of a private business with comparable assets or annual expenditures.

As the size and complexity of governments and nonprofit organizations have increased in recent years, so have the number of career employment opportunities in this sector for college graduates majoring in accounting and public administration (and other disciplines). Likewise, the number of governmental and nonprofit organization auditing and consulting engagements with independent public accounting firms has increased significantly. Accordingly, a significant portion of the Uniform Certified Public Accountant (CPA) Examination is on G&NP accounting, financial reporting, and auditing concepts, principles, and procedures.

Government and nonprofit organizations are similar in many ways to profit-seeking enterprises. For example:

1. They are integral parts of the same economic system and use financial, capital, and human resources to accomplish their purposes.
2. Both must acquire and convert scarce resources into their respective goods or services.
3. Both must have viable information systems, including excellent accounting systems to assure that managers, governing bodies, and others receive relevant and timely information for planning, directing, controlling, and evaluating the sources, uses, and balances of their scarce resources.
4. Cost analysis and other control and evaluation techniques are essential to ensure that resources are utilized economically, effectively, and efficiently.
5. In some cases, both produce similar products. For example, both governments and private enterprises may own and operate transportation systems, sanitation services, and electric utilities.

On the other hand, significant differences distinguish profit-seeking organizations from G&NP organizations. Broad generalizations about such a diversified group as G&NP organizations are difficult, but the major differences include (1) organizational objectives, (2) sources of financial resources, and (3) methods of evaluating performance and operating results.

Organizational Objectives

Expectation of income or gain is the principal factor that motivates investors to provide resources to profit-seeking enterprises. To the contrary:

- The objective of most governmental and nonprofit organizations is to provide as much service each year as their financial and other resources permit.
- Typically, G&NP organizations operate on a year-to-year basis—that is, each year they raise as many financial resources as necessary and expend them in serving their constituencies.
- Government and nonprofit organizations may seek to increase the amount of resources made available to them each year—and most do—but the purpose is to enable the organizations to provide more or better services, not to increase their wealth.

In sum, whereas private businesses seek to increase their wealth for the benefit of their owners, G&NP organizations seek to expend their available financial resources for the benefit of their constituencies. *Financial management in the G&NP environment thus typically focuses on acquiring and using financial resources—on sources and uses of expendable financial resources, budget status, and*

The G&NP Environment

cash flow—rather than on net income. Even G&NP entities whose external financial reports do not require primary emphasis on acquisition and use of financial resources emphasize this information for internal reporting and management decision-making purposes.

Sources of Financial Resources

The sources of financial resources differ between business and G&NP organizations, as well as among G&NP organizations. In the absence of a net income objective, *no distinction generally is made between invested capital and revenue of G&NP organizations. A dollar is a financial resource whether acquired through donations, user charges, sales of assets, loans, or some other manner.*

The typical nondebt sources of financing for business enterprises are investments by owners and sales of goods or services to customers. These sources of financing are usually not the primary sources of G&NP organizations' financial resources. Instead, G&NP organizations primarily rely on the following sources:

- Governments have the unique power to force involuntary financial resource contributions through taxation of property, sales, and income. Indeed, all levels of government rely heavily on this power. Grants and shared revenues from other governments are also important state and local government revenue sources, as are charges for services provided.
- Religious groups and charitable organizations usually rely heavily on donations, although they may have other revenue sources.
- Some colleges and universities rely heavily on donations and income from trust funds; others depend primarily on state appropriations, federal and state grants, and/or tuition and fee charges for support.
- Hospitals and other health care organizations generally charge their clientele, although many do not admit patients solely on the basis of ability to pay. Indeed, many G&NP hospitals serve numerous charity patients and/or have large amounts of uncollectible accounts, and some hospitals rely heavily on gifts, federal and state grants, and bequests.

Other, more subtle differences in sources of G&NP organizations' financial resources as compared with profit-seeking businesses include these:

- Many services or goods provided by these organizations, such as police and fire protection, are monopolistic. Thus, an open market for objectively appraising or evaluating their value does not exist.
- User charges usually are based on the cost of the services provided rather than on supply-and-demand-related pricing policies.
- Charges levied for goods or services often cover only part of the costs incurred to provide them; for example, tuition generally covers only a fraction of the cost of operating state colleges or universities, and token charges (or no charges) may be made to a hospital's indigent patients.
- Governments' revenue-raising capacity is constrained by its geographic boundaries. A well-run city cannot expand its service and taxing reach to other cities or jurisdictions as a result of its superior performance. At some point, all the usable property has been utilized by existing taxpayers and businesses. However, a government typically cannot expand its boundaries and increase its property tax base and revenue once its existing territory is fully developed to its capacity except through annexation.

Evaluating Performance and Operating Results

Profit-seeking enterprises usually will modify or withdraw unprofitable goods or services offered to the consuming public. The direct relationship between the financial resources each consumer provides and the goods or services a consumer receives from each enterprise essentially dictates the type and quality of goods and services each profit-seeking enterprise will provide. Firms with inept or

unresponsive management will be unprofitable and ultimately will be forced out of business. Therefore, the profit motive and profit measurement constitute an automatic allocation and regulating device in the free enterprise segment of our economy.

This profit test/regulator device is not present in the usual G&NP situation. Because governments have the power to tax and lack market competition for most of the services they provide, governments generally continue to operate even if they are ineffective or inefficient. Because government services are unique or are provided without charge or at a token charge, consumers have no “dollar vote” to cast.

Evaluating the performance and operating results of most G&NP organizations is extremely difficult because:

1. No open market supply-and-demand test occurs to evaluate the value of the services they provide.
2. The relationship, if any, between the resource contributors and the recipients of the services is remote and indirect.
3. G&NP organizations are not profit oriented in the usual sense and are not expected to operate profitably; thus, the profit test is neither a valid performance indicator nor an automatic regulating device.
4. Governments can force financial resource contributions through taxation.

Accordingly, G&NP organizations must employ measures and controls of operating results other than net income to ensure that their resources are used appropriately and to prevent inefficient or ineffective G&NP organizations from operating indefinitely. *Governments and nonprofit organizations, particularly governments, are therefore subject to more stringent legal, regulatory, and other controls than are private businesses.*

All facets of a G&NP organization’s operations—especially of state and local governments—may be affected by legal or quasi-legal requirements (1) imposed externally, such as by federal or state statute, grant regulations, or judicial decrees, or (2) imposed internally or by mutual agreement, such as by charter, bylaw, ordinance, trust agreement, donor stipulation, or contract. Furthermore, the need to ensure compliance with such extensive legal and contractual requirements often necessitates more stringent operational and administrative controls than in private enterprise. Aspects of G&NP organizations’ operations that may be regulated or otherwise controlled include:

1. **Organization structure:** form; composition of governing board; number and duties of its personnel; lines of authority and responsibility; policies concerning which officials or employees are to be elected, appointed, or hired
2. **Personnel policies and procedures:** who will appoint or hire personnel; tenure of personnel; policies and procedures upon termination; compensation levels; promotion policies; types and amounts of compensation increments
3. **Sources of financial resources:** types and maximum amounts of taxes, licenses, fines, or fees a government may levy; procedure for setting user charges; tuition rates; debt limits; purposes for which debt may be incurred; allowable methods for soliciting charitable contributions
4. **Uses of financial resources:** purposes for which resources may be used, including the legal restriction of certain resources only for specific purposes; purchasing procedures to be followed; budgeting methods, forms, or procedures
5. **Accounting:** any or all phases of the accounting system—for example, chart of accounts, bases of accounting, forms, and procedures
6. **Financial reporting:** type and frequency of financial reports; report format and content; report recipients
7. **Auditing:** frequency of audit; who is to perform the audit; scope and type of audit; time and place for filing the audit report; who is to receive or have access to the audit report

Finally, managers of G&NP organizations may have limited discretion compared with managers of businesses. The role and emphasis of G&NP financial accounting and reporting thus are correspondingly altered as compared with the profit-seeking business environment.

OBJECTIVES OF G&NP ACCOUNTING AND FINANCIAL REPORTING

Learning Objective 1.2

Financial Accounting Standards Board (FASB) *Statement of Financial Accounting Concepts No. 4* (SFAC 4), “Objectives of Financial Reporting by Nonbusiness Organizations,” addresses the objectives of **general purpose external financial reporting** by *nonbusiness (nonprofit)* organizations. SFAC 4 notes that:

- The *objectives* stem primarily from the needs of *external* users who generally cannot prescribe the information they want from an organization.
- *In addition* to information provided by general purpose *external* financial reporting, *managers* and . . . *governing bodies* need a great deal of *internal accounting information* to carry out their responsibilities in planning and controlling activities.¹

The financial reporting *objectives* set forth in SFAC 4 state that financial reporting by nonbusiness organizations should provide information that is *useful* to present and potential resource providers and other users in:

- *Making rational decisions* about the allocation of resources to those organizations.
- *Assessing the services* that a nonbusiness organization provides *and its ability to continue* to provide those services.
- *Assessing how managers* of a nonbusiness organization have *discharged their stewardship* responsibilities and other aspects of their performance.

In addition, nonbusiness organization financial reporting should include explanations and interpretations to help users understand the financial information provided.²

Note that these broad objectives statements relate to *all* organizations and *nonbusiness* organizations, respectively. The objectives of *state and local government* accounting and financial reporting are discussed later in this chapter.

AUTHORITATIVE SOURCES OF G&NP ACCOUNTING PRINCIPLES AND REPORTING STANDARDS

Learning Objective 1.3

The G&NP accounting and reporting concepts, principles, and standards evolved separately from those for business enterprises. Beginning in the 1930s, unique principles and standards evolved separately for each of the several major types of G&NP organizations.

- The National Council on Governmental Accounting (NCGA) and several similar predecessor committees led the development of accounting concepts, principles, and standards for state and local governments until the Governmental Accounting Standards Board (GASB) was created in 1984.
- The American Hospital Association and the Healthcare Financial Management Association fostered the development of accounting principles and standards for hospitals and other health care institutions.
- The American Council on Education and the National Association of College and University Business Officers led the development of those for colleges and universities.

¹Financial Accounting Standards Board, *Statement of Financial Accounting Concepts No. 4*, “Objectives of Financial Reporting by Nonbusiness Organizations” (Stamford, CT: FASB, December 1980), p. xii. Emphasis added.

²*Ibid.*, pp. xiii–xiv.

- Committees of the American Institute of Certified Public Accountants (AICPA) set forth accounting principles and standards for nonprofit organizations in AICPA audit and accounting guides until the FASB began issuing guidance for nongovernmental, nonprofit organizations in 1993.
- The Comptroller General of the United States led the federal government accounting standards effort until the Federal Accounting Standards Advisory Board (FASAB) was established in 1990.

In addition, each G&NP field has its own journals, newsletters, and professional societies.

Both the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB) are overseen by the Financial Accounting Foundation (FAF). The FAF, which is comprised of prominent government and private-sector leaders, also appoints new members to the FASB and the GASB.

The FAF

The FASB has seven full-time members and over 60 staff members. Although not limited by its original charter or rules of procedure to setting business accounting standards, the FASB devoted its early efforts almost exclusively to business accounting concepts and standards, deferring the decision on what role, if any, it would play in the G&NP standards area.

The FASB

In 1979, the FASB (1) agreed to exercise responsibility for all specialized accounting and reporting principles and practices set forth in AICPA statements of position, accounting guides, and audit guides *except* those dealing with state and local governments (*FASB Statement No. 32*). Subsequently, the FASB rescinded *FASB Statement No. 32* and issued standards for nongovernmental organizations, including nongovernmental not-for-profit organization accounting and financial reporting (discussed in Chapter 16).

The FASB deferred action concerning state and local government standards during this period because discussions were underway among representatives of interested organizations, including the NCGA and the AICPA, about the appropriate structure for setting governmental accounting standards. At issue was whether state and local government accounting standards should continue to be established by the NCGA or should be set by the FASB or perhaps a new standards-setting body. These discussions led to formation of the Governmental Accounting Standards Board in 1984.

The FAF created the Governmental Accounting Standards Board (GASB) in 1984 in a co-equal relationship with the Financial Accounting Standards Board (FASB). The jurisdiction agreement states that:

FASB-GASB
Jurisdictions

- The **GASB** is responsible for establishing accounting and financial reporting standards for activities and transactions of **state and local governments**, including government nonprofit organizations.
- The **FASB** is responsible for establishing accounting and financial reporting standards for **all other organizations**, including nongovernment nonprofit organizations.

Whether an organization is or is not a “government” is a critical determination that dictates whether it must follow GASB or FASB standards and guidance.

Most state and local governments—including states, counties, municipalities, townships, and school districts—clearly are “governments” subject to the GASB’s jurisdiction. But it may be difficult to determine whether some not-for-profit and other organizations are governmental or nongovernmental. Accordingly, the GASB and FASB jointly developed a definition of government.

“Government”
Defined

- This definition, summarized in Illustration 1–1, is published in AICPA audit and accounting guides to assist practitioners in determining whether organizations are governmental or nongovernmental and thus are under GASB jurisdiction or FASB jurisdiction.
- Many nonprofit organizations are established by governments and *are* governments under this definition.

The practitioner must determine whether a specific organization is “government” or “nongovernment” using the FASB-GASB definition to apply the generally accepted accounting principles (GAAP) hierarchy guidance correctly.

The GASB

The GASB succeeded the NCGA in 1984 (see Appendix 1-1) as the body authorized to establish accounting standards for state and local governments (see Illustration 1–2). The GASB, FASB, and FAF offices are in the same building in Norwalk, Connecticut. Again, the GASB is responsible for establishing financial

ILLUSTRATION 1-1 Definition of State and Local Government Entities

Governmental organizations include (1) public corporations¹ and bodies corporate and politic, and (2) other organizations *if* they have *one or more* of the following characteristics:

- The popular election of officers or appointment (or approval) of a controlling majority of the members of the organization’s governing body by officials of one or more state or local governments
- The potential for unilateral dissolution by a government with the net assets reverting to a government
- The power to enact and enforce a tax levy
- The ability to issue directly (rather than through a state or municipal authority) debt that pays interest exempt from federal taxation²

¹*Black’s Law Dictionary* defines a public corporation as “an instrumentality of the state, founded and owned in the public interest, supported by public funds and governed by those deriving their authority from the state.”

²However, organizations possessing only that ability (to issue tax-exempt debt) and none of the other governmental characteristics may rebut the presumption that they are governmental if their determination is supported by compelling, relevant evidence.

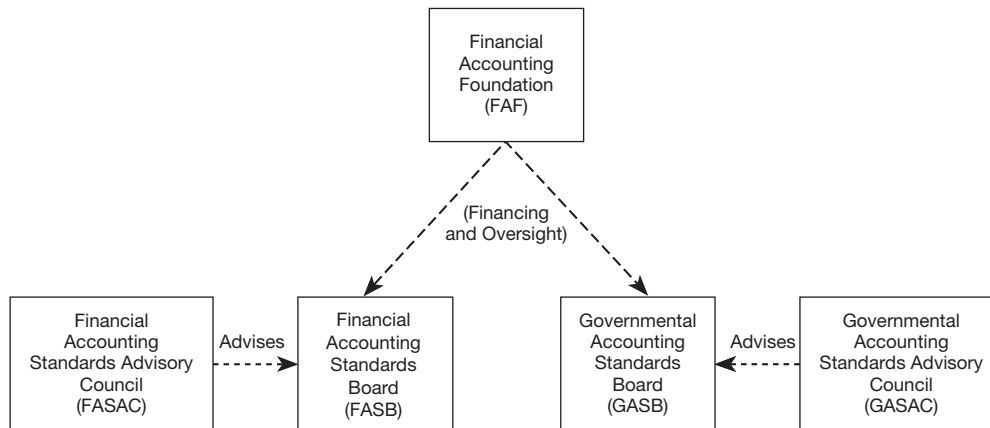
Source: Adapted from “FASB and GASB Define ‘Government,’” *Journal of Accountancy*, July 1996, pp. 16–17. This definition is cited in pertinent AICPA audit and accounting guides.

1-1 IN PRACTICE

Not-for-Profit (Nonprofit) Organizations May Be Governments

1. Several states have established health care, drug abuse, professional licensing, economic development, and other agencies as 501(c)(3) not-for-profit (nonprofit) corporations.
2. Cities and counties also have established industrial development, economic development, civic center, convention center, sports complex, and other activities and facilities as 501(c)(3) corporations.
3. A professional (AAA) baseball team, the Columbus (Ohio) Clippers, is a less commonly encountered type of not-for-profit organization.
4. Finally, many public television stations are legally established as not-for-profit or nonprofit corporations by states, state colleges and universities, or other governments.

Although all of these organizations are established as not-for-profit or nonprofit corporations legally, the GASB requires a “substance over form” approach to financial reporting. Thus, organizations such as these are “*government* not-for-profit or nonprofit organizations” and are under GASB jurisdiction for GAAP reporting.

ILLUSTRATION 1-2 Financial Reporting Standards-Setting Structure


Source: Based on portions of various GASB documents. Complete copies of documents are available from the GASB.

reporting standards for activities and transactions of **state and local governments**; the **FASB** sets reporting standards for **all other organizations**, including *nongovernmental*, nonprofit organizations.

The GASB has seven members. The chairperson serves full time, whereas the other six members serve part time. The board is assisted by a full-time professional staff of approximately 20 persons, led by the director of research, and meets in open session for two to three days about every six weeks, with one-day teleconference meetings in between. The GASB mission—including its mission statement, an overview of how its mission is accomplished, and its due process—is summarized in Illustration 1–3.

The GASB’s activities focus on its agenda topics and projects. It may issue nonauthoritative invitations to comment, discussion memorandums, and preliminary views publications to obtain viewpoints of practitioners and others before issuing exposure drafts and, finally, an authoritative pronouncement. Its authoritative pronouncements are issued as Statements, Technical Bulletins, and Implementation Guides. (The GASB no longer issues Interpretations but some remain effective.) The GASB issues *The GASB Report* electronic newsletter to inform interested persons of its activities and also issues Concepts Statements, research studies, and other nonauthoritative publications from time to time.

GASB *Statement No. 1*, “Authoritative Status of NCGA Pronouncements and AICPA Industry Audit Guide,” issued in 1984, provided a transition from the old standards-setting arrangements to the current one. *Statement No. 1* recognized the then-effective NCGA pronouncements and certain accounting and reporting guidance in the then-effective AICPA state and local government audit guide as authoritative, stating that they are “continued in force until altered, amended, supplemented, revoked, or superseded by a subsequent GASB pronouncement.”³ These NCGA and AICPA pronouncements—now recognized as GASB pronouncements—were integrated into its authoritative *Codification of Governmental Accounting and Financial Reporting Standards* in 1985.⁴

³ Governmental Accounting Standards Board, *Statement No. 1*, “Authoritative Status of NCGA Pronouncements and AICPA Industry Audit Guide” (Norwalk, CT: GASB, July 1984).

⁴ Governmental Accounting Standards Board and Governmental Accounting Research Foundation of the Government Finance Officers Association, *Codification of Governmental Accounting and Financial Reporting Standards as of November 1, 1984* (Norwalk, CT: GASB, 1985).