

Seventeenth Edition

Accounting for Governmental & Nonprofit Entities



Jacqueline L. Reck | Suzanne L. Lowensohn

Mc
Graw
Hill
Education

Accounting for Governmental & Nonprofit Entities

Seventeenth Edition

Jacqueline L. Reck, Ph.D.,
CPA

*James E. and C. Ellis Rooks
Distinguished Professor in Accounting
University of South Florida*

Suzanne L. Lowensohn,
Ph.D., CPA, CGMA

*Associate Professor of Accounting
Colorado State University*





ACCOUNTING FOR GOVERNMENTAL & NONPROFIT ENTITIES, SEVENTEENTH EDITION

Published by McGraw-Hill Education, 2 Penn Plaza, New York, NY 10121. Copyright © 2016 by McGraw-Hill Education. All rights reserved. Printed in the United States of America. Previous editions © 2013, 2010, and 2007. No part of this publication may be reproduced or distributed in any form or by any means, or stored in a database or retrieval system, without the prior written consent of McGraw-Hill Education, including, but not limited to, in any network or other electronic storage or transmission, or broadcast for distance learning.

Some ancillaries, including electronic and print components, may not be available to customers outside the United States.

This book is printed on acid-free paper.

1 2 3 4 5 6 7 8 9 0 DOW/DOW 1 0 9 8 7 6 5

ISBN 978-0-07-802582-2

MHID 0-07-802582-6

Senior Vice President, Products & Markets: *Kurt L. Strand*

Vice President, General Manager, Products & Markets: *Marty Lange*

Vice President, Content Design & Delivery: *Kimberly Meriwether David*

Director: *Tim Vertovec*

Product Developer: *Gail Korosa*

Marketing Manager: *Brad Parkins*

Digital Product Developer: *Kevin Moran*

Director, Content Design & Delivery: *Linda Avenarius*

Content Project Manager: *Lisa Bruflodt*

Content Project Manager (Assessment): *Angela Norris*

Content Project Manager (OLC): *Sandy Schnee*

Buyer: *Susan K. Culbertson*

Cover Image: *Scott Dressel-Martin for the Colorado Convention Center*

Compositor: *Aptara®*, Inc.

Printer: *R. R. Donnelly*

All credits appearing on page or at the end of the book are considered to be an extension of the copyright page.

Library of Congress Cataloging-in-Publication Data

Reck, Jacqueline L.

Accounting for governmental & nonprofit entities / Jacqueline L. Reck, Ph.D., CPA, James E. and C. Ellis Rooks, Distinguished Professor in Accounting, University of South Florida, Suzanne L. Lowensohn, Ph.D., CPA, CGMA, Associate Professor of Accounting, Colorado State University. — Seventeenth Edition.

pages cm

ISBN 978-0-07-802582-2 (alk. paper) — ISBN 0-07-802582-6 (alk. paper)

1. Finance, Public—Accounting. 2. Nonprofit organizations—Accounting. 3. Nonprofit organizations—United States—Accounting. I. Lowensohn, Suzanne L. II. Title. III. Title: Accounting for governmental and nonprofit entities.

HJ9733.R43 2014

657'.825—dc23

2014043201

The Internet addresses listed in the text were accurate at the time of publication. The inclusion of a Web site does not indicate an endorsement by the authors or McGraw-Hill Education, and McGraw-Hill Education does not guarantee the accuracy of the information presented at these sites.

DEDICATION TO EARL R. WILSON

Professors Jackie Reck and Suzanne Lowensohn dedicate the 17th edition of *Accounting for Governmental & Nonprofit Entities* to Professor Emeritus Earl R. Wilson. Professor Wilson served as an author of this textbook from the 9th edition (1992) through the 16th edition. As a result of Professor Wilson’s innovation and dedication, the textbook is recognized nationally and has been adopted by hundreds of institutions. When the GASB issued the financial reporting model standard in 1999, Professor Wilson convinced his co-authors that the dual-track approach used in the textbook would be a better pedagogical approach to teaching the two bases of accounting than teaching the conversion method that is presented as part of Chapter 9 of the textbook. We believe he was correct in advocating the approach that has been taken in the textbook, and to our knowledge we are the only textbook offering this approach to teaching the two accounting and reporting bases for the government reporting model.

Professor Wilson is also responsible for the Smithville_Bingham software that is offered with the textbook. He originally contracted a programmer to work with him in developing the Smithville electronic practice set. Later his work was brought ‘in-house’ at McGraw-Hill and has been moved to a Web-based platform making it more accessible and easier for students and instructors to use. Since the initial development of Smithville, we have added Bingham, and with the 16th edition we introduced a shortened version of Smithville. We will continue to provide and add to this valuable teaching tool that was first developed by Professor Wilson.

Professor Wilson is also responsible for Chapter 17, “Accounting and Reporting for the Federal Government.” He believed that a government and not-for-profit textbook was incomplete if it did not include information on the federal government. As a result, he researched and wrote the chapter on accounting and reporting for the federal government. We continue to believe this is an important chapter in our textbook.

Professor Wilson’s contributions to the textbook were based on his wealth of experience as a researcher, teacher, and his participation in the government community. Among his many accomplishments are the following:

- Professor Emeritus of Accountancy at the University of Missouri—Columbia.
- Academic fellow with the Governmental Accounting Standards Board (GASB).
- Member of the Governmental Accounting Standards Advisory Council, the U.S. Comptroller General’s Advisory Council on Governmental Auditing Standards, the American Institute of CPAs Government Accounting and Auditing Committee.
- President of the American Accounting Association Government and Nonprofit (AAA-GNP) Section.
- Author/co-author of numerous research articles in journals such as *The Accounting Review*; *Journal of Accounting Research*; *Contemporary Accounting Research*; *Journal of Accounting and Public Policy*; *Journal of Accounting, Auditing, and Finance*; *Research in Governmental and Nonprofit Accounting*; and *Public Budgeting and Finance*.
- Recipient of the enduring Lifetime Contribution Award from the AAA-GNP section.
- Recipient of the Cornelius Tierney/Ernst & Young Research Award from the Association of Government Accountants.
- Outstanding Teacher of the Year from the Kansas City MU Business Alumni Association; Outstanding Educator of the Year and Outstanding CPA in Government from the Missouri State CPA.

- Chair or committee member for more than 30 doctoral dissertations, many in the area of governmental accounting.

On a more personal note, Professors Reck and Lowensohn thank Professor Wilson for his guidance and patience as he taught us the “textbook process.” Originally, Professor Wilson intended the 15th edition to be his last with the textbook, but we persuaded him to stay for the 16th edition. Since he has been an Emeritus professor for a number of years, persuasion did not work on the 17th edition. Professor Wilson has decided that he is ready to “fully” retire and spend more time with his golf game. We hope he enjoys his well-deserved retirement!

About the Authors

Jacqueline L. Reck

Serves as the associate dean of financial management and academic affairs for the College of Business and is the James E. and C. Ellis Rooks Distinguished Professor in Accounting at the University of South Florida. She received a BS degree from North Dakota State University, BS and MAcc degrees from the University of South Florida, and her PhD from the University of Missouri–Columbia. She is a certified public accountant (Florida).

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

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

Suzanne L. Lowensohn

Is an associate professor of Accounting at Colorado State University. She received a BS and a MAcc degree from the University of South Florida, and her PhD from the University of Miami. She is a certified public accountant (Florida) and a chartered global management accountant.

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

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

Preface

For more than 60 years, *Accounting for Governmental & Nonprofit Entities* has been the leader in the market. It is a comprehensive governmental and not-for-profit accounting text written for students who will be auditing and working in public and not-for-profit sector entities. Originally published in 1951 and written by Professor R. M. Mikesell, this book—and the many subsequent editions revised by Professors Leon Hay, Earl Wilson, Susan Kattelus, Jacqueline Reck, and Suzanne Lowensohn—have given generations of instructors and students a comprehensive knowledge of the specialized accounting and financial reporting practices of governmental and not-for-profit organizations, as well as an understanding of how those organizations can better meet the information needs of a diverse set of financial statement users and decision makers. The vision of these original authors continues to be reflected in this 17th edition, and their strategy of providing a large and innovative set of instructional support materials prepared and tested in the classroom by the authors continues to be a guiding principle today. The current author team brings to this edition their extensive experience teaching government and not-for-profit courses as well as insights gained from their professional experience, scholarly writing, and professional activities. The result is a relevant and accurate text that includes the most effective instructional tools.

ORGANIZATION AND CONTENT

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

KEY CHANGES IN THIS EDITION

With the 17th edition, we are pleased to integrate McGraw-Hill's Connect and LearnSmart educational technology systems. Connect is a digital teaching and learning platform for homework completion and review that helps improve student performance over a variety of critical outcomes while aiding instructor grading and assessment efficiency. LearnSmart is an adaptive study tool that helps identify specific topics and learning objectives individual students need to study.

As always, readers can count on this edition to include authoritative changes from the Governmental Accounting Standards Board, Financial Accounting Standards Board, Federal Accounting Standards Advisory Board, American Institute of Certified

Public Accountants, Office of Management and Budget, Internal Revenue Service, and Government Accountability Office. Update bulletins will be provided periodically on the text Web site as new authoritative statements are issued.

Since publication of the 16th edition, **important** changes affecting accounting, financial reporting, and auditing for governmental and not-for-profit organizations have occurred, which include:

- Governmental Accounting Standards Board concepts statements and standards (particularly Statements 67 and 68) have been issued, and these describe new financial reporting elements and alter certain financial statements.
- The Office of Management and Budget has issued streamlined guidance relative to accounting and auditing federal grant funds in the *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards*.
- The American Institute of Certified Public Accountants has issued clarified auditing standards.

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

Several notable improvements have been made in this edition of the text. Chapter 3 includes new material on government budgets. Chapter 4 has been reorganized, so that interfund activities are covered after general governmental transactions have been introduced. Chapter 8 now illustrates external financial statements for an investment trust pool. Chapter 10 introduces Electronic Municipal Market Access (EMMA). Chapters 11 and 12 incorporate changes under the new OMB super circular. Chapters 15 and 16 have been reformatted to better identify differences between the accounting for governmental and nongovernmental not-for-profit organizations. Finally, all end-of-chapter material is now sequentially numbered to facilitate problem assignment, and the instructor's manual identifies learning objectives and assessment areas associated with each end of chapter item.

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

INNOVATIVE PEDAGOGY

For state and local government accounting, the authors have found that *dual-track* accounting is an effective approach in showing the juxtaposition of government-wide and fund financial statements in GASB's integrated model of basic financial statements. It allows students to see that each transaction has an effect on the fund financial statements (that are designed to show fiscal compliance with the annual budget), on the government-wide financial statements (that demonstrate accountability for operational performance of the government as a whole), or both. This approach better serves students who will design and use accounting information systems, such as enterprise systems, to allow information to be captured once and used for several purposes. Accounting for federal agencies as well as nongovernmental, not-for-profit entities closely parallels this approach as traditional fund accounting may be appropriate for keeping track of resources with restricted purposes, but citizens and donors also need to see the larger picture provided by the entity as a whole. The dual-track approach is further described inside the front cover of this text.

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

TARGET AUDIENCE

The text continues to be best suited for senior and graduate accounting majors who plan to sit for the certified public accountant (CPA) exam and then audit governmental or not-for-profit entities. Public administration and other students who plan to provide financial management or consulting services to government and not-for-profit entities report that the text provides a more comprehensive set of competencies than traditional public budgeting texts. Students in not-for-profit management education programs find that the coverage of accounting, financial reporting, auditing, taxation, and information systems for both governmental and not-for-profit entities provides the exposure they need to work across disciplines and sectors. Finally, students preparing for the certified government financial manager (CGFM) exam will also find Chapters 1 through 11 useful for Examination 2. We encourage all students who use this book to consider the challenges and rewards of careers in public service—in federal, state, and local governments as well as not-for-profit organizations.

SUPPLEMENT PACKAGE

The following ancillary materials are prepared by the authors to ensure consistency and accuracy and are available on the textbook’s Web site, www.mhhe.com/reck17e.

- Instructor’s Guide and Solutions Manual.
- PowerPoint lecture presentations.
- Test Bank (including a computerized version using EZ Test software).
- McGraw-Hill’s Connect online homework system and LearnSmart adaptive study tool.
- The City of Bingham and City of Smithville Continuous Computerized Problems—general ledger practice sets, downloadable from the publisher’s Web site.
- The City of Bingham and City of Smithville Instructor’s Version software, providing guidance for instructors, solution data files, and solution page image (.pdf) files for all required financial statements, schedules, and reports.

Students can also access the PowerPoint lecture presentations for each chapter at the Online Learning Center on the text’s Web site, www.mhhe.com/reck17e.

Acknowledgments

We are thankful for the encouragement, suggestions, and counsel provided by many instructors, professionals, and students in writing this book. They include the following professionals and educators who read portions of this book and previous editions in various forms and provided valuable comments and suggestions:

Kimball Adams
City of Largo, Florida

Terry D. Balkaran
Queens College

Kelli A. Bennett
City and County of Denver

Irfan Bora
Rutgers University

Barbara Chaney
University of Montana

Michael Crawford
Crawford & Associates

Ruth W. Epps
Virginia Commonwealth University

Mary Foelster
American Institute of Certified Public Accountants

Michael Givens
City of Jacksonville, Florida

Debra Gula
University of South Florida

Kristen Hockman
University of Missouri—Columbia

Larita Killian
IUPUI—Columbus Center

Barbara Lippincott
Tampa, Florida

Allen McConnell
University of Northern Colorado

G. Michael Miller
City of Jacksonville, Florida

Dean Mead
Governmental Accounting Standards Board

Joel Provenza
City of Jacksonville, Florida

Walter A. Robbins
University of Alabama

Gail Sanderson
Lebanon Valley College

Ken Schermann
Governmental Accounting Standards Board

Mark Sutter
El Paso, Texas

Christopher Tenn
Colorado State University

Relmond P. Van Daniker
Association of Government Accountants

Shunda Ware
Atlanta Technical College

Tammy Waymire
Northern Illinois University

We acknowledge permission to quote pronouncements and reproduce illustrations from the publications of the Governmental Accounting Standards Board, American Institute of Certified Public Accountants, and International City/County Management Association. Dr. Reck thanks her family for their support and dedicates her work to the memory of Albert for the inspiration he continues to provide. Dr. Lowensohn would like to express appreciation to her loving family—Tom, Grant, and Tara—for their support and patience and to her friend and colleague, Dr. Laurence Johnson, for his professional guidance.

Although we are extremely careful in checking the text and end-of-chapter material, it is possible that errors and ambiguities remain in this edition. As readers

encounter such, we urge them to let us know, so that corrections can be made. We also invite every user of this edition who has suggestions or comments about the material in the chapters to share them with one of the authors, either by regular mail or e-mail. The authors will continue the service of issuing Update Bulletins to adopters of this text that describe changes after the book is in print. These bulletins can be downloaded from the text Web site at www.mhhe.com/reck17e.

*Dr. Jacqueline L. Reck
School of Accountancy
University of South Florida
4202 East Fowler Avenue, BSN 3403
Tampa, FL 33620
jreck@usf.edu*

*Dr. Suzanne Lowensohn
Colorado State University
College of Business
257 Rockwell Hall
Fort Collins, Colorado 80523-1271
Suzanne.Lowensohn@colostate.edu*

Brief Contents

Preface vi

- 1** Introduction to Accounting and Financial Reporting for Governmental and Not-for-Profit Entities 1

PART ONE

State and Local Governments 21

- 2** Principles of Accounting and Financial Reporting for State and Local Governments 23
- 3** Governmental Operating Statement Accounts; Budgetary Accounting 67
- 4** Accounting for Governmental Operating Activities—Illustrative Transactions and Financial Statements 111
- 5** Accounting for General Capital Assets and Capital Projects 167
- 6** Accounting for General Long-term Liabilities and Debt Service 205
- 7** Accounting for the Business-type Activities of State and Local Governments 253
- 8** Accounting for Fiduciary Activities—Agency and Trust Funds 303
- 9** Financial Reporting of State and Local Governments 351

PART TWO

Accountability for Public Funds 405

- 10** Analysis of Governmental Financial Performance 407
- 11** Auditing of Governmental and Not-for-Profit Organizations 441

- 12** Budgeting and Performance Measurement 479

PART THREE

Accounting and Financial Reporting for Not-for-Profit Organizations and the Federal Government 521

- 13** Accounting for Not-for-Profit Organizations 523
- 14** Not-for-Profit Organizations—Regulatory, Taxation, and Performance Issues 575
- 15** Accounting for Colleges and Universities 605
- 16** Accounting for Health Care Organizations 647
- 17** Accounting and Reporting for the Federal Government 685

GLOSSARY 731

GOVERNMENTAL AND NOT-FOR-PROFIT ORGANIZATIONS 760

INDEX 765

Table of Contents

Preface vi

Chapter 1

Introduction to Accounting and Financial Reporting for Governmental and Not-for-Profit Entities 1

Welcome to Governmental and Not-for-Profit Accounting 1
What Are Governmental and Not-for-Profit Organizations? 2
Distinguishing Characteristics of Governmental and Not-for-Profit Organizations 3
Sources of Financial Reporting Standards 4
Objectives of Financial Reporting 5
Overview of Financial Reporting for State and Local Governments, the Federal Government, and Not-for-Profit Organizations 7

Financial Reporting of State and Local Governments 7

Financial Reporting of the Federal Government 10

Financial Reporting of Not-for-Profit Organizations (NFPs) 11

Expanding the Scope of Accountability Reporting 12

Overview of Chapters 2 through 17 12

GASB Principles, Standards, and Financial Reporting 12

Accountability for Public Funds 13

Not-for-Profit Organizations and the Federal Government 13

A Caveat 13

Key Terms 14

Questions 14

Cases 15

Exercises and Problems 16

PART ONE

State and Local Governments 21

Chapter 2

Principles of Accounting and Financial Reporting for State and Local Governments 23

Activities of Government 24

Financial Reporting Model 25

Elements and Measurement 25

Government-wide Financial Statements 27

Fund Financial Statements 29

Fund Reporting 31

Fund Categories 31

Classification of Fund Balances 35

Major Fund Reporting 36

Summary of Government-wide and Fund

Characteristics 38

Appendix A: Illustrative Financial Statements for City and County of Denver, Colorado 40

Appendix B: Summary Statement of Governmental Accounting and Financial Reporting Principles 54

Key Terms 58

Selected References 59

Questions 59

Cases 59

Exercises and Problems 62

Chapter 3

Governmental Operating Statement Accounts; Budgetary Accounting 67

Classification and Reporting of Expenses and Revenues at the Government-wide Level 68

Reporting Direct and Indirect Expenses 68

Program Revenues and General Revenues 70

Reporting Special Items and Transfers 71

Structure and Characteristics of the General Fund and Other Governmental Funds 72

Governmental Fund Balance Sheet and Operating Statement Accounts 72

Reporting Budgeted and Actual Results 75

Terminology and Classification for Budgetary and Operating Statement Accounts 78

Classification of Appropriations and Expenditures 78

Classification of Estimated Revenues and Revenues 81

Budgetary Accounting 86

Recording the Budget 86

Budgetary Control of Revenues 87
Budgetary Control of Encumbrances and Expenditures 88
Accounting for Allotments 91
 Concluding Remarks 92
 Appendix A: Accounting Information Systems 92
 Appendix B: Accounting for Public School Systems 94
 Key Terms 98
 Selected References 98
 Questions 98
 Cases 99
 Exercises and Problems 102

Chapter 4

Accounting for Governmental Operating Activities—Illustrative Transactions and Financial Statements 111

Illustrative Case 112
Measurement Focus and Basis of Accounting 112
 Dual-track Accounting Approach 114
 Illustrative Journal Entries 115
Recording the Budget 115
Encumbrances and Purchasing Transactions 115
Payment of Liabilities 117
Payrolls and Payroll Taxes 118
Accounting for Property Taxes 120
Other Revenues 124
Tax Anticipation Notes 125
Forecasting Amount of Tax Anticipation Borrowing 126
Repayment of Tax Anticipation Notes 126
 Special Topics 127
Correction of Errors 127
Receipt of Goods Ordered in Prior Year 128
Revision of the General Fund Budget 129
Exchange Transactions with Proprietary Funds 130
Supplies Purchased from an Internal Service Fund 130
Services Provided by an Enterprise Fund 132
Adjusting Entries 133
Pre-Closing Trial Balance 135
Closing Entries 136
Reclassification of Fund Balances 137
General Fund Financial Statements 138
 Special Revenue Funds 141
Accounting for Operating Grants 141

Financial Reporting 142
 Interfund Activity 142
Intra- versus Inter-Activity Transactions (Government-wide Level) 144
 Permanent Funds 145
Budgetary Accounts 145
Illustrative Case 145
 Appendix A: Concepts and Rules for Recognition of Revenues and Expenses (or Expenditures) 148
 Appendix B: Interim Financial Reporting 151
 Key Terms 152
 Selected References 153
 Questions 153
 Cases 154
 Exercises and Problems 156

Chapter 5

Accounting for General Capital Assets and Capital Projects 167

Accounting for General Capital Assets 168
Required Disclosures about Capital Assets 169
Classification of General Capital Assets 170
General Capital Assets Acquired under Capital Lease Agreements 174
Costs Incurred after Acquisition 176
Reduction of Cost or Asset Disposal 176
Asset Impairments and Insurance Recoveries 178
Service Concession Arrangements 178
 Capital Projects Funds 179
Illustrative Transactions—Capital Projects Funds 180
Illustrative Financial Statements for a Capital Projects Fund 185
Alternative Treatment of Residual Equity or Deficits 186
Bond Premium, Discount, and Accrued Interest on Bonds Sold 186
Retained Percentages 188
Claims and Judgments Payable 189
Bond Anticipation Notes Payable and the Problem of Interest Expenditures 189
Investments 191
Multiple-Period and Multiple-Project Funds 191
Capital Projects Financed by Special Assessments 192
Financial Reporting for Capital Projects Funds 193
 Key Terms 194

Selected References 194
Questions 194
Cases 195
Exercises and Problems 196

Chapter 6

Accounting for General Long-term Liabilities and Debt Service 205

General Long-term Liabilities 206
 Accounting for Long-term Liabilities 206
 Long-term Liability Disclosures 207
 Debt Limit and Debt Margin 207
 Overlapping Debt 211
Debt Service Funds 216
 Number of Debt Service Funds 216
 Use of General Fund to Account for Debt Service 217
 Budgeting for Debt Service 217
 Types of Serial Bonds 218
 Debt Service Accounting for Term Bonds 224
 Financial Reporting 228
 Accounting for Bond Premiums and Accrued Interest 229
 Valuation of Debt Service Fund Investments 231
 Deposit and Investment Disclosures 232
 Debt Service Accounting for Special Assessment Debt 233
 Use of Debt Service Funds to Record Capital Lease Payments 235
 Accounting for Debt Refunding 237
 Advance Refunding of Debt 237
Other Long-term Liabilities 238
 Compensated Absences 239
 Pollution Remediation Obligations 239
 Claims and Judgments 240
Key Terms 240
Selected References 240
Questions 240
Cases 241
Exercises and Problems 244

Chapter 7

Accounting for the Business-type Activities of State and Local Governments 253

Proprietary Funds 254
 Assets Acquired under Lease Agreements 254
 Financial Reporting Requirements 255
Internal Service Funds 257

Illustrative Case—Supplies Fund 258
Illustrative Statements Using Supplies Fund 263
External Financial Reporting of Internal Service Funds 265
Dissolution of an Internal Service Fund 266
Special Topics Associated with Internal Service Funds 266

Enterprise Funds 269
Water Utility Funds 270
 Current and Accrued Assets 271
 Restricted Assets 272
 Utility Plant 272
 Current Liabilities 273
 Liabilities Payable from Restricted Assets 273
 Long-term Liabilities 273
 Net Position 274
 Illustrative Case—Water Utility Fund 274
 Illustrative Statements Using Water Utility Fund 280
 External Financial Reporting of Enterprise Funds 282

Appendix: Special Topics in Accounting for the Business-type Activities of State and Local Governments 284
Key Terms 288
Selected References 288
Questions 288
Cases 288
Exercises and Problems 292

Chapter 8

Accounting for Fiduciary Activities—Agency and Trust Funds 303

Agency Funds 304
 Agency Fund for Special Assessment Debt Service 304
 Tax Agency Funds 305
 “Pass-through” Agency Funds 311
 Financial Reporting of Agency Funds 312
Trust Funds 312
Investment Pools 312
 Creation of an Investment Pool 313
 Operation of a Cash and Investment Pool 316
 Withdrawal of Assets from the Pool 320
 Closing Entry 321
 Illustrative Financial Statements 322
Private-purpose Trust Funds 322
Pension Trust Funds 323

<i>General Characteristics of Governmental Pension Plans</i>	324
<i>Required Financial Reporting for Defined Benefit Pension Plans</i>	326
<i>Illustrative Transactions for a Defined Benefit Pension Plan</i>	331
<i>Employer's Pension Accounting</i>	334
<i>Employer Recording and Reporting of Pension Expenditure/Expense</i>	336
Other Postemployment Benefits (OPEB)	336
Termination Benefits	337
Appendix: Managing Investments	337
Key Terms	338
Selected References	338
Questions	339
Cases	339
Exercises and Problems	340
Chapter 9	
Financial Reporting of State and Local Governments	351
Providing Useful Financial Reports	351
The Governmental Reporting Entity	352
<i>Defining the Financial Reporting Entity</i>	353
<i>Component Units</i>	354
<i>Reporting by Other Government Organizations</i>	357
Governmental Financial Reports	357
<i>Need for Periodic Reports</i>	358
<i>Interim Financial Reports</i>	358
<i>Annual Financial Reports</i>	359
Preparation of Basic Financial Statements	361
<i>Fund Financial Statements</i>	368
<i>Required Reconciliations</i>	369
<i>Intra-entity Transactions</i>	372
Other Financial Reporting Issues and Topics	372
<i>Popular Reporting</i>	373
<i>Other Comprehensive Basis of Accounting (OCBOA)</i>	374
<i>International Accounting Standards</i>	374
Appendix A: Converting Accounting Information from the Modified Accrual to the Accrual Basis of Accounting	375
Appendix B: Management's Discussion and Analysis (MD&A)—City and County of Denver	379
Key Terms	390
Selected References	391
Questions	391

Cases	391
Exercises and Problems	397

PART TWO

Accountability for Public Funds 405

Chapter 10

Analysis of Governmental Financial Performance 407

The Need to Evaluate Financial Performance	407
Government Financial Performance Concepts	408
<i>Financial Position and Financial Condition</i>	409
<i>Economic Condition</i>	410
Internal Financial Trend Monitoring	410
<i>Environmental Factors</i>	412
<i>Organizational Factors</i>	415
<i>Financial Factors</i>	415
Analyzing Government-wide Financial Statements	418
<i>Financial Position Ratios</i>	418
<i>Financial Performance Ratios</i>	418
<i>Financial Capability Ratios</i>	418
Use of Benchmarks to Aid Interpretation	420
<i>Sources of Governmental Financial Data</i>	422
<i>Electronic Municipal Market Access</i>	423
<i>Credit Analyst Models</i>	424
Key Terms	425
Selected References	425
Questions	426
Cases	426
Exercises and Problems	431

Chapter 11

Auditing of Governmental and Not-for-Profit Organizations 441

Financial Audits by Independent CPAs	442
<i>Generally Accepted Auditing Standards</i>	442
<i>Format of the Audit Report</i>	443
<i>Types of Opinions</i>	445
<i>The Audit Process</i>	446
<i>Materiality for Government Audits</i>	449
<i>Required Supplementary and Other Information</i>	449
Government Auditing Standards	450
<i>Types of Audits and Engagements</i>	450
<i>GAGAS Financial Audits</i>	452
<i>Ethics and Independence</i>	454

Single Audits 457
 History of the Single Audit 457
 Amendments to Single Audit Requirements 457
 Determining Who Must Have a Single Audit 458
 Single Audit Requirements 460
 Selecting Programs for Audit 462
 Reports Required for the Single Audit 464
 Other Single Audit Requirements 466
Special Topics Related to Audits of Governments
and Not-for-Profits 467
 Single Audit Quality 467
 The Impact of SOX 468
 Auditing Guidance 469
Key Terms 469
Selected References 469
Questions 470
Cases 470
Exercises and Problems 474

Chapter 12 Budgeting and Performance Measurement 479

Objectives of Budgeting in the Public
Sector 480
 Compliance with Laws 480
 Communicate Performance Effectiveness 481
Budgeting Approaches 483
 Line-item Budgeting 483
 Performance Budgeting 484
 Program Budgeting 484
 Entrepreneurial Budgeting 485
Budgeting Process in a State or Local
Government 485
 Budgeting Governmental Appropriations 485
 Budgeting Governmental Revenues 488
 Budgeting Capital Expenditures 489
 Budgeting Cash Receipts 490
 Budgeting Cash Disbursements 490
Integration of Planning, Budgeting, and
Performance Measurement 493
 Service Efforts and Accomplishments (SEA) 494
Managerial Tools to Improve Performance 498
 Total Quality Management 498
 Customer Relationship Management 498
 Activity-based Costing 498
 Balanced Scorecards 500
Conclusion 501

Appendix: Budget and Cost Issues in Grant
Accounting 502
Key Terms 506
Selected References 507
Questions 507
Cases 508
Exercises and Problems 509

PART THREE Accounting and Financial Reporting for Not- for-Profit Organizations and the Federal Government 521

Chapter 13 Accounting for Not-for-Profit Organizations 523

Defining the Not-for-Profit Sector 524
 *Determining Whether an NFP Organization Is
 Governmental* 525
GAAP for Nongovernmental NFP
Organizations 526
Financial Reporting 526
 Statement of Financial Position 527
 Statement of Activities 529
 Statement of Cash Flows 530
 Statement of Functional Expenses 530
 Notes to the Financial Statements 533
Accounting for NFP Organizations 533
 Revenues and Gains 533
 Accounting for Expenses 539
 Accounting for Assets 541
Consolidations and Combinations 543
 Consolidations 543
 Combinations 544
Illustrative Transactions—Voluntary Health and
Welfare Organizations 544
 End-of-the-Year Adjusting Journal Entries 549
 *End-of-the-Year Reclassification Journal
 Entries* 550
 End-of-the-Year Closing Journal Entries 551
Appendix: Optional Fund Accounting 557
Key Terms 558
Selected References 558
Questions 559
Cases 559
Exercises and Problems 563

Chapter 14**Not-for-Profit Organizations—Regulatory, Taxation, and Performance Issues 575**

State Regulation	576
<i>Not-for-Profit Incorporation Laws</i>	577
<i>Licenses to Solicit Contributions or for Other Purposes</i>	577
<i>Taxes</i>	577
<i>Lobbying and Political Activity</i>	578
Federal Regulation	579
<i>Tax-exempt Status</i>	580
<i>Annual Compliance Reporting</i>	583
<i>Unrelated Business Income Tax</i>	584
<i>Excessive Benefits Received by Officers</i>	586
<i>Reorganization and Dissolution</i>	586
Governance	586
<i>Incorporating Documents</i>	587
<i>Board Membership</i>	587
Benchmarking and Performance Measures	588
<i>Financial Performance Measures</i>	588
<i>Nonfinancial Performance Measures</i>	591
Summary	592
Key Terms	592
Selected References	592
Questions	593
Cases	593
Exercises and Problems	595

Chapter 15**Accounting for Colleges and Universities 605**

Accounting and Financial Reporting Standards	606
<i>Private Colleges and Universities</i>	607
<i>Public Colleges and Universities</i>	607
Reporting and Accounting Issues	611
<i>Statement of Net Position or Financial Position</i>	611
<i>Operating Statements</i>	614
<i>Statement of Cash Flows</i>	617
<i>Segment Reporting</i>	618
Illustrative Transactions for Private Colleges and Universities	618
<i>Adjusting Entries</i>	623
<i>Closing Entries</i>	624
Planned Giving	625
<i>Endowments</i>	625
<i>Split-interest Agreements</i>	626

Uniform Prudent Management of Institutional Funds Act 629

Other Accounting Issues	630
<i>Performance Measures</i>	630
<i>Auditing Colleges and Universities</i>	631
<i>Federal Financial Assistance</i>	631
<i>Related Entities</i>	632
Key Terms	632
Selected References	632
Questions	632
Cases	633
Exercises and Problems	637

Chapter 16**Accounting for Health Care Organizations 647**

GAAP for Health Care Providers	649
Reporting and Accounting Issues	649
<i>Balance Sheet or Statement of Net Position</i>	651
<i>Operating Statement</i>	653
<i>Statement of Changes in Net Assets</i>	658
<i>Statement of Cash Flows</i>	658
Illustrative Case for a Not-for-Profit Health Care Organization	661
Other Health Care Issues	669
<i>Related Entities</i>	669
<i>Auditing</i>	669
<i>Taxation and Regulatory Issues</i>	669
<i>Patient Protection and Affordability Act</i>	670
<i>Prepaid Health Care Plans</i>	671
<i>Continuing Care Retirement Communities</i>	671
<i>Financial and Operational Analysis</i>	671
Conclusion	672
Key Terms	673
Selected References	673
Questions	673
Cases	674
Exercises and Problems	676

Chapter 17**Accounting and Reporting for the Federal Government 685**

Federal Government Financial Management Structure	686
<i>Comptroller General</i>	688
<i>Secretary of the Treasury</i>	688
<i>Director of the Office of Management and Budget</i>	689
<i>Director of the Congressional Budget Office</i>	689

Generally Accepted Accounting Principles for the Federal Government 689

Hierarchy of Accounting Principles and Standards 690

Conceptual Framework 691

Objectives 691

Reporting Entity 692

Management's Discussion and Analysis (MD&A) 692

Intended Audience 693

Elements and Recognition Criteria 693

Communicating Information 693

Measurement of Elements after Initial Recording 693

Funds Used in Federal Accounting 693

General Fund 694

Special Funds 694

Revolving Funds 694

Trust Funds 694

Deposit Funds 695

Required Financial Reporting—U.S. Government-wide 695

Required Financial Reporting—Government Agencies 697

Agency Head Message 698

Management's Discussion and Analysis 698

Annual Performance Reports (APR) 698

Annual Financial Statements (AFR) 698

Other Accompanying Information 708

Dual-track Accounting System 708

Illustrative Transactions and Entries 710

Adjusting Entries 716

Illustrative Financial Statements 717

Summary of Accounting and Reporting for Federal Government Agencies 721

Key Terms 722

Selected References 722

Questions 722

Cases 723

Exercises and Problems 724

Glossary 731

Governmental and Not-for-Profit Organizations 760

Index 765

City of Bingham and City of Smithville Continuous Computerized Problems

Note: To download the City of Bingham or City of Smithville computerized problem, visit the Student Edition of the Web site for this textbook: www.mhhe.com/reck17e.

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

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

STUDENTS

Several examples are provided here to show how the software facilitates learning. When a government sends out property tax bills for the year, this transaction is recorded in the General Fund general journal because it impacts the governmental funds statement of revenues, expenditures, and changes in fund balance and in the governmental activities general journal because it has an impact on the government-wide statement of activities. Within each practice set, you

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

INSTRUCTORS

This software can be used in several ways. You can project it each day as part of the classroom experience and discuss transactions that are keyed to the chapter under discussion. Depending on your objectives, you can require a small set of the transactions be recorded for each fund or governmental activity or you can assign either of the full problems as a semester-long case. Regardless of how you choose to use the cases, we recommend that students work on the City of Bingham or City of Smithville problem as they are studying the related chapter in the text and turn in each chapter as they go along. You may find that small student work groups provide an efficient way for students to learn from each other.

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

The Dual-Track Accounting Approach

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


Beginning with the 12th edition of this text in 2001, the authors committed themselves to the importance of providing government-wide and fund accounting information by introducing a *dual-track* approach to recording governmental transactions. The dual-track approach captures both government-wide and fund accounting information at the same time an event is recognized, thereby allowing for the direct production of both government-wide and fund financial statements. As students will learn, some transactions affect the government-wide statements only (e.g., depreciation expense) and others affect the fund financial statements only (e.g., budgetary entries). However, the majority affect both types of statements, although in different ways (e.g., expensing versus capitalizing long-lived assets). The fund financial statements reflect a short-term measurement focus that is intended to assist statement users in assessing *fiscal accountability*—how financial resources were raised and spent. The government-wide financial statements reflect a medium- to long-term measurement focus intended to assist users in assessing *operational accountability*—whether governmental services were efficiently and effectively provided. Both perspectives are important.

The dual-track approach helps students understand how two different sets of accounting records are used to collect financial data as transactions occur. One set of records collects information using the short-term measurement focus and near-cash basis of accounting traditionally used in governmental fund accounting. This set of records includes a chart of accounts, general journal, general ledger, trial balances, and financial statements for each fund. The other set of records collects the same underlying information using a long-term measurement focus similar to that used by business; that is, the accrual basis of accounting. The second set of records assists in preparing statements for governmental activities and business-type activities. Each time we illustrate or explain what, if any, effect a transaction will have on the fund and governmental activities record.

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

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

Chapter One



Introduction to Accounting and Financial Reporting for Governmental and Not-for-Profit Entities

Learning Objectives

After studying this chapter, you should be able to:

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

WELCOME TO GOVERNMENTAL AND NOT-FOR-PROFIT ACCOUNTING

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

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

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

WHAT ARE GOVERNMENTAL AND NOT-FOR-PROFIT ORGANIZATIONS?

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

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

Not-for-profit organizations also exist in many forms and serve many different functions in society. These include private colleges and universities, various kinds of community service and health care organizations, certain libraries and museums, professional and trade associations, fraternal and social organizations, and religious organizations. Currently, there are nearly 2.3 million not-for-profit organizations in the U.S.²

¹ U.S. Department of Commerce, Bureau of the Census, *2012 Census of Governments*, Table 2, <http://www.census.gov/govs/cog2012/>.

² The National Center for Charitable Statistics reports that there were 1.6 million registered not-for-profit organizations in the U.S. as of 2010 (Amy S. Blackwood, Katie L. Roeger, and Sarah L. Pettijohn, *The Nonprofit Sector in Brief: Public Charities, Giving and Volunteering, 2012*, Washington, D.C.: Urban Institute Press, p. 1). Also reported by the National Center for Charitable Statistics were 325,421 religious congregations as of November 2013. (Urban Institute, National Center for Charitable Statistics Web site, <http://nccs.urban.org/statistics/quickfacts.cfm>).

DISTINGUISHING CHARACTERISTICS OF GOVERNMENTAL AND NOT-FOR-PROFIT ORGANIZATIONS

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

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

- a. Receipts of significant amounts of resources from resource providers who do not expect to receive either repayment or economic benefits proportionate to the resources provided.
- b. Operating purposes that are other than to provide goods or services at a profit or profit equivalent.
- c. Absence of defined ownership interests that can be sold, transferred, or redeemed or that convey entitlement to a share of a residual distribution of resources in the event of liquidation of the organization.³

The **Governmental Accounting Standards Board (GASB)** distinguishes government entities in the United States from both not-for-profit and business entities by stressing that governments exist in an environment in which the power ultimately rests in the hands of the people. Voters delegate that power to public officials through the election process. The power is divided among the executive, legislative, and judicial branches of the government, so that the actions, financial and otherwise, of government executives are constrained by legislative actions, and executive and legislative actions are subject to judicial review. Further constraints are imposed on state and local governments by the federal government. In the United States higher levels of government encourage or dictate activities of lower level governments. Higher levels of government finance the activities (partially, at least) by an extensive system of intergovernmental grants and subsidies that require the lower levels to be accountable to the entity providing the resources, as well as to the citizenry. Revenues raised by each level of government come, ultimately, from taxpayers. Taxpayers are required to provide resources to governments even though they often have little choice about which government services they receive and the extent to which they receive them.⁴

This relative lack of taxpayer choice is also identified in a GASB white paper that notes that “most governments do not operate in a competitive marketplace, face

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

⁴ Based on discussion in GASB *Concepts Statement No. 1*, pars. 14–18. Governmental Accounting Standards Board, *Codification of Governmental Accounting and Financial Reporting Standards as of June 30, 2010* (Norwalk, CT, 2010), Appendix B.

virtually no threat of liquidation, and do not have equity owners.”⁵ The white paper further states:

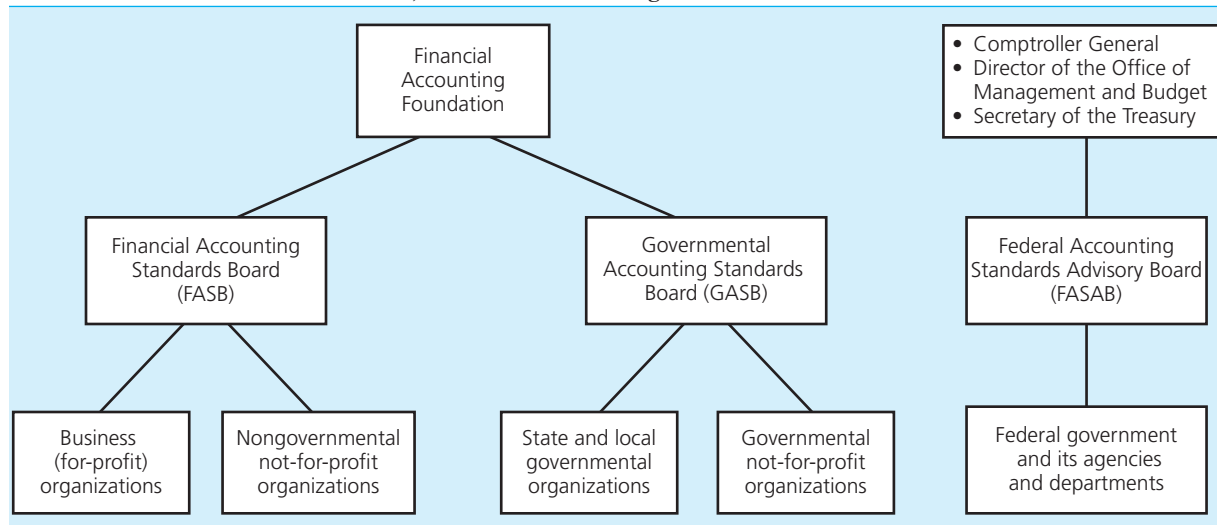
Governmental accounting and financial reporting standards aim to address [the] need for public accountability information by helping stakeholders assess how public resources were acquired and either used during the period or are expected to be used. Such reporting also helps users to assess whether current resources were sufficient to meet current service costs (or whether some costs were shifted to future taxpayers) and whether the government’s ability to provide services improved or declined from the previous year.⁶

SOURCES OF FINANCIAL REPORTING STANDARDS

As shown in Illustration 1–1, Rule 203 of the American Institute of Certified Public Accountants (AICPA) Code of Professional Conduct formally designates the FASB, GASB, and FASAB as the authoritative bodies to establish **generally accepted accounting principles (GAAP)** for state and local governments, the federal government, and business organizations and nongovernmental not-for-profit organizations, respectively. In practice, the “authority to establish accounting principles” means the “authority to establish accounting and financial reporting standards.” In addition, for publicly held business organizations, FASB standards are officially recognized as authoritative by the Securities and Exchange Commission (SEC) (Financial Reporting Release No. 1, Section 101, and reaffirmed in its April 2003 Policy Statement).

Authority to establish accounting and reporting standards for not-for-profit organizations is split between the FASB and the GASB because a sizable number of not-for-profit organizations are governmental in nature, particularly public colleges

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



⁵ Governmental Accounting Standards Board, *White Paper “Why Governmental Accounting and Financial Reporting Is—and Should Be—Different”* (Norwalk, CT, 2013, revised), Executive Summary, p. ii.

⁶ Ibid.

and universities and government hospitals. The FASB is responsible for setting accounting and reporting standards for not-for-profit organizations that are independent of governments. Governmental not-for-profit organizations follow standards established by the GASB.

The GASB and the FASB are parallel bodies under the oversight of the Financial Accounting Foundation. The foundation appoints the members of the two boards and supports the boards' operations. The federal Sarbanes-Oxley Act greatly enhanced financial support for the FASB by mandating an assessed fee on corporate security offerings. The Dodd-Frank Wall Street Reform and Consumer Protection Act (2010) required the establishment of an accounting support fee to fund the GASB. In February 2012 the Financial Industry Regulatory Authority (FINRA) established such a fee.⁷

Because of the method of support and the lack of ties to any single organization or government, the GASB and the FASB are referred to as “independent standards-setting boards in the private sector.” Before the creation of the GASB and the FASB, financial reporting standards were set by groups sponsored by professional organizations: The forerunners of the GASB (formed in 1984) were the National Council on Governmental Accounting (1973–84), the National Committee on Governmental Accounting (1948–73), and the National Committee on Municipal Accounting (1934–41). The forerunners of the FASB (formed in 1973) were the Accounting Principles Board (1959–73) and the Committee on Accounting Procedure (1938–59) of the American Institute of Certified Public Accountants.

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

OBJECTIVES OF FINANCIAL REPORTING

GASB *Concepts Statement No. 1*, “Objectives of Financial Reporting,” states that “**Accountability** is the cornerstone of all financial reporting in government. . . . Accountability requires governments to answer to the citizenry—to justify the raising of public resources and the purposes for which they are used.”⁸ The board elaborated:

Governmental accountability is based on the belief that the citizenry has a “right to know,” a right to receive openly declared facts that may lead to public debate by the citizens and their elected representatives. Financial reporting plays a major role in fulfilling government’s duty to be publicly accountable in a democratic society.⁹

Illustration 1–2 shows several ways that state and local government financial reporting is used in making economic, social, and political decisions and assessing accountability. Closely related to the concept of accountability as the cornerstone of

⁷ Financial Industry Regulatory Authority, Regulatory Notice 13–17, “GASB Accounting Support Fee,” April 2013.

⁸ GASB, *Codification*, Appendix B, *Concepts Statement No. 1*, par. 56.

⁹ *Ibid.*

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

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

^aSource: GASB Concepts Statement No. 1, par. 32.

^bSource: FASAB Statement of Federal Accounting Concepts No. 1, par. 134.

^cSource: FASB Concepts Statement No. 4, pp. 13–15.

governmental financial reporting is the concept the GASB refers to as **interperiod equity**. This concept and its importance are explained as follows:

The Board believes that interperiod equity is a significant part of accountability and is fundamental to public administration. It therefore needs to be considered when establishing financial reporting objectives. In short, *financial reporting should help users assess whether current-year revenues are sufficient to pay for services provided that year and whether future taxpayers will be required to assume burdens for services previously provided.* (Emphasis added.)¹⁰

Accountability is also the foundation for the financial reporting objectives the FASAB has established for the federal government. The FASAB's *Statement of Accounting and Reporting Concepts Statement No. 1* identifies four objectives of federal financial reporting (see Illustration 1–2) focused on evaluating budgetary integrity, operating performance, stewardship, and adequacy of systems and controls.

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

Financial reports of not-for-profit organizations—voluntary health and welfare organizations, private colleges and universities, private health care institutions, religious organizations, and others—have similar uses. However, as Illustration 1–2 shows, the reporting objectives for not-for-profit organizations emphasize decision usefulness over financial accountability needs. The FASB *Statement of Financial Accounting Concepts No. 4* indicates that not-for-profit and business enterprises are similar in many ways and thus the emphasis on decision usefulness in reporting objectives.

¹⁰Ibid., par. 61.

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

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

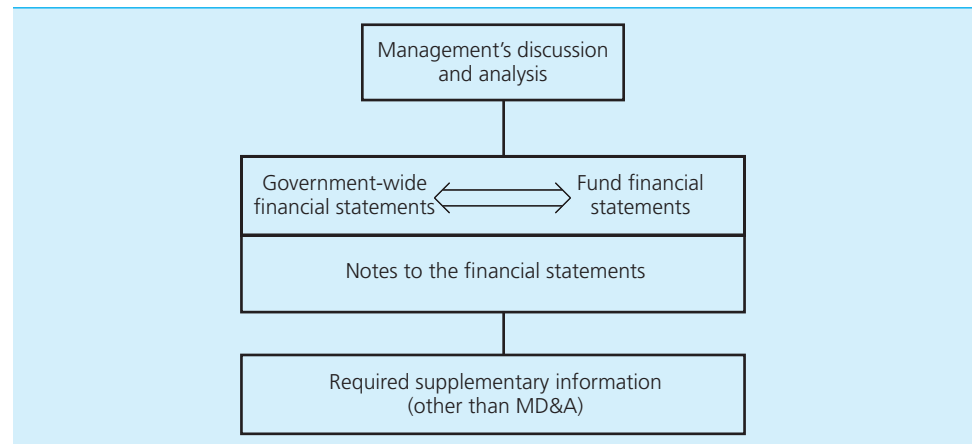
Financial Reporting of State and Local Governments

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

General Purpose External Financial Reporting

Illustration 1–3 displays the minimum requirements for general purpose external financial reporting under the governmental financial reporting model specified by

ILLUSTRATION 1–3 Minimum Requirements for General Purpose External Financial Reporting



Source: GASB Codification, Sec. 2200.103.

the GASB.¹¹ Central to the model is the **management's discussion and analysis (MD&A)**. The MD&A is **required supplementary information (RSI)** designed to communicate in narrative, easily readable form the purpose of the basic financial statements and the government's current financial position and results of financial activities compared with those of the prior year.

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

Fund financial statements, the other category of basic financial statements, provide more detailed financial information about the government. Certain funds, referred to as *governmental funds*, focus on the short-term flow of current financial resources rather than on the flow of economic resources.¹² The focus on current financial resources makes it easier for users assessing **fiscal accountability**, which relates to ensuring the government is complying with rules and regulations related to the use of financial resources. Because of the short-term focus, governmental funds use a modified accrual basis of accounting rather than the accrual basis. Under **modified accrual**, revenues are recognized in the period they are measurable and available for spending and expenditures (not expenses) are recognized when they create an obligation to be paid from current financial resources. The characteristics and roles of the government-wide and fund financial statements are summarized in Illustration 1–4.

ILLUSTRATION 1–4 Dual Roles of Governmental Financial Statements in Assessing Accountability

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

¹¹ GASB *Codification*, Sec. 2200.102.

¹² The definition of *fund* is given in Chapter 2. For now, you can view a fund as a separate set of accounts used to account for resources segregated for particular purposes.

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

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

Comprehensive Annual Financial Report

Serious users of government financial information need more detail than is found in the MD&A, basic financial statements, and RSI (other than MD&A). For state and local governments, much of that detail is found in the government’s **comprehensive annual financial report (CAFR)**. Although governments are not required to prepare a CAFR, most do so as a matter of public record and to provide additional financial details beyond the minimum requirements shown in Illustration 1–3. As such, the GASB provides standards for the content of a CAFR in its annually updated publication *Codification of Governmental Accounting and Financial Reporting Standards*. A CAFR prepared in conformity with these standards should contain the following sections.¹³

Introductory Section¹⁴ The introductory section typically includes items such as a title page and contents page, a letter of transmittal, a description of the government, and other items deemed appropriate by management. The letter of transmittal may be literally that—a letter from the chief financial officer addressed to the chief executive and governing body of the government—or it may be a narrative over the signature of the chief executive. In either event, the letter or narrative material should cite legal and policy requirements for the report.

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

Laws regarding the audit of governments vary from state to state. Some states have laws requiring that all state agencies and all local governments be audited by an audit agency of the state government. In other states, local governments are audited by independent public accounting firms. In still other states, some local governments are audited by the state audit agency and some by independent public accounting firms.

¹³ GASB, *Codification*, Sec. 2200.104–193.

¹⁴ For a view of the introductory section, as well as the other sections of the CAFR, you may wish to look at the City and County of Denver, Colorado’s CAFR at <http://www.denvergov.org/Default.aspx?alias=www.denvergov.org/finance>. Portions of Denver’s CAFR for 2013 are included for illustrative purposes in various places in this text.