



THIRTEENTH EDITION

# Essentials of Accounting

*for Governmental and  
Not-for-Profit Organizations*

Paul A. Copley



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# Essentials of Accounting for Governmental and Not-for-Profit Organizations

Thirteenth Edition

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ESSENTIALS OF ACCOUNTING FOR GOVERNMENTAL AND NOT-FOR-PROFIT ORGANIZATIONS,  
THIRTEENTH EDITION

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# Preface

Thank you for considering the thirteenth edition of *Essentials of Accounting for Governmental and Not-for-Profit Organizations*. The focus of the text is on the preparation of external financial statements. The coverage is effective in preparing candidates for the CPA examination. I have used the text with traditional three-semester-hour classes, with half-semester GNP courses, and as a module in advanced accounting classes. It is appropriate for accounting majors or as part of a public administration program.

The most notable change from earlier editions is in the presentation of college and university accounting. Both private sector and public sector colleges are now presented in a single chapter, Chapter 11. Readers are taken through a representative set of transactions for two similar-sized colleges. By examining both public and private institutions at the same time, it is easier to gain an appreciation for the similarities and differences in these two groups.

Among other changes, the thirteenth edition is updated for recent professional pronouncements including:

- *GASB Statement No. 72: Fair Value Measurement and Application*
- *GASB Statement Nos. 74 and 75: Financial Reporting for Postemployment Benefit Plans Other Than Pensions and Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*
- *GASB Statement No. 76: Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*
- *GASB Statement No. 81: Irrevocable Split-Interest Agreements.*

Additionally, a discussion is provided in Chapter 10 of *FASB Accounting Standards Update (2016-14) - Presentation of Financial Statements of Not-for-Profit Entities*. This newly issued standard becomes effective in 2018.

The text contains a discussion of the *GASB Codification of Financial Reporting Standards*. References are made throughout the text to specific segments of the Codification. With the implementation of *GASB 54* (Fund Balance Reporting), the last vestige of budgetary accounting is phased out of government financial statements. The thirteenth edition continues to provide budget and encumbrance journal entries, but presents these as distinct accounts that are not commingled with the accounts appearing in the basic financial statements. This approach should reduce confusion sometimes experienced by students, particularly with the recording of encumbrances.

Among the more challenging aspects of state and local government reporting is the preparation of government-wide financial statements. The approach demonstrated in the text is similar to that used in practice. Specifically, day-to-day events are recorded at the fund level using the basis of accounting for fund financial statements. Governmental activities are recorded using the modified accrual basis. The fund-basis statements are then used as input in the preparation of government-wide statements. The preparation of government-wide statements is presented in an Excel worksheet. This approach has two advantages: (1) it is the approach most commonly applied in practice, and (2) it is

an approach familiar to students who have studied the process of consolidation in their advanced accounting classes. State and local government reporting is illustrated using an ongoing example integrated throughout Chapters 4 through 8 and 13.



Additional features of the text are available in Connect and the ebook, including:

- An auto-gradable test bank and chapter-specific quizzes;
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*Paul A. Copley*

In memory of Ann Koch Copley and Joe Ernsberger.



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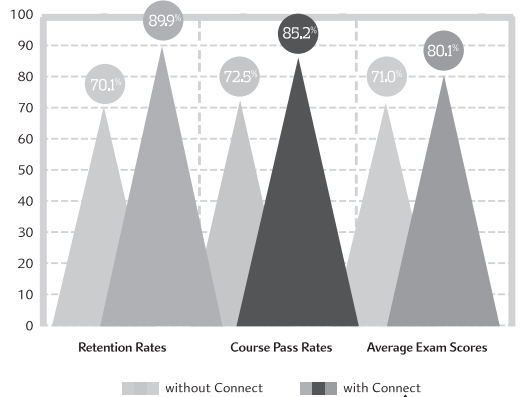
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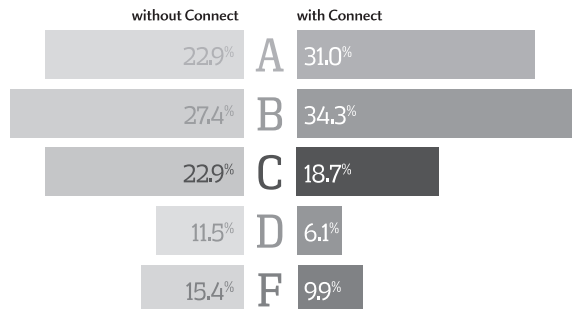
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**Index I**



# Chapter One

## Introduction to Accounting and Financial Reporting for Governmental and Not-for-Profit Organizations

*The truth is that all men having power ought to be mistrusted.*

*If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary.* James Madison, fourth president of the United States and principal author of the U.S. Constitution

### Learning Objectives

- Obtain an overview of financial reporting for nonbusiness entities.
- Distinguish between private and public sector organizations.
- Identify the sources of authoritative accounting standards for various public and private sector organizations.
- Define the 11 fund types used by state and local governments.

In its relatively short existence, the United States has grown to be the largest and most successful economy in history. Why then would a country founded on the principles of free markets and private investment rely on governments to provide many goods and services? The answer lies in understanding the incentives of a free enterprise economy. There are many services that simply cannot be priced in a way that naturally encourages commercial entrepreneurs to enter the marketplace. Commonly this is because the service is subject to free-riding. For example, public

safety and a clean environment benefit all citizens, whether or not they contribute to its cost. In other instances, free market incentives do not align with public interest. For example, society finds it desirable to provide a K–12 education to all its citizens, not just those with the ability to pay. Because there is no practical means for businesses to sell these services, governments are called upon through the political process to provide those services that citizens demand.<sup>1</sup>

Although the majority of products and services are provided by either businesses or governments, in some circumstances private organizations are formed to provide goods or services without the intent of earning a profit from these activities. Examples include public charities, trade associations, and civic groups. Again, the goods or services they provide often cannot be priced in a way that encourages commercial entrepreneurship. For example, a public radio broadcast cannot be effectively restricted to only those individuals choosing to support the public radio station. While this explains why the services are not provided by businesses, why aren't governments called upon to provide them?

In some instances, obstacles exist that prevent government involvement. For example, the U.S. Constitution provides for separation of church and state. Therefore, any group that wishes to promote religious activities must do so through private organizations rather than through government. More commonly the reason is lack of political influence. Support for the arts may be important to a group of individuals but unless that group is sufficiently large to influence the political process, it is unlikely that elected officials will use government funds for that purpose. However, support for the arts could still be provided by forming a charitable foundation with no relationship to the government and having the foundation solicit donations from that segment of the public that finds the arts important.

The organizations introduced in the preceding paragraphs are the focus of this book: governmental and not-for-profit organizations. They are distinguished from commercial businesses by the absence of an identifiable individual or group of individuals who hold a legally enforceable residual claim to the net resources. Throughout the text a distinction will be made between **public** and **private** organizations. Public organizations are owned or controlled by governments. Private organizations are not owned or controlled by governments and include businesses as well as private not-for-profit organizations. **Not-for-profit organizations** lack a residual ownership claim and the organization's purpose is something other than to provide goods and services at a profit.

Because significant resources are provided to governments and not-for-profit organizations, financial reporting by these organizations is important. To paraphrase the James Madison quotation provided at the beginning of the chapter, because humans (not angels) operate governments, controls are necessary. Financial reports that reflect the policies and actions of governmental managers are an effective means to control the actions of those entrusted with public resources. To be effective, external financial reports must be guided by a set of generally accepted accounting principles. The generally accepted accounting principles for governmental and private

<sup>1</sup> The branch of economics that studies the demand for government services is termed *public choice*.



not-for-profit organizations are the subject of this book. The first nine chapters of the text deal with public sector (state and local government) organizations and Chapters 10, 11, and 12 deal primarily with private not-for-profit organizations. Chapter 13 discusses auditing and tax-related issues unique to governments and private not-for-profits and also evaluates performance of these entities. Chapter 14 describes financial reporting by the federal government.

## GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

Biologists tell us that organisms evolve in response to characteristics of their environment. Similarly, accounting principles evolve over time as people find certain practices useful for decision making. Further, we expect organisms in different environments to evolve differently. Similarly, if the environments in which governments and not-for-profits operate differ in important ways from that of commercial enterprises, we would expect the accounting practices to evolve differently. It is important to understand how governments and not-for-profit organizations differ from commercial businesses if we are to understand why the accounting practices of these nonbusiness organizations have evolved in the manner we will see throughout the remainder of this text.

The Governmental Accounting Standards Board published a document titled *Why Governmental Accounting and Financial Reporting Is—and Should Be—Different* ([http://www.gasb.org/white\\_paper\\_full.pdf](http://www.gasb.org/white_paper_full.pdf)). This white paper identifies five environmental differences between governments and for-profit business enterprises and describes how those differences manifest in differences in the objectives and practice of financial reporting.

**1. Organizational Purposes.** While the purpose of a commercial business is to generate a profit for the benefit of its owners, governments exist for the well-being of citizens by providing public services—whether or not the services are profitable undertakings. The result is that government accounting practices are not focused on the measurement of net income for the purpose of measuring return to investors. Rather they are intended to satisfy the information needs of a variety of users.

While the purpose of government operations differs greatly from commercial businesses, the purpose of governmental accounting is the same—to provide information that is useful to stakeholders in making decisions. However, governments have vastly different sets of users of accounting information. Like businesses, governments have creditors who are interested in assessing the creditworthiness of the government. Citizens and businesses, both within the government's jurisdiction and those considering relocation to the jurisdiction, are also stakeholders who rely on governmental reporting to make economic decisions. In addition, governments receive resources from other governments and grantors who may require financial reports and audits as a condition of the grant. Since this diverse set of resource providers have varying interests, the information needs of one group may not meet the needs of another. The result is that governments report far more disaggregated information than commercial enterprises.

2. **Sources of Revenues.** Net income is a universally accepted measure of business performance. The calculation of net income begins with sales. A sale occurs when an independent party perceives that the service offered both provides value and is fairly priced. Net income then simply determines whether this measure of demand (sales) exceeds the cost of providing the service and is an accepted measure of performance for business organizations. On the other hand, governments derive many of their resources from taxes. Individuals and businesses pay taxes to avoid penalty, not voluntarily because they perceive government services to be of value and fairly priced. Since taxes do not involve an earnings process, the timing of the recognition of tax revenue is not always clear.

3. **Potential for Longevity.** Because the U.S. and state constitutions grant state and local governments the ability to tax, governments very rarely go out of business. This long-term view of operations changes the focus of accounting from one of near-term recovery of amounts invested in assets to a longer-term focus on the sustainability of services and the ability to meet future demand. As a result, governments may elect not to depreciate some capital assets but expense improvements that extend an asset's useful life.

4. **Relationship with Stakeholders.** Taxes are levied through the legislative process by officials elected by the citizens. Because citizens and businesses are then required to pay these taxes, governments have an obligation to demonstrate accountability for these public funds. Whereas a business can use its resources as it deems appropriate, governments frequently receive resources that are restricted to a particular purpose. For example, a city may collect a telephone excise tax legally restricted to operating a 911 emergency service. In an effort to provide assurance that resources are used according to legal or donor restrictions, governments use **fund accounting**. A fund represents part of the activities of an organization that is separated from other activities in the accounting records to more easily demonstrate compliance with legal restrictions or limitations.

5. **Role of the Budget.** Many businesses prepare budgets, but these are for planning and control purposes and are rarely made available to creditors or investors. In contrast, government budgets are expressions of public policy and often carry the authority of law, preventing public officials from spending outside their budgetary authority. The increased importance of budgets is reflected in government financial reports by a required report comparing budgeted and actual amounts.

For these and other reasons, the accounting practices of governmental organizations evolved differently from those of businesses. As you will see in later chapters, the accounting practices of not-for-profit organizations more closely resemble those of commercial businesses. However, the not-for-profit environment shares some important characteristics with governments. Similar to governments, not-for-profits do not have residual owners. "Investors" in not-for-profits are diverse and include donors, volunteers, and members. In addition, as with governments, the excess of revenues over expenses is not an effective measure of organizational performance. Finally, like governments, not-for-profits receive resources with donor-imposed restrictions.

## Sources of Generally Accepted Accounting Principles

Further complicating accounting issues is the fact that we have three levels of government (federal, state, and local) and not-for-profits may be either publicly or privately owned. This is important because different standards-setting bodies have authority for establishing reporting standards for these groups. Illustration 1-1 summarizes the various organizational types and the bodies with primary standard-setting authority.

Accounting and financial reporting standards for the federal government are published by the **Federal Accounting Standards Advisory Board (FASAB)**. The standards are technically “recommendations” since, as a sovereign nation, the federal government cannot relegate authority to an independent board. Recommendations of the FASAB are reviewed and become effective unless objected to by one of the **principals**, the U.S. Government Accountability Office (GAO), the U.S. Department of the Treasury, or the U.S. Office of Management and Budget. These standards apply to financial reports issued by federal agencies and to the Consolidated Financial Report of the United States Government. Accounting and financial reporting standards for the federal government are illustrated in Chapter 14.

Accounting and financial reporting standards for state and local governments in the United States are set by the **Governmental Accounting Standards Board (GASB)**. The GASB also sets accounting and financial reporting standards for governmentally related not-for-profit organizations, such as colleges and universities, health care entities, museums, libraries, and performing arts organizations that are owned or controlled by governments. Accounting and financial reporting standards for profit-seeking businesses and for nongovernmental not-for-profit organizations are set by the **Financial Accounting Standards Board (FASB)**.

The GASB and the FASB are parallel bodies under the oversight of the **Financial Accounting Foundation (FAF)**. The FAF appoints the members of the two boards and provides financial support to the boards by obtaining contributions from business corporations; professional organizations of accountants and financial analysts; CPA firms; debt-rating agencies; and state and local governments. Because of the breadth 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 bodies.” Standards set by the FASAB, GASB, and FASB are the primary sources of **generally accepted accounting principles (GAAP)** as the term is used in accounting and auditing literature.

### ILLUSTRATION 1-1 Summary of Standards-Setting Organizations

Reporting Organization	Standards-Setting Board
Federal government	Federal Accounting Standards Advisory Board (FASAB)
State and local governments	Governmental Accounting Standards Board (GASB)
Public not-for-profits	Governmental Accounting Standards Board (GASB)
Private not-for-profits	Financial Accounting Standards Board (FASB)
Investor-owned businesses	Financial Accounting Standards Board (FASB)

GASB standards are set forth in documents called **Statements** of Financial Accounting Standards. Although no longer used, in the past the GASB also issued **Interpretations** that provided guidance on previously issued statements. From time to time, the Board finds it necessary to expand on standards in **Technical Bulletins** and **Implementation Guides**. The sources of authoritative GAAP for state and local governments therefore are:

- Category A: GASB Statements (and Interpretations)
- Category B: GASB Implementation Guides, GASB Technical Bulletins, and literature of the American Institute of Certified Public Accountants (AICPA) specifically cleared by the GASB

If the accounting treatment for a given transaction is not specified by a statement in Category A, a state and local government should consider whether it is covered by one of the sources identified in Category B. If the accounting treatment is not specified within one of these authoritative sources, the government should consider whether the transaction is sufficiently similar to ones covered by one of the authoritative sources that a similar accounting treatment can be applied. If not, the government may use non-authoritative sources for guidance, including:

- GASB Concept Statements,
- FASB, FASAB, or International Standards Board pronouncements,
- AICPA literature not specifically cleared by the GASB,
- Other sources provided by professional organizations, regulatory agencies, textbooks, and published articles, or
- Prevalent practices that evolved among governments without specific authoritative action.

Both the FASB and FASAB have similar hierarchies of GAAP for entities falling within their jurisdictions. The GASB, FASB, and FASAB publish **codifications** (organized versions) of accounting standards. The GASB also publishes a comprehensive collection of its implementation guides. The advantage of using the codified versions of standards is that all relevant standards for a particular topic are presented together and any superseded segments of standards have been removed. Codification references are presented in two parts: the first (section) identifies a topic and the second identifies a paragraph within the codification. Letters typically give a clue as to the topic (e.g., L for leases and Ho for hospitals). Paragraph numbers may be used to determine the level of authority within the GAAP Hierarchy. These are summarized as follows:

<b>Section #s</b>	<b>Topics</b>
1000–1900	General Principles
2000–2900	Broad Financial Reporting Requirements
Letters (A–Z)	Specific Balance Sheet or Operating Accounts
Double letters	Specialized Industries or Reporting Units

Paragraph #s	Level of Authority
100–499	GASB Standards
500–599	Definitions
600–699	GASB Technical Bulletins and AICPA Audit and Accounting Guides and Statements of Position
700–799	AICPA Practice Bulletins
900–999	Non-authoritative discussions

**For example:**

Codification Reference	Section	Paragraph
1000.101	Section 1000 indicates this pertains to general principles (in this case GAAP Hierarchy).	Paragraphs 101–104 present the GAAP Hierarchy and since the paragraph number is <500, it comes from a GASB Statement (in this case Statement No. 76).
1700.601	Section 1700 indicates this pertains to reporting of budgetary information.	Paragraph 601 states what to disclose if a government is not legally required to adopt a budget. Since the paragraph number is 600–699, this is Level B GAAP.
F60.101	The single letter (F) identifies a specific account (in this case Food stamps).	The paragraph number (<500) indicates this standard comes from a GASB Statement.
Co5.902	The double letters (Co) identify a specialized industry (Colleges and universities).	The paragraph number (>900) indicates these are non-authoritative examples of financial statements for a state university.

**Definition of Government**

Some organizations possess certain characteristics of both governmental and non-governmental not-for-profit organizations. Since there are different standard-setting boards, it is important to identify which board's standards apply to a given entity. For this reason, the FASB and GASB agreed upon a definition of governmental organizations:

Public corporations and bodies corporate and politic are governmental organizations. Other organizations are governmental organizations if they have one or more of the following characteristics:

- a. 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;
- b. The potential for unilateral dissolution by a government with the net resources reverting to a government; or
- c. The power to enact and enforce a tax levy.

Furthermore, organizations are presumed to be governmental if they have the ability to issue directly (rather than through a state or municipal authority) debt that pays interest exempt from federal taxation.

## OBJECTIVES OF ACCOUNTING AND FINANCIAL REPORTING

All three standards-setting organizations—the Federal Accounting Standards Advisory Board, the Financial Accounting Standards Board, and the Governmental Accounting Standards Board—take the position that the establishment of accounting and financial reporting standards should be guided by conceptual considerations so that the body of standards is internally consistent and the standards address broad issues. The cornerstone of a conceptual framework is said to be a statement of the objectives of financial reporting.

### Objectives of Accounting and Financial Reporting for State and Local Governmental Units

GASB has issued six concept statements. *Concepts Statement No. 1* identifies three primary user groups of government accounting information: creditors, citizens, and oversight bodies (including granting agencies and the legislature). The information needs of government creditors are not greatly different from their counterparts in the corporate world, namely to evaluate the likelihood the government will continue to make its debt payments as they come due. Citizens and oversight bodies have a very different purpose, which is to determine whether elected officials have raised and expended the public's money in a manner consistent with law and the public's best interest. Satisfying this citizen "right to know" objective is not easily accomplished and commonly requires government financial reports to provide much greater detail than can be found in corporate annual reports.

One difficulty governments have in meeting the information needs of citizens is that traditional financial statements, which measure events in dollars, are not well designed to evaluate the government's effectiveness in delivering services. For example, consider a public school system. A traditional financial report will show the sources of revenues and amounts expended, but does little to tell the reader whether the schools are doing a good job. In many cases nonfinancial measures are better indicators of performance. These might include the number of students advancing to the next grade, graduation rates, and scores on college entrance exams. *Concepts Statements No. 2* and *No. 5* relate to the reporting of nonfinancial measures, called **service efforts and accomplishments** reporting. Service efforts and accomplishments reporting will be more fully described in Chapter 13.

*Concepts Statement No. 3* defines methods of presenting information in financial reports and develops the following disclosure hierarchy:

1. When items (assets, liabilities, revenues, etc.) can be measured with sufficient reliability, they should be reported in the **basic financial statements**.
2. The **notes to the financial statements** are intended to enhance the understanding of items appearing in the financial statements but are not a substitute for recognition when a transaction or event can be measured with sufficient reliability.
3. Occasionally the GASB determines that additional information is necessary to provide context and understanding of information in the statements or notes.