

## CHAPTER 1: INTRODUCTION TO ACCOUNTING AND FINANCIAL REPORTING FOR GOVERNMENTAL AND NOT-FOR-PROFIT ENTITIES

### OUTLINE

| <u>Number</u>              | <u>Topic</u>                                                                 | <u>Type/Task</u>        | <u>Status<br/>(re: 14/e)</u>                |
|----------------------------|------------------------------------------------------------------------------|-------------------------|---------------------------------------------|
| <b>Questions:</b>          |                                                                              |                         |                                             |
| 1-1                        | Distinguishing between general purpose and special purpose governments       | Justify/Explain         | 1-3 revised                                 |
| 1-2                        | Distinguishing GNP accounting and reporting standards from business entities | Contrast                | New                                         |
| 1-3                        | Standards-setting bodies                                                     | Contrast                | 1-4 revised                                 |
| 1-4                        | Determining whether a not-for-profit organization is governmental            | Identify/Explain        | New                                         |
| 1-5                        | Conceptual basis for reporting                                               | Evaluate/Explain        | Revised                                     |
| 1-6                        | Types of accountability                                                      | Contrast                | Revised                                     |
| 1-7                        | Measurement focus and basis of accounting                                    | Explain                 | New                                         |
| 1-8                        | Distinguishing bases of accounting                                           | Explain                 | New                                         |
| 1-9                        | Comprehensive annual financial report                                        | Describe                | 1-7                                         |
| 1-10                       | Service efforts and accomplishments                                          | Explain                 | New                                         |
| <b>Cases:</b>              |                                                                              |                         |                                             |
| 1-1                        | Internet Case—FASB                                                           | Internet/Written report | New                                         |
| 1-2                        | Internet Case—GASB                                                           | Internet/Written report | New                                         |
| 1-3                        | Internet Case—FASAB                                                          | Internet/Written report | Revised                                     |
| 1-4                        | Research Case—Government or NFP entity?                                      | Written report          | Revised                                     |
| <b>Exercises/Problems:</b> |                                                                              |                         |                                             |
| 1-1                        | Examine the CAFR                                                             | Examine                 | Revised                                     |
| 1-2                        | Various                                                                      | Multiple Choice         | Items 1 is new; several other items revised |
| 1-3                        | Reporting characteristics of government-wide and fund financial statements   | Matching                | Same                                        |

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### Answers to Questions

- 1-1. General purpose governments differ from special purpose governments primarily in terms of the scope of their legal powers and the range of services provided. General purpose governments typically have much more power over citizens and provide a much greater range of services than do special purpose governments. Examples of general purpose governments include states, counties, townships, cities, and villages. Special purpose governments typically include such special districts as those for police and fire protection, sanitation, and water, and organizations such as school districts and public colleges and universities.
- 1-2. Disagree. As discussed in this chapter, government and not-for-profit organizations serve different functions in society than do business organizations. Not surprising, then, the objectives of financial reporting for these organizations, as shown in Illustration 1-2, are quite different from the objectives of business reporting. The most striking difference is the need for government and not-for-profit organizations to report on accountability, in addition to financial performance. The different functions served and different reporting objectives lead to different accounting and reporting practices.
- 1-3. Illustration 1-1 depicts the standard-setting jurisdiction of the FASB, GASB and FASAB. As shown, the FASB has responsibility for setting accounting and financial reporting standards for business enterprises and *nongovernmental* not-for-profit organizations. The GASB has responsibility for setting standards for state and local governments and *governmental* not-for-profit organizations. The FASAB has responsibility for setting accounting and reporting standards for federal agencies and departments.
- 1-4. One should apply the criteria discussed in the section headed *Determining Whether a Not-for-Profit Organization is Governmental*. Essentially if an organization is a public corporation or body corporate and politic or has certain government-like characteristics described in this section, then it should be treated as a governmental organization and GASB standards should be followed. Otherwise, one would follow FASB standards.
- 1-5. Interperiod equity, whether current period revenues were sufficient to pay for current period services, is an important component of accountability. But, as noted in Chapter 1, accountability is the cornerstone of governmental financial reporting and is a broader concept than interperiod equity. See, for example, the discussion of fiscal and operational accountability in the answer to Question 1-6.
- 1-6. Disagree. The statement is incomplete. While it is true that GASB standards assist in assessing operational accountability of business-type activities, those standards assist in assessing *both* fiscal accountability and operational accountability of governmental activities. Specifically, governmental fund reporting standards promote fiscal

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accountability reporting by helping elected officials demonstrate that they have complied with spending restrictions related to the legally approved budget. Government-wide reporting standards for governmental activities help officials report on *operational accountability*—whether the government’s resources were utilized efficiently and effectively in meeting operating objectives.

- 1-7. Financial information related to governmental activities is reported in two different ways to meet two different reporting objectives. The government-wide financial statements are intended to report on the government’s operational accountability and therefore governmental activities are reported in those statements using accrual accounting with an economic resources measurement focus—similar to commercial accounting. In the governmental fund financial statements, the reporting objective is fiscal accountability, leading to the use of modified accrual and a focus on the flow of current financial resources. As a result, the same underlying transactions result in different amounts being reported in the government-wide and governmental fund financial statements. These differences must be reconciled so that readers can understand how the statements relate to each other.
- 1-8. Modified accrual accounting is used for preparing governmental fund financial statements since those statements focus on the flow of current (i.e., expendable) financial resources and whether resources were raised and expended in conformity with budget and other fiscal constraints. Revenues that will not be collected in time to pay current period obligations cannot be used to meet the current year budget. Similarly, obligations that will not be paid from currently available financial resources do not affect current period fiscal performance. Thus, under modified accrual only revenues that will be collected in time to pay for current obligations and only expenditures that will be paid in the current period or shortly thereafter are recognized in the current period. By contrast, the government-wide financial statements, as well as proprietary and fiduciary fund financial statements, focus on the flow of economic resources, both current and noncurrent. Consequently, the use of the accrual basis of accounting, similar to that used by business entities, is appropriate for these statements.
- 1-9. A CAFR should have an introductory section, financial section, and statistical section, the contents of which are discussed in this chapter. The basic financial statements required under *GASBS 34* are the government-wide financial statements and fund financial statements with accompanying notes. The basic financial statements, along with the Management Discussion & Analysis, and other required supplementary information (RSI), comprise only part of the financial section of a typical CAFR. The contents of each section are described briefly in the section headed *Comprehensive Annual Financial Report*.

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- 1-10. The GASB recognizes that while financial information is helpful in assessing operational accountability, additional information about an organization's service efforts and accomplishments is essential for a complete understanding of whether a government's resources have been utilized efficiently and effectively. Information about service efforts includes indicators of nonmonetary resource inputs as well as monetary. Information about service accomplishments includes indicators of output measures (i.e., units of work accomplished) and outcome measures (i.e., impact of work on achieving goals and objectives). To date the GASB has conducted significant research on SEA measures and continues to encourage governments to experiment with SEA reporting.

Solutions to Cases

- 1-1. A search of the FASB's Web site, [www.fasb.org](http://www.fasb.org), should reveal the following Statements of Financial Accounting Standards that are focused on not-for-profit organizations:

**Statement No. 136**

***Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others***

(Issue Date 6/99)

**Statement No. 124**

***Accounting for Certain Investments Held by Not-for-Profit Organizations***

(Issue Date 11/95)

**Statement No. 117**

***Financial Statements of Not-for-Profit Organizations***

(Issue Date 6/93)

**Statement No. 116**

***Accounting for Contributions Received and Contributions Made***

(Issue Date 6/93)

**Statement No. 99**

***Deferral of the Effective Date of Recognition of Depreciation by Not-for-Profit Organizations—an amendment of FASB Statement No. 93***

(Issue Date 9/88)

**Statement No. 93**

***Recognition of Depreciation by Not-for-Profit Organizations***

(Issue Date 8/87)

In addition, the FASB has issued one Statement of Financial Accounting Concepts related to not-for-profit organizations:

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**Concepts Statement No. 4**

***Objectives of Financial Reporting by Nonbusiness Organizations***

(Issue Date 12/80)

Brief summaries of each statement are also provided at the Web site.

There is also a Proposed FASB Staff Position, FAS 117-a, *Endowments of Not-for-Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of the Uniform Prudent management of Institutions Fund Act, and Enhanced Disclosures*. In addition, the FASB is re-deliberating two proposed statements relating to not-for-profit organizations involved in mergers and acquisitions.

Many FASB standards applicable to for-profit entities may also apply to nongovernmental not-for-profit organizations. Full-text copies of all FASB pronouncements can be downloaded free of charge from the FASB's Web site.

- 1-2. Instructors may wish to provide specific instructions for the students' brief reports. The GASB's Web site provides extensive information about the Board's mission, structure, and the due-process it follows in setting standards. Significant information about the GASB's strategic plan is also provided at the Web site.

Obviously, the content of GASB's technical agenda and members of its advisory council will change over time. Although exposure drafts of proposed statements and abbreviated summaries of new pronouncements can be downloaded from the GASB's Web site at no charge, the full-text of statements and other pronouncements can only be obtained by purchasing them from the GASB's publication department. In addition, the GASB sells two annually updated compendiums of its official pronouncements—*Original Pronouncements and Codification of Governmental Accounting and Financial Reporting Standards*—and an annually updated *Comprehensive Implementation Guide*. All of these documents are available in hardcopy or as a searchable computer data base called GARS, the Governmental Accounting Research System. GASB's Web site provides full information on how to order all publications and their cost, as well as information about becoming an annual subscriber to GASB pronouncements and due-process documents.

- 1-3. Instructors may wish to provide specific instructions for their students' brief reports. FASAB's Web site may change over time, but the Web site does provide extensive information about the FASAB's mission, structure, and due-process. A good source of information is the Memorandum of Understanding between the Comptroller General, Director of OMB, and the Secretary of the Treasury that created the FASAB, which currently is a 10-member board. Because FASAB's technical projects and members of the Accounting and Auditing Policy Committee will change over time, students should describe the projects and committee representation that currently exist.

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All statements and other pronouncements of the FASAB, including compendiums of all original pronouncements and a Current Text that codifies all pronouncements in topical format are available for downloading from its Web site at no charge. All due-process documents are available at that site as well.

- 1-4. **Issue:** Is the Native-American Heritage Center and Museum a governmental not-for-profit entity or nongovernmental not-for-profit entity? This is an essential determination because if the museum is governmental the auditor will need to examine whether the museum's financial statements are in conformity with GASB standards. If it is nongovernmental, its financial statements must conform to FASB standards.

**Analysis:** There is no evidence to suggest that the Heritage Center and Museum is a government per se, that is, a "public corporation or body corporate and politic." Thus, it is necessary to apply the three criteria listed in the text to determine whether the organization is governmental in character. A controlling majority of its governing board is appointed or approved by the Mound City Council, thus, criterion *a* is clearly met. Criterion *b* is likely met as well, considering that the City could probably dissolve the center and museum if they wished to do so according to the original charter. It doesn't appear that the organization has the power to enact or enforce a tax levy (criterion *c*). Only one of the three criteria needs to be met for the museum to be considered governmental in character. Criterion *a* is clearly met and *b* is likely met, so careful application of the AICPA criteria to the fact situation in this case should lead one to reach the conclusion that the organization is governmental in character and therefore should conform to GASB financial reporting standards if it expects to receive an unqualified (clean) audit opinion. [Note to instructors: In order to avoid confusing students this early in the course, we have intentionally not discussed specific GASB and FASB standards applicable to not-for-profit organizations. Unusually inquisitive students can be referred to Chapter 14 for further information.]

Solutions to Exercises and Problems

- 1-1. As students may have different CAFRs, there is no single solution to this exercise. It works well to devote class time to asking students some of the questions listed in the exercise, and perhaps tabulating the numbers of reports containing statements that are audited (1) by CPAs, (2) by state auditors, and (3) by employees of the reporting government. If such a tabulation is made, students may be interested in knowing in which states the local governmental units are located that are audited by each of the classes of auditors (or whatever other characteristic is being tabulated). Requiring that students download or obtain a hardcopy CAFR is a good exercise in obtaining financial information. Allow students to share their experiences, as some organizations make it easier to get CAFRs than others. Remind students that governments are not required to prepare a full CAFR, so some governments may simply refer to their report as the "audited annual financial statement," or even the "audit report." Budgets are often quite detailed and can be most useful for Chapter 13, so instructors may wish to have their student's download or request a hardcopy budget document in addition to the CAFR.

## Ch. 1, Solutions (Cont'd)

- 1-2.
1. *a*.
2. *d*.
3. *c*.
4. *d*.
5. *b*.
6. *b*.
7. *a*.
8. *c*.
9. *d*.
10. *a*.

- 1-3. This is an exercise that may generate considerable discussion in class, as some of the answers depend on individual judgments and interpretations. Keeping this in mind, you may wish to provide some leeway in grading this exercise, depending on how literally you interpret the terms “funds” and “activities.” See Notes a and b for suggested guidelines.

| <b>Financial Statements</b>                                                          | <b>Activities or Funds Reported</b> | <b>Basis Of Accounting</b> | <b>Measurement Focus</b> |
|--------------------------------------------------------------------------------------|-------------------------------------|----------------------------|--------------------------|
| Statement of net assets—government –wide                                             | GA, BTA<br>(see Note a)             | A                          | ER                       |
| Statement of activities—government-wide                                              | GA, BTA<br>(see Note a)             | A                          | ER                       |
| Balance sheet—governmental funds                                                     | GF<br>(see Note b)                  | MA                         | CFR                      |
| Statement of revenues, expenditures, and changes in fund balances—governmental funds | GF<br>(see Note b)                  | MA                         | CFR                      |
| Statement of net assets—proprietary funds                                            | PF<br>(see Note b)                  | A                          | ER                       |
| Statement of revenues, expenses, and changes in fund net assets—proprietary funds    | PF<br>(see Note b)                  | A                          | ER                       |
| Statement of cash flows—proprietary funds                                            | PF<br>(see Note b)                  | A                          | ER                       |
| Statement of fiduciary net assets                                                    | FF                                  | A                          | ER                       |
| Statement of changes in fiduciary net assets                                         | FF                                  | A                          | ER                       |

Notes: a. Some students may wish to put governmental funds (GF) and proprietary funds (PF) here, but technically that would be incorrect as the information reported in funds is not the same as that reported at the government-wide level. Nevertheless, you could give full or partial credit for these answers and use the opportunity to point out the differences.

- b. Some students may understandably view financial information for governmental activities as being reported in both the governmental funds and the governmental activities column of the government-wide statements. If so, they will put GA in the cells for the two governmental funds statements, in addition to GF. Although not all governmental activities financial information is reported in the fund financial

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statements, enough of it is to justify giving credit for this answer as well, as long as the student understands that the long-term components of GA do not belong in these cells. Similarly, you may wish to grant credit to students who put BTA in the three cells for proprietary fund statements, although internal service fund information in these statements is usually considered part of GA rather than BTA.