PacificCPE

COURSE
21154A

Revenue Recognition in Governmental Funds

Revenue recognition in government follows rules that look very different from commercial accounting, and getting them right matters. This course walks through how governmental funds recognize revenues under GASB standards, from taxes and intergovernmental grants to other sources. Real-world examples—including how COVID-19 affected government revenue streams unevenly—bring the standards to life. Ideal for CPAs and finance professionals who need a working knowledge of governmental revenue accounting and the GASB guidance that shapes it.

CREDIT HOURS 2 | FIELD OF STUDY ACCOUNTING | EXAM QUESTIONS 10

Start Course ↓ | Final Exam Copy ↓

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recall various revenue recognition criteria.

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TABLE OF CONTENTS

CHAPTER 01

Recognizing Revenues In Governmental Funds 4

1.01 Why And How Do Governments Use The Modified Accrual Basis? 4

1.02 How Should Property Taxes And Other Imposed Nonexchange Revenues Be Accounted For? 10

1.03 What Are Tax Abatements And Why And How Must They Be Disclosed?. 29

1.04 How Should Grants And Similar Government-Mandated And Voluntary Nonexchange Revenues Be Accounted For? 31

1.05 How Should Licenses, Permits, And Other Exchange Transactions Be Accounted For? 41

1.06 Summary 44

Test Your Knowledge..... 49

Final Exam Copy 57

Glossary 55

Index .....

Chapter 1: RECOGNIZING REVENUES IN GOVERNMENTAL FUNDS

Chapter Objective

After completing this chapter, you should be able to:

- Recall various revenue recognition criteria.

We now turn to what are among the most intriguing questions of government and not-for-profit accounting: when should revenues and expenditures or expenses be recognized, and how should the related assets, liabilities, and deferred inflows and outflows of resources be measured?

In Chapter 1 of course 21151F, Chapter 1 of course 21151F of course 21155F, we consider revenue and expenditure/expense recognition in governments. Most of the examples in this and the next chapter will implicitly be directed toward governments' general funds. However, the discussion is equally applicable to all governmental funds, including special revenues funds, capital projects funds, debt service funds, and permanent funds. In Chapter 1 of course 21159F, we examine the same issues as they apply to proprietary funds (those that account for activities operated like businesses).

WHY AND HOW DO GOVERNMENTS USE THE MODIFIED ACCRUAL BASIS?

Rationale for the Modified Accrual Basis

The foundation for our discussion of revenue and expenditure recognition was laid out in Chapter 1 of course 21151F. In that chapter, we pointed to two key objectives of financial reporting:

- Indicating the extent to which the entity achieved interperiod equity (i.e., whether current-year revenues were sufficient to pay for current-year services)
- Demonstrating whether the entity obtained and used its resources in accordance with its legally adopted budget

As suggested in Chapter 1 of course 21151F, no one set of financial statements prepared on a single basis of revenue and expenditure recognition can adequately fulfill both objectives. Therefore, standards setters must choose among three courses of action:

- Adopt principles that fulfill one of the objectives, but not the other
- Adopt principles that compromise between the two objectives, fulfilling both to some extent, but neither one adequately

- Developing a reporting model that incorporates more than one basis of revenue and expenditure recognition in separate groups of financial statements within the same report

Generally accepted accounting principles as incorporated in the current Governmental Accounting Standards Board (GASB) model reflect the *fourth* approach. The government-wide statements consolidate all funds on a full accrual basis (except for fiduciary funds, which are not consolidated because the beneficiaries of their resources are parties other than the government). They thereby demonstrate whether the entity's current-year revenues were sufficient to pay for the current year's services. The fund statements, by contrast, present governmental funds on a modified accrual basis (and, for reasons to be explained in Chapter 1 of course 21159F, present proprietary funds statements on a full-accrual basis).

The modified accrual basis is far more budget-oriented than the full accrual basis in that the budgets of most governments focus on either cash or cash plus selected short-term financial resources. However, the budgetary principles of any individual government are determined by applicable state or local laws. Except for governments that elect or are required to budget on a modified accrual basis as defined by GAAP, the revenue and expenditure principles that underlie their fund statements would not necessarily be identical to those of their legally adopted budgets. Hence, as discussed in Chapter 1 of course 21153F, schedules that show the variances between budgetary estimates and actual results may have to include a reconciliation of the different accounting principles.

In developing its current model, the GASB opted to retain the modified accrual basis of the previous model—rather than a budgetary basis—for governmental funds statements. This approach ensures that all governments report on the same basis and thereby facilitates comparisons among entities. Comparisons would have been difficult if each entity reported on its own particular budgetary basis.

Relationship Between Measurement Focus and Basis of Accounting

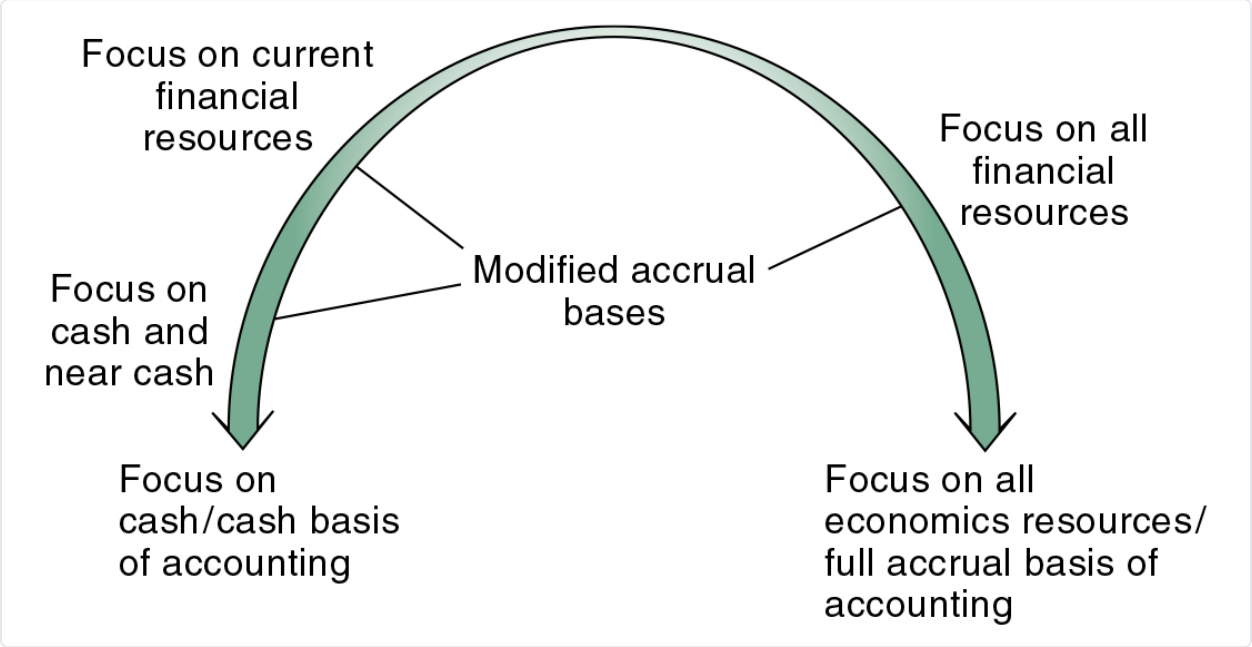
The criteria by which an entity determines when to recognize revenues and expenditures necessarily stem from its measurement focus and its basis of accounting. As pointed out in Chapter 1 of course 21152F, measurement focus refers to what is being reported on—that is, to which assets, liabilities, and deferrals are being measured. *Basis of accounting* refers to when transactions and other events are recognized. The two concepts obviously are closely linked. If an entity opts to focus on cash, then it will necessarily adopt a *cash basis of accounting*. Correspondingly, if it elects to focus on all economic resources (both current and long-term assets and liabilities), then it will adopt a *full accrual basis of accounting*.

Measurement focus and basis of accounting can be viewed as a continuum. As depicted in Figure 4-1 (next page), on one end of the continuum is a cash focus, and correspondingly, the cash basis of accounting. On the other end is a focus on all economic resources, and thus the *full accrual basis.*

Between the two ends of the continuum are any number of "modified accrual" (or "modified cash") bases of accounting in which the focus is on resources in addition to cash but not on the full array of economic resources.

If a government's budget is on a cash or near-cash basis, as is common, then a basis of accounting near the cash end of the continuum best satisfies the reporting objective of demonstrating that resources were obtained in accordance with the legally adopted budget. A basis of accounting on the full accrual end of the continuum best fulfills the interperiod equity objective. Any basis between the extremes would compromise the two objectives, satisfying both objectives to some extent, but neither one completely.

FIGURE 4-1. MEASUREMENT FOCUS AND BASIS OF ACCOUNTING



Overview of the Modified Accrual Basis

Per today's generally accepted practices, governmental funds are accounted for on a modified accrual basis. The measurement focus is on *current financial resources*. "Current financial resources" has been interpreted to mean "expendable financial resources"—cash and other items that can be expected to be transformed into cash in the normal course of operations (less current liabilities). The "other items" include investments and receivables but not capital assets.

Inventories and prepaid items are also reported on the balance sheet, even though they do not fall within the conventional view of a financial resource. A frequently cited justification for this apparent inconsistency is that these assets will not ordinarily be transformed into cash (i.e.,

inventories will be consumed, not sold for cash), but they generally will result in short-term cash savings in that the entity will not have to expend additional cash to acquire them.

The current claims against financial resources include wages and salaries payable, accounts payable, and deferred inflows of resources. They exclude long-term obligations such as *bonds* payable, the liabilities for vacation pay, sick leave pay, and legal judgments. Consistent with conventional relationships between the balance sheet and operating statement accounts, revenues and expenditures are accompanied by an increase or decrease in net current financial resources (as opposed to increases or decreases in net economic resources, as would be true under the full accrual basis).

Recognition of Revenue

Accepting the accrual basis of accounting (even if modified) still leaves unresolved the thorny issue of when revenues should be recognized. What key economic event in the revenue generation process should trigger the recognition of revenue and the corresponding increase in net position? In business accounting, revenues are ordinarily recognized when a firm has fulfilled contractual performance obligations. But standards setters and individual governments still have to grapple with the problem of when the various types of revenue transactions satisfy these criteria. To enhance consistency of practice, standards setters have established specific guidelines for the recognition of such diverse revenues as those from ordinary sales, from sales that bundle both goods and services, licensing agreements, and construction contracts.

The revenue-recognition issues facing governments are less amenable to resolution than those of businesses. Businesses derive their revenues mainly from exchange transactions—those in which each party gives and receives consideration of equivalent value. Governments (except those that engage primarily in business-type activities) derive their revenues mainly from nonexchange transactions— those in which one party gives or receives value without directly receiving or giving equivalent value in exchange.

GASB Codification Section N50—Nonexchange Transactions governs the recognition of nonexchange revenue under both the modified-accrual basis (for governmental funds) and the full-accrual basis (for the proprietary and fiduciary funds and government-wide statements). The recognition guidelines discussed in the next sections are the same for both bases. However, when accounted for under the modified accrual basis, revenues are subject to an additional, extremely significant, stipulation. They cannot be recognized until they are both *measurable and available to finance expenditures of the fiscal period*.

Meaning of and Rationale for "Available to Finance Expenditures of the Current Period"

The nonexchange revenues of governments are intrinsically associated with expenditures; they are generated solely to finance expenditures. Budgets are formulated so that each period's estimated revenues are sufficient to cover appropriated expenditures. Expenditures of a current period may

either require cash outlays during the period or create liabilities that must be satisfied shortly after the end of the period. For example, goods or services that a government receives toward the end of one year would ordinarily not be required to be paid for until early the next year. Available therefore means "collected" within the current period or "soon enough thereafter to be used to pay liabilities of the current period[1]."

Business accounting principles dictate that the collection of cash must be probable before revenue can be recognized. The "available" stipulation ensures that, in addition, the cash has been collected or will be collected soon enough to pay the liabilities they are intended to cover.

The liabilities that the revenues may be used to pay are only current liabilities. Recall that long-term liabilities are outside the measurement focus of governmental funds, and hence are not recorded by them. As is discussed in the following chapter, under the modified accrual basis of accounting, transactions that result in long-term liabilities are not recorded as expenditures.

How many days after the close of the year must revenues be received to satisfy the criteria of having been received soon enough to pay the liabilities of the current period? With respect to property taxes— and only property taxes—existing standards provide that, in the absence of unusual circumstances, revenues should be recognized only if cash is expected to be collected within 60 days of year-end[2].

Because existing standards provide no specific guidance as to time periods for recognition of other revenues, this "60-day rule" has become a widely used benchmark for all types of revenues, not just property taxes. However, many governments have established other time periods—30 days, 90 days, or even one year—for revenues other than property taxes.

WHAT ARE THE MAIN TYPES OF NONEXCHANGE REVENUES AND THE LIMITATIONS ON HOW AND WHEN THEY CAN BE USED?

GASB standards for nonexchange transactions originated in Statement 33, *Accounting and Financial Reporting for Nonexchange Transactions*, and are codified with subsequent amendments in Codification Section N50—Nonexchange Transactions. The standards define nonexchange transactions as those in which the government receives (or gives) value without directly giving (or receiving) equal value in return. There are four types of nonexchange transactions:

- **Imposed nonexchange revenues**. These are assessments imposed on individuals and business entities. The most prominent of these are property taxes, which are recognized in the year for which they are levied. They also include fines and penalties, which generally are recognized as revenue when the government has an enforceable claim or cash is collected.
- **Derived tax revenues**. These are taxes derived (i.e., that result) from assessments on exchange transactions carried on by taxpayers. They include sales taxes (derived from

sales transactions) and income and other taxes on earnings or assets (derived from various income-producing commercial transactions) and are recognized when the exchange transaction to which the tax is applied occurs.

- **Government-mandated nonexchange transactions**. These occur when a government at one level (e.g., the federal or a state government) provides resources to a government at another level (e.g., a local government or school district) and requires the recipient to use the resources for a specific purpose (and possibly in a specific period). For example, a state may grant funds to a county, stipulating that the resources be used for road improvements. Acceptance and use of the resources are mandatory and are recognized when all eligibility requirements are met.
- **Voluntary nonexchange transactions**. These result from legislative or contractual agreements entered into willingly by two or more parties. They include grants given by one government to another and contributions from individuals (e.g., gifts to public universities). Often the provider imposes eligibility requirements or restrictions as to how the funds may be used (and possibly when). These types of transactions are similar to the government-mandated nonexchange transactions but differ in that the recipient government is not required to accept the awards. However, if the government accepts the awards, it must observe the accompanying requirements on how they may be spent. Like the government-mandated nonexchange transactions, they too are recognized when all eligibility requirements are met.

Codification Section N50 contains the standards, discussed in the next sections, for each of the four types of transactions. The standards for government-mandated and voluntary nonexchange transactions apply to both revenues and expenditures. Thus, payments from one government to another are expected to be accounted for symmetrically.

Codification Section N50 also identifies two types of limitations that constrain when and how a government may use the resources it receives in nonexchange transactions:

- **Time requirements**. These specify the period during which resources must be used or when use may begin. For example, local governments typically levy property taxes designated for a particular fiscal year. Similarly, state governments that grant funds to local school districts may require that the funds be used during the state's fiscal year.
- **Purpose restrictions**. These specify the purpose for which the resources must be used. For example, certain sales taxes must be used for road improvements, certain property taxes must be used to repay debt, and certain grants or private donations must be used to acquire specific goods or services.

As noted in the discussions of the various types of revenues, governments should not recognize revenue or expenditures on nonexchange transactions until time requirements have been met (e.g.,

until the start of the specific time period during which resources may be used). By contrast, however, they need not delay recognition of revenue until they have satisfied the purpose restrictions. Nevertheless, they must specifically identify resources that are subject to purpose restrictions by appropriately classifying a portion of the fund balance in the financial statements as restricted and possibly by reporting the revenues in a fund other than the general fund, such as a special revenue fund. In government-wide statements, they would identify restricted resources by denoting a portion of net position as "restricted." These requirements continue in force until the restricted amounts are spent for the purposes specified.

HOW SHOULD PROPERTY TAXES AND OTHER IMPOSED NONEXCHANGE REVENUES BE ACCOUNTED FOR?

Property taxes are the bread and butter of local governments. Although gradually being supplemented by other taxes and fees, they still account for approximately 31 percent of local government revenues (see Figure 1-1 in Chapter 1 of course 21151F). Independent school districts and special-purpose districts with taxing power also are heavily dependent on property tax revenue.

Classified as *ad valorem* taxes (based on value), property taxes are most typically levied against real property (land and buildings). However, some jurisdictions also include within the tax base personal property—such as automobiles, boats, and business inventories—and intangible assets, such as securities and bank deposits.

Property taxes are levied against the assessed value of taxable assets. Most jurisdictions are required to assess (i.e., assign a taxable value to) property at 100 percent of its appraised fair market value. Many, however, assess property as a fraction of appraised value (perhaps in the hope of discouraging taxpayer protests) and then adjust the tax rate upward to offset the reduction in tax base.

Governments establish the property tax rate by dividing the amount of revenue that they need to collect from the tax by the assessed value of the property subject to tax. For example, if a government needs $400 million in tax revenue and its jurisdiction has $22 billion in taxable property, then the tax rate would be the $400 million in needed revenue divided by the $22 billion in taxable property—1.818 percent or 18.18 mils (dollars per thousand).