PATRICIA DOUGLAS

GOVERNMENTAL AND NONPROFIT ACCOUNTING

THEORY AND PRACTICE

SECOND EDITION

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PATRICIA P. DOUGLAS
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PREFACE

TEXT PURPOSE AND ORGANIZATION

Governmental and Nonprofit Accounting: Theory and Practice, Second Edition, provides the fundamental knowledge necessary for understanding the operation of governmental and nonprofit entities, their accounting, auditing, and financial reporting practices, and the standards that shape their accounting and financial reporting systems.

Accounting Practices

Because an appropriate blanace between theory and practice is always an important goal, all governmental and nonprofit textbooks attempt to integrate theory and practice. This textbook uses an early emphasis on a conceptual framework for governmental accounting and financial reporting to introduce readers to that desirable blend of theory and practice. Chapters 1 and 2 expose them to the Governmental Accounting Standards Boards (GASB) concept statement and trace the evolution of that work in relation to earlier conceptual work done by the National Council on Governmental Accounting. These first two chapters also describe the efforts being made to develop generally accepted accoutning principles from a conceptual framework.

Organization

Governmental accounting, financial reporting, and auditing are described in the first 13 chapters of this book. After assigning Chapters 1 to 3, which provide the fundamental concepts, professors may order the material to suit their particular needs. (This book is intended to be as current as possible. However, because governmental accounting is developing so rapidly, the instructor may want to update some topics as needed.)

Colleges and universities, hospitals, volunteer health and welfare organizations, and other nonprofit organizations are covered in Chapters 14-16. Similarities and differences among these organizations, and between them and governmental entities, are highlighted. Here too, chapters can be interchanged without any loss of efficacy.

Relation to Business Accounting

Most students who take a course in nonprofit accounting are already familiar with business accounting. And to avoid the burden of learning a "new accounting language," this book frequently brings in the relationship between governmental or nonprofit accounting and business accounting. Chapter 3, for example, provides an overview of the significant similarities and differences between governmental and business accounting.

"Future and Current" GAAP

Governmental accounting will change markedly in the future. The GASB has issued a pronouncement changing the measurement focus and basis of accounting for governmental funds. Currently, those funds use current financial resources and the modified accrual basis of accounting. Future GAAP will be total financial resources and the accrual basis of accounting. The effective date of the pronouncement has been deferred to allow the GASB more time to develop implementation aids and to complete related projects such as the one on financial reporting. Until the effective date and during the transition period, practitioners need to understand and apply current GAAP. Thereafter, future GAAP will be important. Therefore, each chapter covers both the current and future GAAP. Current GAAP is covered in the body of each chapter. Future GAAP is covered in an appendix to the appropriate chapters.

Capturing the Essence of Change

Because the rapidly evolving nature of governmental and nonprofit accounting is important to overall understanding, change constitutes a major focal point of the textbook. The Governmental Accounting Standards Board has passed the five-year structure review with its purview unchanged and its credibility substantiated. In addition to the measurement focus/basis of accounting project, the Board is addressing and expected to finalize soon standards relating to the financial reporting, capital assets, and a host of other accounting and financial reporting issues. Some of those may be finalized by the time this book is published.

The Financial Accounting Standards Board (FASB) is taking an increasingly active role in establishing accounting standards for the nonprofit organizations within its jurisdiction. Recently issued standards related to financial reporting, contributions, and pledges all reflect the Board's concern for the inconsistent accounting and reporting practices of nonprofit organizations. Other nonprofit topics, such as investments, are on the Board's agenda.

Within the last few years, the American Institute of Certified Public Accountants has issued several auditing standards that relate directly or indirectly to governmental and nonprofit organizations. More are expected in the years ahead. The Institute is also in the process of revising several auditing guides related to these entities.

These rapid and fundamental changes in the accounting and financial reporting for governmental and nonprofit entities lend excitement to teaching and learning. Providing professors and students a guide to current accounting and reporting practices and, at the same time, giving a flavor of possible future practices was also challenging.

Pedagogy

Governmental and Nonprofit Accounting provides an extensive array of pedagogic elements. Each chapter ends with both review questions and exercises. Additionally, the book offers cases that allow discussion of practical

and theoretical issues to create an awareness of the accounting and standard-setting environment impossible to achieve with problems and exercises alone.

The review questions tend to focus on specific issues and can be used to reinforce major points made in the text. Most exercises integrate several concepts and are especially useful for providing a broader review of the chapter material. Most chapters in Part 1 also contain an exercise related to the financial statements of Raleigh, North Carolina, which appear in the Appendix to the book. This continuing example helps integrate the separate topics.

Observation Blocks

Fact and editorial license are often confused in textbooks. To avoid that confusion and to add an occasional theoretical or practical implication, the text is sprinkled with personal observations. They are clearly marked as such. Students who have used this book have commented that these made the "text come alive" or "the theory clearer." They also represent yet another attempt to blend theory and practice.

ANCILLARY MATERIALS

A solutions Manual and Test Bank accompany the textbook. The Test Bank includes true-false, multiple-choice, and essay questions, as well as miscellaneous problems and exercises. Solutions to all Test Bank questions are provided, with detailed calculations where appropriate.

ACKNOWLEDGMENTS

This textbook has only one author who assumes responsibility for the accuracy and quality of material. Many people, however, helped make it better than it would otherwise have been. First among them is Professor Robert Anthony whose critical questions helped shape the way in which the FASB standards on contributions and financial reporting were incorporated into the nonprofit chapters.

Many students assisted by reading selected chapters and evaluating the ease with which material can be understood and the relationship between the text and the end-of-chapter materials.

Two graduate students, Darlene Bay and Dong Feng Lin, merit special attention. Darlene Bay has patiently read the chapters for typographical errors, conceptual flaws, and author inconsistencies as well as helped check the Solutions Manual and Test Bank. Dong Feng Lin prepared an outstanding Index and offered insightful observations which make the text easier for students to understand.

Sherry Rosette handled all of the tough typing assignments with only general guidance and lots of author frustration. To say that she served as typist greatly understates her editorial talents.

Harcourt Brace also has a fine staff of editors, and I most grateful for the patient assistance of Jim Patterson who kept everyone on schedule and always explained perfectly the limitations and potential of modern typesetting.

I am grateful, too, for the encouragement from Kenneth Rethmeier, Tim Vertovec, and Bill Teague, without whose support the textbook would not have been published. Thanks also to Brian Salisbury, art director; Ann Marie Coburn, production manager; Diana Farrell, marketing manager; and Glenn Martin, developmental editor.

Professors Michael Emerson, Harding University; Marc Rubin, Miami University; John L. Farbo, University of Idaho; Alexander E. C. Yuen, San Francisco State University; and Henry H. Davis, Eastern Illinois University; all provided an excellent critique of the first edition. Those critiques provided an excellent basis for sometimes subtle but always significant changes in the second edition. Bobbe M. Barnes, Economics Institute—affiliated with the University of Colorado at Denver—checked accuracy in the textbook and the solutions manual for this edition.

I extend my thanks once more to Joyce Watson of the City of Raleigh for making sure that the Appendix was available in the form desired and was received in a timely fashion.

Most of those acknowledged here are different from those acknowledged for their work on the first edition. Positions and lives change. One person, however, has remained in the same position, provided the same encouragement, and withstood the additional demands related to a textbook. He is Chuck Douglas, my husband, and I am deeply appreciative of his willingness to put life on the back burner while I finished this second edition.

BRIEF TABLE OF CONTENTS

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PART I

INTRODUCTION TO GOVERNMENTAL ACCOUNTING SECTION

Chapters 1–12 describe accounting and financial reporting for governmental entities. The environment in which governmental units operate and the general concepts and accounting principles are discussed in the first two chapters. Chapter 3 gives a broad overview of the differences between accounting for governments and businesses.

Beginning with Chapter 4 and ending with Chapter 9, each individual fund and account group used in governmental accounting is described in detail, along with the general reporting practices of each one. Because the basis of accounting for many of these funds will change sometime in the future, the text provides guidance to the reader for both current and future standards. The current standards are described in the body of the chapter, and the future standards are described in the appendix to each chapter.

Chapter 10 covers the annual and interim financial reporting requirements for governmental entities. It includes illustrations of the various financial statements and describes the format and inclusions for the comprehensive annual financial report.

Auditing considerations relating to governmental units are discussed in Chapter 11 and Chapter 12, including the requirements of the Single Audit Act. Generally accepted auditing standards for governmental entities are described, and illustrative note disclosures are provided.

The final chapter in this section, Chapter 13, covers several important current topics in the governmental area. The continued concern over the jurisdiction of the Governmental Accounting Standards Board and the Financial Accounting Standards Board is one such topic. Others include pension accounting and the accounting and reporting for general fixed assets.

Governmental accounting is changing rapidly and will continue to do so. The first section of the textbook provides direction to those who will be examining these changes. It also will help those making the transition from current, generally accepted accounting principles to the principles applicable in the future.

CHAPTER 1

Governmental and Nonprofit Entities: An Overview of Accounting, Reporting, and Auditing

In its broadest sense, the term *nonprofit* refers to all entities that are not in business to make a profit. Thus, the term encompasses both governmental and all other not-for-profit entities. Frequently, the term is used in a narrower sense to refer to all nongovernmental not-for-profits, such as colleges and universities, hospitals, voluntary health and welfare organizations, and health care organizations. As sometimes happens when different meanings are attributed to a single term, the reader may have to determine the context in which the term is being used before the meaning is clear. Although this textbook uses the term in the narrower sense, quotes from other authors or from standard-setting bodies may not always be entirely consistent with this usage.

Governmental and nonprofit entities are a critically important force in our society. The federal government alone employs 3 million people, and its annual budget exceeds $1 trillion. In addition, local governments (states, counties, cities, towns, and school districts) spend billions of dollars and employ over 14 million workers. Nonprofit organizations, such as hospitals, colleges and universities, foundations, churches, and health care organizations, also spend considerable sums and employ a substantial work force.

Everyone regardless of occupation, locale, or status, comes into daily contact with governmental and nonprofit entities. When paying taxes, attending school, using public services, or working for local charities, people contribute to or benefit from these organizations.

The pervasive influence and economic significance of governmental and nonprofit organizations require the public to understand how they are organized and managed, and how they can be held accountable for the resources they spend. Accountants, in particular, need that understanding because they audit these organizations or prepare the information that others will audit. In addition, accountants frequently are called upon to assist laypersons in interpreting financial statements and to develop ways in which performance can be improved.

Chapters 1 and 2 of this text define the environment and character of governmental and nonprofit entities. In this first chapter, the external environment is discussed. The importance of these entities and their impact on society are briefly described. This chapter also covers the standard-setting process for governmental and nonprofit organizations: its historical development, significance, and current status. Another major topic covered is the

nature and scope of auditing in the governmental and nonprofit area, including a description of the forces that are expanding the audit function.

The Distinction Between For-Profit and Nonprofit Organizations

Accounting and reporting for governmental and nonprofit organizations differ markedly from that of for-profit organizations. In a profit-making organization, management decisions are made, theoretically at least, to increase owners' welfare, which is usually measured in terms of profitablility.

Because both investors and managers are interested in maximizing profits, there is a single purpose, and everyone associated with the business acts to contributc to the attainment of an agreed-upon objective. The same criterion can be used to evaluate decisions. This notion of a single goal is so deeply ingrained in our society that many people equate profit maximization with capitalism and democracy.

Judging the performance of entities whose goal is not profit maximization is more difficult and subjective. For most governmental and nonprofit organizations, the goal is to provide the best and highest level of service possible with the available resources. In government, an organization's objectives and its management actions may not coincide with the will of its elected officials. Evaluating performance to determine whether any service was "best" or at the "highest" level possible is not simply an economic judgment but a social and political one as well.

This basic distinction between for-profit and nonprofit entities results in a number of reporting and managerial differences. In for-profit organizations, the unit as a whole is evaluated. For example, consolidated financial statements are prepared for companies with subsidiaries. In governmental and nonprofit entities, certain activities or functions tend to be examined separately, combining those activities in only the most superficial way. The premise is to provide accountability at the lowest level feasible. Because no one element of information is a good substitute for "the bottom line," lots of detail is typically shown.

In the governmental and nonprofit arena, operating activities tend to be segregated from long-term financing and activities related to the purchase of long-lived assets. This separation helps decision makers focus on which services or facilities are funded from current revenue sources and which ones are financed through longer-term debt commitments.

Without a single criterion to measure performance of these units, it is difficult to compare the operating results of one entity to those of another. Is sheer size important? How can one set of services be compared to another? What makes one better or worse than the other? This lack of a single criterion also makes goal formation more complicated in the governmental and nonprofit sector. Each contributing and benefiting party has a notion of what

the goals ought to be but those notions differ and, without a single evaluation criterion, it is difficult to build a consensus about good or bad performance.[1]

Accounting and Reporting Support for Public Policy

Goals for governmental and nonprofit units cannot be established by asking which are best solely from an economic perspective: they are established for governmental and nonprofit units in political and social realms. For example, the city of Dallas does not decide that the marginal revenue of another social worker will enhance the city's profitability. Instead, the city council, with input from the citizens, decides that another social worker is or is not "needed" and ultimately whether that need is greater or less than the need for other services. Sometimes the decision may be based on the relative voter appeal of several services. Social needs and political votes often determine which programs are funded and at what levels.

Once programmatic decisions have been made, accounting and financial reporting enable the citizenry to determine whether the programs responded to the public mandate. In the 1988 revision of the audit standards of governmental organizations, the Comptroller General states:

> Our system of government today rests on an elaborate structure of interlocking relationships among all levels of government for managing public programs. Officials and employees who manage these programs must render a full account of their activities to the public.... Public officials, legislators, and private citizens want and need to know not only whether government funds are handled properly and in compliance with laws and regulations, but also whether government organizations and programs are achieving the purposes for which they were authorized and funded and are doing so economically and efficiently.[2]

Those few words describe explicitly the context in which accounting information is used to evaluate the extent to which public policy is being implemented. Accounting information and financial reports are used to determine if program managers have complied with the purpose and level of funding. Was less spent than authorized? More? If so, how much more? Were the program objectives achieved?

Comparisons of budgeted versus actual figures are particularly important for determining how much was spent, and in what areas expenditure patterns differed from what was anticipated. In fact, because budgets are considered an expression of public policy, such presentations are frequently a part of public financial reporting. Overspending may result in a fine or a more serious consequence. Compliance is not just an indication of good man-

[1] Specific accounting differences between business and governmental entities are the subject of Chapter 3.

[2] Comptroller General of the United States, *Government Auditing Standards* (Washington: GAO, July 1988), 1-3.