The Government and Not-for-Profit Environment

LEARNING OBJECTIVES

After studying this chapter, you should understand:

- The characteristics that distinguish governments and not-for-profit organizations from businesses and the accounting and reporting implications of these characteristics
- Why other characteristics of governments and not-for-profit entities may affect accounting and reporting practices
- The overall purpose of financial reporting in the government and not-for-profit sectors
- The information requirements of the primary users of the financial reports of governments and not-for-profit entities
- The specific objectives of financial reporting, as established by the Governmental Accounting Standards Board (for state and local governments), the Financial Accounting Standards Board (for not-for-profits), and the Federal Accounting Standards Advisory Board (for the federal government), and the obstacles to achieving these objectives within a set of financial statements prepared on a single basis of accounting
- How differences in accounting principles affect financial reporting and thus can have economic consequences
- The institutional arrangements for establishing accounting standards for these entities

Governments and not-for-profit organizations have much in common with businesses. However, the differences between the two environments are sufficiently pronounced that business schools have established a separate course in governmental and not-for-profit accounting apart from the usual accounting courses—financial accounting, managerial accounting, auditing, and information systems.

Every accounting issue or problem that affects governments and not-for-profit entities has a counterpart in the business sector. But the distinctions between accounting for governments and not-for-profits and accounting for businesses are so marked that the two disciplines warrant specialized textbooks, separate statements of concepts, and separate accounting principles and practices. As we shall see in this text, some of these differences may be justified by substantive distinctions in the two operating environments. Others are the result of long-standing differences in the traditions, composition, and perspectives of the standard-setting boards—the Governmental Accounting Standards Board (GASB), for
state and local governments; the Federal Accounting Standards Advisory Board (FASAB), for the federal government; and the Financial Accounting Standards Board (FASB), for the private sector, including private (nongovernmental) not-for-profits.

This chapter is divided into eight sections. The first examines the ways in which governments and not-for-profits differ from businesses, and why they require unique accounting principles and practices. The second points out the characteristics of governments and not-for-profits that might not distinguish them from businesses, but nevertheless do have significant implications for accounting and reporting. The third contrasts governments and not-for-profits, emphasizing that although they have much in common, they also differ significantly. The next four sections provide an overview of financial reporting for governments and not-for-profits—highlighting key user groups, their information needs, and the resultant objectives of financial reporting—and address the question of whether differences in accounting practices really matter. The last section spotlights the GASB, the FASB, and the FASAB.

In this book, we use the term not-for-profit rather than the equally acceptable term nonprofit. Not-for-profit differentiates entities that don’t intend to earn a profit from those that simply fail to do so.

Governments and not-for-profits differ from businesses in ways that have significant implications for financial reporting. For the most part, governments and not-for-profits provide services targeted at groups of constituents either advocating a political or social cause or carrying out research or other activities for the betterment of society. The objectives of governments and not-for-profits cannot generally be expressed in dollars and cents, are often ambiguous, and are not easily quantifiable. Moreover, governments and not-for-profits have relationships with the parties providing their resources that are unlike those of businesses.

DIFFERENT MISSIONS

As implied by the designation not-for-profits, the goal of governments and similar organizations is something other than earning profit. A key objective of financial reporting is to provide information about an entity’s financial performance during a specified period. The main objective of a typical business is to earn a profit—to ensure that over the life of the enterprise, its owners get a return greater than the amount invested. Accordingly, financial statements that focus on net income are consistent with the entity’s main objective. Specifically, an income statement is a report on how well the entity achieved its goals. To be sure, businesses may have objectives that go beyond “the bottom line.” They may seek to promote the welfare of their executives and employees, improve the communities in which they are located, and produce goods that will enhance the quality of life. Financial accounting and reporting, however, are concerned almost exclusively with the goal of maximizing either profits or some variant of it, such as cash flows.

The financial reports of governments and not-for-profits can provide information about an organization’s inflows (revenues) and outflows (expenditures) of cash and other resources. As a general rule, an excess of expenditures over revenues, particularly for an extended period of time, signals financial distress or poor managerial performance. However, an excess of revenues over expenditures is not necessarily commendable. An excess of revenues over expenditures may be achieved, for example, merely by reducing the services provided to constituents, which may be at odds with the entity’s objectives.

If the financial statements of a government or not-for-profit incorporate only monetary measures, such as dollars and cents, they cannot possibly provide the information necessary to assess the organization’s performance. For an organization to report properly on its accomplishments,
it must augment its financial statements to include nonfinancial data that relate to its objectives. A school, for example, might include statistics on student achievement, such as test scores or graduation rates. A center for the homeless might present data on the number of people fed or adequately housed.

**BUDGETS, NOT THE MARKETPLACE, GOVERN**

Governments and not-for-profits are governed mainly by their budgets, not by the marketplace. These organizations control or strongly influence both their revenues and expenditures through the budgetary process. The revenues of a government may be determined by legislative action, and if they are, the government may not be subject to the forces of competition faced by businesses. Those of the not-for-profits, although they cannot be established by legal mandate, may be obtained from contributions, dues, tuition, or user charges—none of which are comparable to the sales revenue of a business.¹

**EXPENDITURES MAY DRIVE REVENUES**

Governments and many not-for-profits establish the level of services that they will provide, calculate their cost, and then set tax rates and other fees to generate the revenues required to pay for them. Colleges and universities, unlike businesses, do not set tuition charges at the highest level that the market will bear. Instead, they calculate operating costs; estimate contributions, endowment revenues, and other sources of funds; and then set tuition charges at the rate necessary to cover the shortfall. Similarly, fraternities and sororities calculate their expenditures for housing, food, and social activities, and then set dues and other fees accordingly. In sum, expenditures drive revenues.

Although governments and not-for-profits do not participate in competitive markets, they cannot simply raise revenues without regard to their services or increase taxes without limit. Governments may be constrained by political forces. Universities may have to restrict tuition rates to approximately those of peer schools. Further, some not-for-profits, such as the United Way or organizations that fund medical research, base their expenditures exclusively on their revenues. The more funds they raise, the more they spend.

**THE BUDGET, NOT THE ANNUAL REPORT, IS THE MOST SIGNIFICANT FINANCIAL DOCUMENT**

For businesses, the annual report is the most significant financial document. A major company’s announcement of annual earnings (the preview of the annual report) makes front-page news. By contrast, its annual budget is nothing more than an internal document, seldom made available to investors or the general public.

A government or not-for-profit’s release of its annual report is customarily ignored by both organizational insiders and outsiders. Seldom does the report contain surprises, for if revenues and expenditures were markedly different from what were initially budgeted, the entity probably was required to amend the budget during the year.

For governments and not-for-profits, the budget takes center stage—properly so, because the budget is the culmination of the political process. It encapsulates almost all the decisions of consequence made by the organization. It determines which constituents give to the entity and which receive; which activities are supported, and which are assessed.

¹ Although market mechanisms are widely thought of as providing a more efficient distribution of goods and services, they can operate only when there can be no “free riders”—parties who are able to obtain the goods or services without paying for them. Many government services, such as police protection, cannot practically be provided only to paying customers. Hence, we must resort to nonmarket mechanisms to allocate resources. See Richard A. Musgrave and Peggy B. Musgrave, *Public Finance in Theory and Practice*, 5th ed. (New York: McGraw-Hill, 1989), Chapter 3, “The Theory of Social Goods,” for a discussion of this concept from the perspective of economists.
Because it is so important, the budget, unlike the annual report, is a source of constituent concern and controversy. Government budget hearings often draw standing-room-only crowds to the legislative chambers. The budget debates of religious organizations such as churches and synagogues are frequently marked by fervor more intense than that found in the congregants’ worship services.

A government’s budget may be backed by the force of law. State and local government officials are ordinarily prohibited from spending more than what was budgeted. Indeed, they can go to jail for severe violations of budgetary mandates. The budget is not a document to be taken casually. In light of the significance of the budget relative to the annual report, it is ironic that the standard-setting agencies focus exclusively on the annual report. Except insofar as governments—such as states—establish rules for cities or other governments within their jurisdiction, or parent not-for-profits—such as national fraternities—set guidelines for local affiliates, budgetary practices are within the discretion of the individual entity. Neither the GASB nor the FASB or FASAB has been granted the kind of statutory authority over budgets that it has over annual reports. As a consequence—which shall be made evident in discussions to follow—annual reports are in fact better than budgets at capturing the economic substance of the transactions and are far less subject to preparer efforts to artificially boost revenues or reduce expenditures.

BUDGETS DRIVE ACCOUNTING AND FINANCIAL REPORTING

 Constituents of an organization want information on the extent of adherence to the budget. They want assurance that the organization has not spent more than what was authorized. They want to know whether revenue and expenditure estimates were reliable. The accounting system and the resultant financial reports must be designed to provide that information.

In addition, managers need an accounting system that provides them with ongoing data about whether they are on target to meet budget projections. Even more critically, they need a system that either prevents them from overspending or sets off warning signals when they are about to do so. The budget is a control device, but it requires the support of a complementary accounting and reporting system. Finally, auditors and other parties concerned with the organization’s performance require a basis on which to evaluate accomplishments. As will be discussed in subsequent chapters, state-of-the-art budgets establish that basis by indicating not only how much will be spent on a particular activity but also what the activity will achieve.

A postperiod assessment can then focus not only on whether the entity met its revenue and expenditure projections but also, equally important, on whether it attained what was expected of it. Evaluators can then assess organizational efficiency by comparing inputs (such as dollar expenditures) with outcomes (results). The accounting system should be fashioned to facilitate this comparison, ensuring that the organization reports and categorizes both revenues and expenditures in a way that is consistent with the budget. Currently, few governments and not-for-profits have established budgetary and accounting systems to measure and report adequately on the nonmonetary aspects of their performance. However, accounting standard-setting authorities have recognized the importance of performance measures and have taken steps to encourage the entities under their purview to provide them.2

NEED TO ENSURE INTERPERIOD EQUITY

Most governments are required by law, and most not-for-profits are expected by policy, to balance their operating budgets. Balanced operating budgets ensure that, in any particular period, revenues cover expenditures and that, as a group, the entity’s constituents pay for what they receive. If organizations fail to balance their budgets—and borrow to cover operating deficits—then the cost of benefits enjoyed by the citizens of today must be borne by those of tomorrow.

The concept that constituents pay for the services that they receive and do not shift the burdens to their children has traditionally been labeled as **intergenerational equity**. In recent years, to emphasize that entities should not transfer the costs even to future years, to say nothing of future generations, the term **interperiod equity** has been accepted as more appropriate. To maintain interperiod equity, the accounting systems of governments and not-for-profits must provide information about whether this objective is being attained. Table 1-1 compares fiscal practices that promote interperiod equity with those that do not.

The concept of interperiod equity does not suggest that governments should never borrow. The prohibition against debt applies only to operating, not capital, expenditures. A government-constructed highway or university-purchased lab equipment will produce benefits over more than one year. It is only fair, therefore, that they be paid for by incorporating debt service costs into the taxes or tuition charges of the citizens or students who will benefit from them.

### IN PRACTICE
**WHY IS STATE AND LOCAL GOVERNMENT ACCOUNTING IMPORTANT?**

- There are over 90,000 state and local governments in the United States.
- State and local governments received $1.35 trillion in tax revenues in 2016.*
- Expenditures for state and local governments increased 28.4% to $2.58 trillion from 2006 to 2016. Consumption expenditures were the largest expenditures for state and local governments in 2016 at $1.69 trillion followed by government social benefit payments and Medicaid of $692.6 billion and $574.5 billion respectively.
- Total debt outstanding for state and local governments increased 6.4 percent, from $2.9 trillion in 2012 to $3.1 trillion in 2016.
- Education, the single largest functional category for all governments, employed 11.1 million people, or 57.0 percent of the total number of federal, state, and local government employees.


### TABLE 1-1 Fiscal Practices that Promote or Undermine Interperiod Equity

<table>
<thead>
<tr>
<th>Promote</th>
<th>Undermine</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Setting aside resources for employee pensions during the years in which the employees provide their services.</td>
<td>1. Paying the pensions of retired employees out of current operating funds.</td>
</tr>
<tr>
<td>2. Issuing conventional 30-year bonds to finance the purchase of a new building that is expected to have a useful life of 30 years; repaying the bonds, along with appropriate amounts of interest, over the 30-year period.</td>
<td>2. Financing the purchase of the new building with 30-year zero-coupon bonds that permit the entire amount of principal and interest to be paid upon maturity of the bonds; making no provision to set aside resources for payment of principal and interest on the bonds until the year they mature.</td>
</tr>
<tr>
<td>3. Paying the current-year costs of an administrative staff out of current operating funds.</td>
<td>3. Issuing 30-year bonds to finance the current-year operating costs of an administrative staff.</td>
</tr>
<tr>
<td>4. Charging payments of wages and salaries made in the first week of the current fiscal year to the previous fiscal year, that in which the employees actually provided their services.</td>
<td>4. Charging wages and salaries applicable to services provided in the last week of the current fiscal year to the following fiscal year, that in which the payments were made.</td>
</tr>
<tr>
<td>5. Charging the cost of supplies as expenditures in the year in which they were used rather than when they were purchased.</td>
<td>5. Charging the cost of supplies as expenditures in the year they were purchased, irrespective of the year in which they were used.</td>
</tr>
<tr>
<td>6. Recognizing interest on investments in the year in which it is earned, irrespective of when it is received.</td>
<td>6. Recognizing interest in the year in which it is received, irrespective of when it is earned.</td>
</tr>
<tr>
<td>7. Setting aside funds each year to pay for an anticipated 20-year renovation of a college dormitory.</td>
<td>7. Paying for an anticipated 20-year renovation of a college dormitory out of current funds in the year the work is performed.</td>
</tr>
</tbody>
</table>
REVENUE NOT INDICATIVE OF DEMAND FOR GOODS OR SERVICES

For competitive businesses, revenues signal customer demand for goods and services. Holding prices constant, the greater the revenues, the greater the demand—an indication that the entity is satisfying a societal need.

In a government or not-for-profit, revenues may not be linked to constituent demand or satisfaction. An increase in tax revenues, for example, tells nothing about the amount or quality of service provided. Therefore, a conventional statement of revenues and expenditures cannot supply information on demand for services. Supplementary information is required.

NO DIRECT LINK BETWEEN REVENUES AND EXPENSES

Just as the revenues of governments and not-for-profits may not be directly linked to customer demand, they may also be unrelated to expenditures. The revenues from donations of a not-for-profit entity may increase from one year to the next, but the change may be unaccompanied by a corresponding increase in the quantity, quality, or cost of services provided. Thus, the matching concept—financial accounting’s central notion that expenditures must be paired with corresponding revenues—may have a different meaning for governments and not-for-profits than for businesses. Businesses attempt to match the costs of specific goods or services with the revenues that they generate. Governments and not-for-profits, however, can sometimes do no more than associate overall revenues with the broad categories of expenditures they are intended to cover.

CAPITAL ASSETS MAY NEITHER PRODUCE REVENUES NOR SAVE COSTS

Unlike businesses, both governments and not-for-profits make significant investments in assets that neither produce revenues nor reduce expenditures. Therefore, the conventional business practices used to value assets may not be applicable.

According to financial theory, the economic value of an asset is the present or discounted value of the cash inflows that it will generate or the cash outflows that it will enable the entity to avoid. Hence, conventional capital budgeting models specify that in evaluating a potential asset acquisition, the business should compare the present value of the asset’s expected cash outflows with its inflows.

Many capital assets of governments and not-for-profits cannot be associated with revenues or savings. The highway or bridge being considered by a state or local government will not yield cash benefits—at least not directly to the government. The proposed college library may enrich the intellectual life of the community, but not the college’s coffers. In fact, some governments and not-for-profit “assets,” such as historical monuments and heritage sites, may be more properly interpreted as liabilities. Inasmuch as they have to be maintained and serviced, they will consume, rather than provide, resources.

RESOURCES MAY BE RESTRICTED

In contrast to the resources of businesses, many of the assets of government and not-for-profit entities are restricted to particular activities or purposes. As shown in Figure 1-1, for example, a sizable share of one government’s revenues may be from other governments and, more than likely, restricted for specific purposes. The federal government may give a state or local government a grant for construction of low-income housing, in which case the award can be used only for low-income housing and not for any other purposes, irrespective of how worthy they might be.

Taxes and membership dues may also be restricted. A city’s hotel tax may be dedicated to financing a local convention center or to promoting tourism. A state’s gasoline tax may be targeted by law at highway construction and maintenance. A portion of a not-for-profit cemetery association’s fees may have to be set aside for the acquisition of new land.

Both governments and not-for-profits need to assure the parties providing the restricted funds that the money is used properly. At the same time, they must show in their financial reports
that the restricted resources are unavailable for purposes other than those specified. Therefore, the financial statements must either segregate the restricted from the unrestricted resources or disclose by some other means that some resources can be used only for specific purposes.

As with budgetary mandates, slipups regarding restrictions carry serious consequences. At the very least, they may cause the organization to forfeit past and future awards. Therefore, as with budgets, the organization must design its accounting system so that management is prevented from inadvertently misspending restricted resources. To this end, governments and not-for-profits employ a system of accounting known as fund accounting, which is discussed in Chapter 2.

FIGURE 1-1  State and Local Government Revenues by Sources
_Source: U.S. Census Bureau. Total State and Local Tax Revenues by Type – Fourth Quarter 2016._
NO DISTINCT OWNERSHIP INTERESTS

Neither governments nor not-for-profits have defined ownership interests like those of businesses. Typically, these entities cannot be sold or transferred. Should they be dissolved, they involve no stockholders or bondholders who are entitled to receive residual resources.

The most obvious financial reporting implication of this distinction is that the mathematical difference between assets and liabilities cannot sensibly be termed *owners’ equity*. Some other term is required.

More substantively, however, the distinction suggests that the financial statements of governments and not-for-profits must be prepared from the perspective of parties other than stockholders. (The main groups of statement users will be identified later in this chapter.) Similarly, for certain entities, the distinction implies that there may be less interest in the market values of their resources. Governments do not typically sell their highways and sewers, and few statement users are interested in their market values. Libraries and museums may be able to sell their collections, but may have to use the funds to acquire similar assets. The market values may be of concern only if the entire institution were to be closed and its assets liquidated. Yet, at the same time, market values may be relevant indicators of whether assets are being put to their optimum use. For example, a city might be better off selling an office building located downtown and using the proceeds to acquire property in outlying neighborhoods.

LESS DISTINCTION BETWEEN INTERNAL AND EXTERNAL ACCOUNTING AND REPORTING

In the government and not-for-profit arena, the line between external and internal accounting and reporting is less clear-cut than in the business sector. First, in the business sector, external reports focus on profits. Nevertheless, even in businesses, few organizational units are profit centers in which management controls all the key factors that affect profits. Therefore, internal reports present data on other measures of performance, such as total fixed costs or per-unit variable costs.

In the government and not-for-profit arenas, profit is no more an appropriate measure of performance for external parties than it is for internal departments. The relevant performance measures must be drawn from the organizations’ unique goals and objectives and are unlikely to be the same for all user groups.

Second, in business, the budget is an internal document, seldom made available to external parties. In governments and not-for-profits, it stands as the key fiscal document that is as important to taxpayers, bondholders, and other constituencies as it is to managers.

Third, the distinction between internal and external parties in governments and not-for-profits is more ambiguous than it is in business. Taxpayers and organizational members, for example, cannot be categorized neatly as either insiders or outsiders. Although they are not paid employees (and thus, not traditional “insiders”), they may nevertheless have the ultimate say (through either direct vote or elected officers) on organizational policies.

Governments and not-for-profits have additional characteristics that do not necessarily distinguish them from businesses but have significant accounting and reporting implications.

WHAT OTHER CHARACTERISTICS OF GOVERNMENTS AND NOT-FOR-PROFITS HAVE ACCOUNTING IMPLICATIONS?

MANY DIFFERENT TYPES OF GOVERNMENTS AND NOT-FOR PROFITS

Approximately 90,000 local governments currently exist in the United States (Figure 1-2). In common usage, a municipality is a village, town, or city. Government specialists, however, use the term to refer also to any other nonfederal government, including school districts, public authorities, and even states.

The number of municipalities may be surprisingly large but consider how many separate governments have jurisdiction over a typical neighborhood. The neighborhood may be part of
What Other Characteristics of Governments and Not-for-Profits Have Accounting Implications?

A town, several of which constitute a township. The township may be part of a county, which, in turn, may be a subdivision of a state. Further, the neighborhood school may be administered by an independent school district. The local hospital may be governed by a hospital district, the water and sewage system by a utility authority, and the bus system by a transportation authority. The community college may be financed by a community college district, and the nearby airport may be managed by an independent airport authority.

Each category of government will likely differ from others in the services it provides, the type of assets it controls, its taxing and borrowing authority, and the parties to which it is accountable. Moreover, even governments in the same category may vary in the services they provide. New York and Dallas are among the nation’s ten largest cities. But New York operates its own school system, whereas Dallas’s schools are under the control of an independent school district. San Antonio—Texas’s third-largest city—provides electric service to its residents, whereas in Houston—the state’s largest city—the citizens receive their power from a privately owned utility.

As shown in Table 1-2, not-for-profits are also many in number: over one million in the United States. These entities constitute what is sometimes referred to as the independent, or third, sector. Their diversity limits the suitability of a common accounting model (i.e., set of accounting and reporting principles) for any single, or even for any particular type of, government or not-for-profit entity. Assuming that comparability among entities is a desirable characteristic of financial reporting, standard-setting authorities face a policy question. To what extent should they adopt common standards for all governments and not-for-profits, as opposed to common standards only for entities of the same type? When entities are similar, common standards may promote comparability. When the entities are not, common standards may, like ill-fitting clothes, distort reality. As will be discussed in succeeding chapters, rule-making authorities have issued one set of common principles for all not-for-profits and a separate set for all state and local governments.

**SHORT-TERM FOCUS OF MANAGERS AND ELECTED OFFICIALS**

U.S. managers of both corporations and public enterprises have been accused of sacrificing the long-term welfare of their organizations for short-term benefits—sometimes for their organizations and other times only for themselves. This failing is said to be especially pronounced in governments.

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**FIGURE 1-2** Composition of the Local U.S. Government Units


- The average number of local government units per state is 1,801, but Illinois has 6,963, whereas Hawaii has only 21.
- Nine states account for slightly less than half of all local government units in the nation.
### CHAPTER 1 The Government and Not-for-Profit Environment

#### TABLE 1-2 Dimensions of the Not-for-Profit (“Independent”) Sector

**2016 Contributions by Source ($ Billion)**

<table>
<thead>
<tr>
<th>Source</th>
<th>Amount ($ Billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individuals</td>
<td>$281.86</td>
</tr>
<tr>
<td>Foundations</td>
<td>$59.28</td>
</tr>
<tr>
<td>Corporations</td>
<td>$18.55</td>
</tr>
<tr>
<td>Bequests</td>
<td>$30.36</td>
</tr>
<tr>
<td>Bequests</td>
<td>$30.36</td>
</tr>
<tr>
<td>Corps</td>
<td>$18.55</td>
</tr>
</tbody>
</table>

**2016 Contributions by Type of Recipient Organization**

- Health: $33.14
- Public-Society Benefit: $29.89
- Arts, Culture, and Humanities: $18.21
- International Affairs: $22.03
- Environment/Animals: $11.05
- Gifts to Individuals: $7.12
- Gifts to Foundations: $40.56
- Education: $59.77
- Human Services: $46.80
- Religion: $122.94

**Total contributions for 2016:** $391.5 billion

**Current Highlights**

The nonprofit sector in America includes hospitals, museums, schools, homeless shelters, houses of worship, symphony orchestras, research centers, youth groups, and many other organizations in every community across the nation. These charitable groups are sometimes collectively referred to as the “independent sector” to emphasize their unique role in society, distinct from business and government.

**Size and Scope**

- Number of not-for-profit organizations registered with IRS (2016): 1.21 million
- Total nonprofit sector revenues (2013): $1.74 trillion
- Percentage of wages and salaries paid in the United States by NFP (2013): 8.9%

**Giving 2016**

- Annual contributions from private sources: $391 billion
- Giving as a percentage of GDP: 2%

**Volunteering 2016**

- Percentage of Americans who volunteered: 24.9%
- Number of Americans who volunteered: 62.6 million
- Number of hours volunteered on average annually per person: 52
- Value of volunteered time: $1.5 trillion

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*All figures are rounded. Total may not be 100%.
*Foundation Center and Giving USA estimate.

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*https://www.nptrust.org/philanthropic-resources/charitable-giving-statistics/
*https://www.bea.gov/newsreleases/national/gdp/gdpnewsrelease.htm
*https://www.nationalservice.gov/vcla
Government officials typically face election (at the national level) every even-numbered year. In the periods preceding an election, they have powerful incentives both to avoid unpopular measures, such as tax increases and to make their government look fiscally sound. They can use budgetary and accounting techniques to make cosmetic improvements to their entity’s budget or annual report. Many of these activities will be described throughout the text.

Standard-setting authorities, the accountants and auditors of individual organizations, and statement users need to be aware that budgets and financial statements can be intended to mislead. They must resist and adjust for any biases. The difficulty they face, however, is that the motives for slanting budgets and statements in a particular direction vary from situation to situation. In some circumstances, government officials may artificially overestimate revenues (or underestimate expenditures) to avoid cuts in services or increases in taxes. In others, however, they may do the opposite so they can take credit at year-end for managerial effectiveness by presenting better-than-anticipated results.

GOVERNMENTS AND NOT-FOR PROFITS ENGAGED IN BUSINESS-TYPE ACTIVITIES

Many governments and not-for-profit organizations engage in business-type activities. Cities, for example, operate electric utilities, trash collection services, and golf courses. Colleges and universities operate bookstores, cafeterias, and computer repair services. Environmental organizations publish and sell magazines.

Even if profit maximization is not their overriding objective, these enterprises may, and perhaps should, be managed as if it were. Therefore, both their managers and the parties to whom they are accountable need the same type of financial information that the owners and operators of businesses do. The accounting and reporting practices that are appropriate for the business-type activities of governments and not-for-profits may differ from those that are most suitable for their nonbusiness activities. Thus, the challenge of developing accounting and reporting principles for governments and not-for-profits is made even more formidable by the potential need for more than one set of standards—even for a single organization.

As explained earlier, governments and not-for-profits share characteristics that distinguish them from businesses. But there are also important differences between governments and not-for-profits. Governments, unlike not-for-profits, have the authority to command resources. They have the power to tax, collect license and other fees, and impose charges. Should a government lack funds to satisfy its obligations or enhance services, it can obtain them by legislative action. From the perspective of accountants or financial analysts, this ability suggests that the actual assets reported on a government’s balance sheet may not represent all the assets under its control. To obtain a comprehensive picture of a government’s fiscal health, one must consider not only the resources actually owned by the government but also those that it has the power to summon.

Suppose that two towns each report an operating deficit and a high ratio of debt to financial assets. One is a wealthy community with high property values, prosperous industries, little unemployment, and a low tax rate. The other has low property values, little industry, high unemployment, and high tax rates. Clearly, the fiscal capacity of the first town exceeds that of the second. With greater fiscal effort—that is, by increasing tax rates—the first town can readily improve its economic circumstances, whereas the second cannot. This point is further addressed in Chapter 11.

Governments are currently required to include in their annual reports substantial amounts of demographic and economic data about the jurisdictions they serve. An ongoing issue, however, is how much disclosure is enough: what types of data are needed by statement users and to what extent are such disclosures within the purview of accounting and financial reporting?

Surprisingly, whether an entity should be categorized as a government or as a not-for-profit is not always obvious, and no definitive criteria exist to distinguish the two. The homeowners’
association of a residential development, for example, may carry out activities similar to those of a government—constructing and maintaining roads and providing utility and security services. Moreover, it may have the right to assess the residents’ annual fees. The following characteristics, in addition to the power to tax, are indicative of a government:

- **It may issue tax-exempt debt.** Section 103(a) of the Internal Revenue Code exempts the interest on the debt of states, territories, and their political subdivisions from federal taxation. This privilege is a substantial economic benefit to governments because it reduces their borrowing costs. Virtually all local governments qualify as subdivisions of states and territories. Not-for-profits, such as colleges, universities, and hospitals, do not have this opportunity. However, they may be the beneficiaries of it, as governments may be permitted, on a limited basis, to issue tax-exempt debt on their behalf.

- **Its governing bodies are either popularly elected or appointed by another government.** The governing body of a typical government is elected by the citizens within its jurisdiction. The governing boards of other governments, particularly public authorities, may be appointed by the legislature or by public officials of another government.

- **Another government can unilaterally dissolve it and assume its assets without compensation.** Under our legal system, a government can arbitrarily seize the assets only of other governments within its jurisdiction—not those of not-for-profits or businesses.3

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**WHAT ARE THE OVERALL PURPOSES OF FINANCIAL REPORTING?**

Financial statements have value only to the extent that they serve the needs of users. Having considered the characteristics of government and not-for-profit entities, we now consider the general purposes of financial statements and the groups most likely to use them. We can then address the need for specific objectives of financial reporting and can review the objectives developed by both the GASB and the FASB. The purposes for which external financial statements—those included in an annual report—are employed vary from user to user and facilitate a combination of functions.4 For the most part, they should allow users to:

- **Assess financial condition.** Users need to analyze past results and current financial conditions to determine the ability of the entity to meet its obligations and to continue to provide expected services. By establishing trends, users are better able to predict future fiscal developments and to foresee the need for changes in revenue sources, resource allocations, and capital requirements.

- **Compare actual results with the budget.** In light of the importance of the adopted budget, users want assurance that the entity adhered to it. Significant variations from the budget may signify either poor management or unforeseen circumstances that require an explanation.

- **Determine compliance with appropriate laws, regulations, and restrictions on the use of the funds.** Users want evidence that the organization has complied with legal and contractual requirements, such as bond covenants, donor and grantor restrictions, taxing and debt limitations, and applicable laws. Violations not only can have serious financial repercussions but can also jeopardize the entity’s viability.

- **Evaluate efficiency and effectiveness.** Users want to know whether the entity is achieving its objectives and, if so, whether it is doing so efficiently and effectively. Hence, they need to compare accomplishments (outcomes) with service efforts and costs (resource inputs).

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3 These characteristics have been drawn from Martin Ives, “What Is a Government?” *The Government Accountants Journal* 43 (Spring 1994): 25–33. They are similar to those that have been agreed upon by the American Institute of Certified Public Accountants (AICPA) and the Governmental Accounting Standards Board (GASB). See *State and Local Governments*, AICPA Audit and Accounting Guide (New York: AICPA, 2013), para. 1.12.

The main users of the financial statements of governments and not-for-profits—like those of the financial statements of businesses—are the parties to whom the organizations are accountable. They include

- Governing boards
- Investors and creditors
- Taxpayers and citizens and organizational members
- Donors and grantors
- Regulatory and oversight agencies
- Employees and other constituents

*General-purpose* financial statements are targeted mainly at parties external to the organization. As is the case in corporate accounting, reports intended for external groups are inappropriate for many types of managerial decisions. Executives, agency heads, and other managers can, and should, rely on their organization’s internal reporting system for the financial information they require. Nevertheless, the information needs of internal and external parties may overlap. Therefore, internal parties, though not intended to be principal users of general-purpose financial statements, may in fact rely on them for a considerable amount of necessary data.

This text focuses primarily on the information needs of external users and hence is concerned largely with general-purpose financial statements. However, special attention is also given to the interests of managers and other internal parties.

**GOVERNING BOARDS**

Just as the auditors’ reports on the financial statements of corporations are generally addressed to their boards of directors, those of governments and not-for-profits are directed to their governing boards. That the governing boards are the prime recipients of the audit reports strongly implies that they are among the principal users of both the auditors’ reports themselves and the accompanying financial statements.

A government’s governing body is typically an elected or appointed legislature, such as a city council or a board of commissioners. A not-for-profit’s governing body is usually a board of trustees or a board of directors.

Governing boards cannot neatly be categorized as either internal or external users. Customarily, they are composed of members from outside the management team. However, in almost all organizations they approve budgets, major purchases, contracts, employment agreements with key executives, and significant operating policies—thereby not only overseeing managers but also getting involved, sometimes directly, in the decisions that managers make.

**INVESTORS AND CREDITORS**

As noted earlier, neither governments nor not-for-profits have owners, and therefore they do not issue shares of stock. Nevertheless, they look to the same financial markets as do corporations to satisfy their capital requirements.

As shown in Figure 1-3, in the third quarter of 2016 state and local governments had an estimated $3.8 trillion of bonds outstanding. This compares with $8.4 trillion outstanding for U.S. corporations. The amounts highlight the economic significance of the municipal bond sector. The main purchasers of this debt are households (e.g., individual investors), money market funds, mutual funds, and insurance companies.
Both governments and not-for-profits issue bonds primarily to finance long-term assets. For governments, these include buildings, parking garages, office buildings, roads, highways, and utility systems. For not-for-profits, they include buildings, other facilities, and equipment.

Investors commonly acquire the bonds of governments and not-for-profits as part of an investment portfolio that also includes corporate securities. Their investment requirements are essentially the same as those for similar corporate bonds. They want assurance that the issuing entity will meet its obligations to make scheduled interest and principal payments. In a sense, therefore, the same group of investors constitutes the major users of business, government, and not-for-profit financial statements.

Many—probably most—bondholders do not themselves evaluate the bonds they acquire. Instead, they rely on the assessments of bond-rating services and are thereby only indirect users of financial reports. The three best-known rating services are Standard & Poor’s, Moody’s, and Fitch Ratings. These services assign a rating (e.g., AAA, AA, A, BBB) to publicly traded bonds reflective of the security’s risk of default.

Governments and not-for-profits also borrow routinely from banks and other financial institutions. The loans may either finance new facilities or cover short-term imbalances between cash receipts and cash disbursements. The lenders and potential lenders use the financial statements of the governments and not-for-profits just as they would those of corporations—to help assess the creditworthiness of the borrowers.

**FIGURE 1-3** Outstanding U.S. Bond Market Debt as of 4Q 2016


Citizens (or taxpayers) are invariably placed near the top of any list of government financial statement users. In reality, few citizens ever see the annual reports of the governments that have jurisdiction over them. Moreover, a government’s release of its annual report is seldom newsworthy. The reports are ordinarily issued at least three months after the close of the government’s fiscal year, and current reporting practices are anything but user friendly. The majority of the governmental entities make their financial statements available on the Internet in either the HTML form or as a PDF document and thus do not routinely have to send their reports to the local newspaper. In fact, few local newspapers have reporters who can understand and interpret these reports.
Nevertheless, the significance of citizens as a primary user group should not be underestimated. Citizens obtain financial data through a variety of “filters,” including civic associations such as the League of Women Voters, political action groups, and newspapers, TV, and radio. Even if they don’t pay attention to the annual report, they most definitely take notice, at any time of the year, of instances of fiscal mismanagement or other unforeseen circumstances that will cause unexpected revenue shortfalls or cost overruns.

The extent to which members of not-for-profit organizations are interested in either the statements themselves or the data derived from them depends largely on the size of the organization and their involvement in it. A larger percentage of a country club’s members can be expected to pay attention to their organization’s fiscal affairs—mainly because it has a direct impact on their dues and fees—than members of broad-based organizations such as the National Geographic Society or the American Automobile Association.

**DONORS AND GRANTORS**

Few individuals—including accountants—request financial statements each time they drop their coins into Salvation Army kettles or Muscular Dystrophy Association canisters. But major donors and grantors—such as the United Way; the Ford Foundation; and federal, state, and local governments—are more discriminating in how they part with their resources. They not only will request financial reports and other relevant fiscal information from supplicant associations but will also examine and analyze them with the same care as a banker making a loan.

In addition, individual donors can, and should, obtain financial information about a charity prior to contributing to it. They can inquire as to the organization’s allocation of resources, the proportion of its resources directed to substantive programs as opposed to fundraising, and the salaries of the most highly paid executives. Such data will likely be available from the organization itself, from state or local regulatory authorities, and from independent watchdog agencies such as Charity Navigator, GuideStar, and the Better Business Bureau’s Wise Giving Alliance (and are generally accessible on their websites).

**REGULATORY AGENCIES**

Local governments are normally obligated to file financial reports with state agencies; charitable organizations may have to file IRS Form 990 with the federal government as well as similar financial forms with either state or local authorities, and religious and fraternal associations may have to file financial reports with their umbrella organizations. The recipients of these reports use them to ensure that the entities are spending and receiving resources in accordance with laws, regulations, or policies; to help assess management’s performance; to allocate resources; and to exercise general oversight responsibility.

**EMPLOYEES AND OTHER CONSTITUENTS**

Few employees of governments or not-for-profits spend their off-hours poring over their organization’s financial statements. Still, officers of their unions or employee associations may examine them, looking for ways to free up resources for salary increases or projects in which they have a special interest.

Other constituent or interest groups also use financial reports on an ad hoc basis. Almost certainly, few readers of this text have ever seen the financial statements of the college or university they attend. However, students have been known to use budgets and annual reports to support claims that their college or university need not raise tuition, that it can afford a new student activities center, or that it should privatize a money-losing cafeteria or bookstore.
CHAPTER 1 The Government and Not-for-Profit Environment

As noted previously, the overall objective of financial reporting is to meet the information needs of statement users. But financial reports cannot possibly satisfy all the requirements of all users. Therefore, both the GASB and the FASB have established objectives that circumscribe the functions of financial reports. These objectives provide the foundation for their standards. Having agreed on objectives at the outset, the standard-setters should not have to determine the overall purpose of a proposed new standard each time they consider a specific accounting issue.

GASB OBJECTIVES

Taking into account the unique characteristics of governments and their environment, the Governmental Accounting Standards Board has established accountability as the cornerstone of financial reporting. “Accountability,” the GASB says, “requires governments to answer to the citizenry—to justify the raising of public resources and the purposes for which they are used.” It “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.” The GASB has divided the objective of accountability into three subobjectives:

• Interperiod equity. “Financial reporting should provide information to determine whether current-year revenues were sufficient to pay for current-year services.” It should show whether current-year citizens shifted part of the cost of services they received to future-year taxpayers.

• Budgetary and fiscal compliance. “Financial reporting should demonstrate whether resources were obtained and used in accordance with the entity’s legally adopted budget; it should also demonstrate compliance with other finance-related legal or contractual requirements.”

TABLE 1-3 Governmental Accounting Standards Board’s Additional Objectives of Financial Reporting

<table>
<thead>
<tr>
<th>Financial reporting should assist users in evaluating the operating results of the governmental entity for the year.</th>
</tr>
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<tbody>
<tr>
<td>a. Financial reporting should provide information about sources and uses of financial resources. Financial reporting should account for all outflows by function and purpose, all inflows by source and type, and the extent to which inflows meet outflows. Financial reporting should identify material nonrecurring financial transactions.</td>
</tr>
<tr>
<td>b. Financial reporting should provide information about how the government entity financed its activities and met its cash requirements.</td>
</tr>
<tr>
<td>c. Financial reporting should provide information necessary to determine whether the entity’s financial position improved or deteriorated as a result of the year’s operations.</td>
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</table>

<table>
<thead>
<tr>
<th>Financial reporting should assist users in assessing the level of services that can be provided by the governmental entity and its ability to meet its obligations as they become due.</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Financial reporting should provide information about the financial position and condition of a governmental entity. It should provide information about resources and obligations, both actual and contingent, current and noncurrent. The major financial resources of most governmental entities are derived from the ability to tax and issue debt. As a result, financial reporting should provide information about tax sources, tax limitations, tax burdens, and debt limitations.</td>
</tr>
<tr>
<td>b. Financial reporting should provide information about a governmental entity’s physical and other nonfinancial resources having useful lives that extend beyond the current year, including information that can be used to assess the service potential of those resources. This information should be presented to help users assess long- and short-term capital needs.</td>
</tr>
<tr>
<td>c. Financial reporting should disclose legal or contractual restrictions on resources and risks of potential loss of resources.</td>
</tr>
</tbody>
</table>

• **Service efforts costs and accomplishments.** “Financial reporting should provide information to assist users in assessing the service efforts costs and accomplishments of the governmental entity.” This information helps users assess the government’s “economy, efficiency, and effectiveness” and “may help form a basis for voting or funding decisions.”

The GASB established two additional objectives, each also having three subobjectives. These are set forth in Table 1-3.

The GASB objectives, taken independently, are unquestionably reasonable. But taken together, do they establish the basis for resolving specific issues and establishing specific standards? Consider the simplified example, “Clash Among Reporting Objectives.”

The district provided the new district with $10 million in start-up funds. During its first year of operations, the district prepared a cash-based budget and engaged in the following summary transactions, all of which occurred without variance from the budget.

- It purchased sanitation vehicles and other equipment for $10 million cash. The anticipated economic lives of the assets were 10 years.
- It billed residents for $9 million, but because bills for the last month of the year were not mailed until early the following year (as planned), it collected only $8.2 million.
- It incurred operating costs, all paid in cash, of $6 million.

Let us prepare a statement of revenues and expenditures that would embody accounting standards consistent with the GASB objectives. The distinction between expenses and expenditures, a term commonly used in government accounting, is drawn in a subsequent chapter. For now, consider them to be the same.

Two problems are readily apparent:

- How should the district report the expense related to the equipment? Should it use the $10 million paid to purchase the equipment or $1 million, an amount representative of the one-tenth of the assets consumed during the period? The broader question is whether governments should be required to depreciate their assets.
- How much revenue should the district recognize? Should it be the $9 million billed or the $8.2 million collected? More generally, should revenues be recognized on a cash or an accrual basis?

Inasmuch as the district prepared its budget on a cash basis, a statement of revenues and expenditures that would fulfill the GASB’s subobjective of reporting whether resources were obtained and used in accordance with the entity’s legally adopted budget would also have to be on a cash basis. The district would recognize the revenue as the cash is collected; it would record the vehicle-related expense in the period in which the vehicles are acquired and paid for. Thus (in millions):

<p>| | |</p>
<table>
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</thead>
<tbody>
<tr>
<td>Revenues from customers</td>
<td>$ 8.2</td>
</tr>
<tr>
<td>Operating expenditures</td>
<td>$ 6.0</td>
</tr>
<tr>
<td>Vehicle-related costs</td>
<td>10.0</td>
</tr>
<tr>
<td>Excess of revenues over expenditures</td>
<td>$ (7.8)</td>
</tr>
</tbody>
</table>

As a consequence of preparing statements on a cash basis—the same basis on which the budget was prepared—the entire cost of acquiring the long-term assets would fall on the taxpayers in the year of purchase. In the following nine years, the district would report no further expenses.

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related to the purchase or “consumption” of these particular vehicles. The financial statements
would thereby allow management to appear far more efficient in those years than in the first year.
In addition, if tax rates were set so that revenues would cover expenses, taxpayers would enjoy
a rate decrease. However, because the taxpayers of all 10 years will benefit from the assets, the
reporting objective of interperiod equity would not be served. On the other hand, the government
would be credited with only $8.2 million in revenues, even though it provided $9.0 million in
services—another, though reverse, violation of the interperiod equity concept.

By contrast, a statement that would fulfill the interperiod equity subobjective would rec-
ognize the $10 million in vehicle costs over the 10 years in which they would be used and the
$9.0 million in revenues in the years in which the services were provided. Thus:

<table>
<thead>
<tr>
<th>Revenues from customers</th>
<th>$9.0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating expenses</td>
<td>$6.0</td>
</tr>
<tr>
<td>Vehicle-related costs</td>
<td>1.0</td>
</tr>
<tr>
<td>Excess of revenues over expenses</td>
<td>$2.0</td>
</tr>
</tbody>
</table>

But the statement, prepared on a full accrual basis, cannot readily be compared with the
adopted budget and therefore cannot, without adjustment, be used to demonstrate budgetary
compliance.

As will be apparent throughout this text, the conflict between the two objectives of inter-
period equity and budgetary compliance characterizes many of the issues that government
accountants, and the GASB in particular, have to face in ensuring that financial statements are
informative and useful to the parties that rely on them. In particular, the conflict casts doubt on
whether the objectives can be fulfilled within a single set of financial statements or whether, as
an alternative, two sets—one on a full accrual basis, the other on a budget or near-budget basis—
might be necessary.

GASB STATEMENT NO. 34: TWO SETS OF FINANCIAL STATEMENTS

Upon its establishment in 1984, the GASB undertook to develop a new model for state and local
government reporting. However, owing to numerous controversial issues, it did not issue its final
pronouncement (Statement No. 34, Basic Financial Statements—and Management’s Discussion
and Analysis—for State and Local Governments) until June 1999. Statement No. 34 required the
most significant changes to the reporting model in 60 years and, in fact, does require that govern-
ments prepare the two sets of financial statements cited in the previous paragraph.

FASB OBJECTIVES

Financial Accounting Standards Board objectives for not-for-profit entities are, for the most part,
seemingly similar to those of the GASB for governments. They are presented, in summary form
in Table 1-4. However, a careful reading reveals significant differences in emphasis. These dis-
parities have resulted in accounting and reporting standards that give decidedly different looks
to the financial reports of the two types of entities. For example, FASB objectives refer only
obliquely to budgetary compliance. They provide that information should be useful in “assessing
how managers of a nonbusiness organization have discharged their stewardship responsibilities.”
In elaborating on this objective, the FASB stresses that external financial statements can “best
meet that need by disclosing failure to comply with spending mandates (which presumably are
expressed in budgets) that may impinge on an organization’s financial performance or on its
ability to provide a satisfactory level of services.” By contrast, the GASB makes budgetary and
What are the Specific Objectives of Financial Reporting as Set Forth by the GASB and the FASB?

Fiscal compliance a central concern of financial reporting. As a consequence, government financial statements incorporate numerous mechanisms to demonstrate that the entity has acted in accord with budgetary mandates, has adhered to the provisions of grants and contracts, and has complied with all applicable laws and regulations. These include reporting by fund, accounting for encumbrances (goods and services on order), and required actual-to-budget comparisons. Moreover, although the FASB statement of objectives, like that of the GASB, lists a wide range of potential users, in practice the FASB standards aim at a far narrower group of users—mainly donors and other contributors of resources.

Service Efforts and Accomplishments

GASB and FASB objectives both endorsed the notion that financial reporting encompasses information on service efforts and accomplishments (SEA). This information cannot easily be expressed in monetary units and is still only rarely included in the financial statements of either state and local government or not-for-profit organizations. Yet, the reporting of SEA performance information is important in assisting both governments and not-for-profits to demonstrate accountability to citizens and other resource providers. SEA reporting provides decision-useful information about an entity’s efficiency and effectiveness in providing services to its citizens and other constituents that is not included in traditional financial statements. In 1994, the GASB stressed the importance of SEA information by issuing Concepts Statement No. 2, Service Efforts and Accomplishments Reporting. Fourteen years later, after conducting research and constituent outreach, it reaffirmed the importance of SEA information by issuing Concepts Statement No. 5, Service Efforts and Accomplishments Reporting (An Amendment of GASB Concepts Statement No. 2). This statement reflected developments in SEA accounting and reporting that occurred in the years since Concept Statement No. 2 was issued. Then, in July 2010, the GASB further promoted SEA reporting by issuing Suggested Guidelines for Voluntary Reporting, SEA

**TABLE 1-4 Financial Accounting Standards Board’s Objectives of Financial Reporting**

- Financial reporting by nonbusiness organizations should provide information that is useful to present and potential resource providers and other users in making rational decisions about the allocation of resources to those organizations.
- Financial reporting should provide information to help present and potential resource providers and other users in assessing the services that a nonbusiness organization provides and its ability to continue to provide those services.
- Financial reporting should provide information that is useful to present and potential resource providers and other users in assessing how managers of a nonbusiness organization have discharged their stewardship responsibilities and about other aspects of their performance.
- Financial reporting should provide information about the economic resources, obligations, and net resources of an organization, and the effects of transactions, events, and circumstances that change resources and interests in those resources.
- Financial reporting should provide information about the performance of an organization during a period, periodic measurement of the changes in the amount and nature of the net resources of a nonbusiness organization, and information about the service efforts and accomplishments of an organization.
- Financial reporting should provide information about how an organization obtains and spends cash or other liquid resources, about its borrowing and repayment of borrowing, and about other factors that may affect an organization’s liquidity.
- Financial reporting should include explanations and interpretations to help users understand financial information provided.

Financial statements demonstrate what happened to an entity in the past. But they present the evidence from the perspective of the accountant who prepared them. Other accountants may describe the events differently. The underlying accounting principles dictate how the evidence is presented. In this section, we address the issue of whether differences in accounting principles really affect the decisions made on the basis of financial statements.

Just as a witness’s explanation of an accident cannot change what actually occurred, neither can an accountant’s report on an entity’s past transactions change what actually transpired. In the sanitation district example, the district paid $10 million in cash for vehicles, billed its customers $9 million for services, and paid $6 million in operating expenses. Whether the district’s financial statements report revenues over expenditures of $2 million, expenditures over revenues of $7.8 million, or any amount in between is irrelevant to the actual event. Moreover, financial statements, no matter how they are prepared, do not directly affect the economic worth of an entity. At year-end, the district’s customers owed it $0.2 million, irrespective of whether the district reports a receivable of that amount (as it would under an accrual basis of accounting) or of zero (as it would under a cash basis of accounting).

**USER ADJUSTMENTS**

Users of financial statements can be indifferent to how an entity’s fiscal story is told, as long as they are given adequate information to reconfigure the statements to a preferred form. Research in the corporate sector provides compelling evidence that stockholders are able to see through certain differences in accounting practices and adjust financial statements to take the differences into account. Thus, if one firm reports higher earnings than another solely because it employs more liberal accounting principles, the total market value of its shares may be no greater.

The “efficiency” of the municipal bond market—the extent to which it incorporates all public information in pricing securities—has been investigated much less than that of the corporate stock market. Nevertheless, the available evidence, albeit inconclusive, suggests that investors in tax-exempt bonds, like their stock market counterparts, understand the impact of differences in accounting practices.

**ECONOMIC CONSEQUENCES**

Accounting principles can—and frequently do—have economic consequences. Important decisions and determinations are made on the basis of financial data as presented and without adjustment.

As stated earlier, budgets are governments’ paramount financial documents. Most jurisdictions must present balanced budgets (expenditures cannot exceed revenues) in accord with accounting principles either that they select themselves or that are imposed on them by higher-order governments. The choice of accounting principles is critical. Whereas one set of accounting principles may result in a balanced budget, another set with identical revenue and expenditure proposals may not. Most governments budget on a cash or near-cash basis. If they were required to budget on a full accrual basis, their balanced budgets might quickly become unbalanced.

Governments may face restrictions on the amount of debt they can incur. The use of one set of accounting principles in defining and measuring debt (e.g., not recording a lease obligation as a liability) might enable them to satisfy the legal limits and thereby be permitted to issue additional bonds. The use of a different set (e.g., counting the lease obligation as a liability), might cause them to exceed the limits and be barred from further borrowing.
Other examples abound of how specific reporting practices have economic consequences. Many of these will be discussed again later in the book cite three:

- An alumnus makes a generous monetary gift to a university. He stipulates that the funds may be invested in stocks, bonds, and real estate, but only the income from the investment may be used to support university activities. If trading gains from the purchase and sale of the investments were accounted for as income, then the amount available to the university for expenditure would be significantly greater than if the gains were treated as an increase in the original capital.

- A government agrees to keep its pension plan fully funded—that is, to make sufficient annual contributions to ensure that the plan’s assets equal or exceed the plan’s actuarial liabilities. The way in which asset and liability values are established will determine its required annual payments.

- A city establishes a policy whereby it will contract out for any services that private vendors can provide for less than the city’s own departments can. The principles used to establish the cost of internal services will affect the decision to use internal departments or outside vendors.

### IN PRACTICE

**WILL ACCOUNTING CHANGES MAKE A DIFFERENCE?**

In 2004, the Governmental Accounting Standards Board adopted new rules pertaining to how governments must account for certain of their employees’ postretirement benefits. The rules were effective for large governments for periods beginning after December 15, 2006, and for smaller governments one or two years later. Prior to the pronouncement, most governments accounted on a “pay as you go” basis for health insurance to be provided to retirees; that is, they recognized an insurance expense only as they paid the premiums for the retirees. The rules require that they recognize an expense during the working years in which employees provide their services and thereby earn the benefits. To the extent that they don’t “fund” (put aside the necessary cash) the benefits as the employees earn them, they will have to report a liability.

Before the new rules were established, most governments did not fund their postretirement benefits. The new rules do not require that they now do so—only that they report a liability if they fail to do so.

Have the new rules encouraged governments either to fund their postretirement benefits or to modify the plans? The evidence is that some governments, started to fund the benefits and that many others reassessed whether they can still afford the benefits they have been granting.

Moreover, in 2015, the GASB modified the rules in a way that, for most governments, would significantly increase both their reported health care liability and annual expenses. Several public-sector employee labor unions spoke out strongly against the rule changes when they were proposed, fearing that they would inevitably cause their employer governments to cut back on their benefits.

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**Generally accepted accounting principles (GAAP)** embrace the rules and conventions that guide the form and content of general-purpose financial statements. These principles are expressed mainly in pronouncements of officially designated rule-making authorities and should be consistent with the objectives that they established. However, in the absence of pronouncements by those authorities, GAAP may also be derived from historical convention and widespread practice.


Each of the primary standard-setting authorities—the Governmental Accounting Standards Board (GASB) for state and local governments, the Federal Accounting Standards Advisory Board (FASAB) for the federal government, and the Financial Accounting Standards Board (FASB) for nongovernmental not-for-profits—has been sanctioned by the **American Institute of Certified Public Accountants (AICPA)** to establish accounting principles pursuant to Rule 203 of its Code of Professional Conduct.
Rule 203 provides that an auditor should not express an unqualified opinion on financial statements that are in violation of the standards established by the designated authorities. In addition, the AICPA provides accounting guidance on issues not yet addressed by either the GASB or the FASB. This guidance is now incorporated in the FASB’s Accounting Standards Codification.

Both the GASB and the FASB are supported by advisory councils composed of representatives of constituent groups—the Governmental Accounting Standards Advisory Council (GASAC) for the GASB and the Financial Accounting Standards Advisory Council (FASAC) for the FASB. The boards share facilities in Norwalk, Connecticut. The GASB currently has a full-time chair, a half-time vice chair, and five part-time members; the FASB has seven full-time members, including its chair.

Established in 1984, the GASB succeeded the National Council on Governmental Accounting (NCGA) as the standard-setting body for state and local governments. The NCGA, which was sponsored by the Government Finance Officers Association (GFOA), was thought to be too unwieldy (21 volunteer members) and inadequately staffed to deal with the complexities of modern government finance.

The FASB, created in 1973, has directed its attention mainly to business enterprises rather than not-for-profits. However, in 1979, it assumed responsibility for the not-for-profit and other specialized-industry accounting principles that had previously been addressed in the AICPA industry audit guides and Statements of Position. In 1980, the FASB issued its statement of objectives and standards dealing with the form and content of financial statements, depreciation, revenue recognition from contributions, and valuation of investments, as discussed previously and summarized in Table 1-4.

In 2002, in response to financial scandals involving Enron Corporation and the CPA firm of Arthur Andersen, Congress passed the Sarbanes–Oxley Act (Public Law 107-204). In an effort to enhance the independence of the FASB, it provided that the Board should no longer have to rely for funding on contributions from its constituents. Instead, it would be supported by fees from SEC registrants. Then, in 2010, as a consequence of the financial crisis of 2008, Congress passed the Dodd–Frank Wall Street Reform Act (Public Law 111-203). This bill provided that the GASB, like the FASB, will be funded mainly from an independent source—in this case fees from financial firms that engage in secondary trading of municipal securities.
ENTITIES COMMON TO GOVERNMENT AND NOT-FOR-PROFIT SECTORS

Soon after the GASB was established, it, the FASB, and its constituents faced a politically sensitive and potentially divisive issue: Which of the two should set standards for entities, such as colleges and universities that are common to the government and the not-for-profit sector? Some constituents of the two boards asserted that there are too few conceptual or operational differences between same-type entities in the two sectors to justify different accounting standards and hence separate standard-setting authorities. Others, however, contended that governmental hospitals, utilities, and universities differ fundamentally from their not-for-profit counterparts in that they have different rights, responsibilities, and obligations. For example, governmental entities may have the ability to impose taxes and to issue tax-exempt debt and may be accountable to the citizenry at large rather than to a board of trustees.

The jurisdiction issue was made more complex by concerns over sovereignty. Some managers of the not-for-profit entities maintained that they had little in common with state and local governments and did not want to be within the authority of the GASB. Similarly, state and local government officials refused to yield standard-setting control over any of their component units to the FASB, a board mainly concerned with the private sector.

In 1989, the Financial Accounting Foundation and the constituents of the two boards agreed on a jurisdictional formula that, in essence, reaffirmed the status quo: The GASB would have authority over all state and local government entities, and the FASB would have authority over all other entities. Thus, government colleges and universities (such as the State University of New York, University of California) are now within the purview of the GASB, and private colleges and universities (such as New York University, Rice University) are within the purview of the FASB.

If the GASB or the FASB has not issued a pronouncement on a particular issue, then the organizations under each of their jurisdictions can look to other sources for guidance. These other sources are set forth in two “hierarchies” that are now incorporated in GASB Statement...
CHAPTER 1  The Government and Not-for-Profit Environment

No. 76, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments,* and FASB Statement No. 168. The requirements in this GASB Statement improve financial reporting by (1) raising the category of implementation guidance in the GAAP hierarchy; (2) emphasizing the importance of analogies to authoritative literature when the accounting treatment for an event is not specified in authoritative GAAP; and (3) requiring the consideration of consistency with the GASB Concepts Statements when evaluating accounting treatments specified in nonauthoritative literature. As shown in Table 1-5, the GAAP hierarchy sets forth what constitutes authoritative GAAP for all state and local governmental entities. It establishes the order of priority of pronouncements and other sources of accounting and financial reporting guidance that a governmental entity should apply. In June 2009, the FASB issued Statement No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles,* which became the single official source of authoritative, nongovernmental U.S. GAAP. Thus, the FASB GAAP hierarchy includes only two levels of GAAP—authoritative (and in the Codification, Level 1 items in Table 1-5) and nonauthoritative (not in the Codification, Level 2 items in Table 1-5).

### TABLE 1-5  A Summary of the “Hierarchy” of Generally Accepted Accounting Principles

<table>
<thead>
<tr>
<th>Level</th>
<th>Governmental Entities (GASB)</th>
<th>Nongovernmental Entities (FASB)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Officially established accounting principles—GASB Statements&lt;sup&gt;a&lt;/sup&gt;</td>
<td>1. Authoritative:</td>
</tr>
<tr>
<td></td>
<td>GASB Technical Bulletins&lt;sup&gt;b&lt;/sup&gt;; GASB Implementation Guides&lt;sup&gt;c&lt;/sup&gt;; and literature of the American Institute of Certified Public Accountants (AICPA) cleared by the GASB.&lt;sup&gt;d&lt;/sup&gt;</td>
<td>FASB Statements and Interpretations; AICPA Accounting Research Bulletins; Accounting Principles Board Opinions; FASB Technical Bulletins; and AICPA Industry Audit and Accounting Guides, Statements of Position, and Practice Bulletins if cleared (not, objected to) by the FASB; consensus positions of the FASB Emerging Issues Task Force; Implementation guides published by the FASB staff; AICPA accounting interpretations and implementation guides</td>
</tr>
<tr>
<td>2.</td>
<td></td>
<td>2. Nonauthoritative:</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Practices widely recognized and FASB concepts statements, guidance from and prevalent generally or in professional and regulatory organizations, the industry; other accounting textbooks, handbooks, etc.</td>
</tr>
</tbody>
</table>

<sup>a</sup>Category (a) standards, including GASB Interpretations heretofore issued and in effect as of June 2015.

<sup>b</sup>Authoritative material from GASB Implementation Guides is incorporated periodically into the *Comprehensive Implementation Guide,* and when presented in the *Comprehensive Implementation Guide,* retains its authoritative status.

<sup>c</sup>AICPA literature, such as AICPA Industry Audit and Accounting Guides, cleared by the GASB is subject to the Memorandum of Understanding between the GASB and the AICPA.

<sup>d</sup>Such literature specifically made applicable to state and local governmental entities contains a statement that indicates that it has been cleared by the GASB (that is, the majority of the GASB members did not object to its issuance).

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<sup>6</sup> This Statement supersedes Statement No. 55, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments.* It also amends Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements,* paragraphs 64, 74, and 82. The requirements of this Statement are effective for financial statements for periods beginning after June 15, 2015, and should be applied retroactively.

<sup>7</sup> Authoritative GAAP is incorporated periodically into the *Codification of Governmental Accounting and Financial Reporting Standards* (Codification) and, when presented in the Codification, retains its authoritative status.
If the accounting treatment for a transaction or other event is not specified within a source of authoritative GAAP described in category a (Table 1-5), a governmental entity should consider whether the accounting treatment is specified by a source in category b (Table 1-5) and then may consider nonauthoritative accounting literature from other sources that does not conflict with or contradict authoritative GAAP.

Sources of nonauthoritative accounting literature include GASB Concepts Statements; pronouncements and other literature of the Financial Accounting Standards Board, Federal Accounting Standards Advisory Board, International Public Sector Accounting Standards Board, and International Accounting Standards Board and AICPA literature cleared by the GASB; practices that are widely recognized and prevalent in state and local government; literature of other professional associations or regulatory agencies; and accounting textbooks, handbooks, and articles.

Even though FASB standards are classified as nonauthoritative accounting literature, the influence of the FASB on the accounting practices of governments is greater than might appear from the hierarchies because governments engage in many business-type activities, such as operating utilities, parking garages, and hospitals. Per standards issued by the GASB, governments are required to account for these activities similar to their private-sector counterparts.

**FASAB FOR THE FEDERAL GOVERNMENT**

Although the U.S. government was constitutionally established in 1789, it was not until the republic was more than two centuries old that Congress enacted the Chief Financial Officers Act of 1990. The act acknowledged that the federal government was losing billions of dollars each year through financial mismanagement and that its accounting system was incapable of issuing comprehensive financial statements that could earn the government an unqualified audit opinion. The measure took the first steps toward elevating the federal government to a level of fiscal proficiency taken for granted by businesses and other governments. The act:

- Established a chief financial officer (CFO) for fiscal management, a new position housed within the Office of Management and Budget
- Created corresponding CFO positions in each of the federal departments and agencies
- Mandated that the federal government develop accounting systems capable of providing complete, accurate, and timely financial information
- Required that selected federal agencies prepare annual financial statements and make them subject to audits

The act also led the federal government’s “big three” agencies concerned with financial reporting—the Department of the Treasury, the Government Accountability Office (GAO), and the Office of Management and Budget (OMB)—to join forces to create the Federal Accounting Standards Advisory Board (FASAB). This board establishes accounting standards for both the federal government at large and the individual federal agencies.

The FASAB, like the GASB and the FASB, has issued a statement of objectives and a series of accounting standards and related pronouncements. As a result, there is now a reasonable degree of consistency among the reporting practices of federal agencies. Today, owing largely to the CFO act and the standards of the FASAB, federal accounting, although no means perfect, is tremendously improved over what it was prior to the act and the establishment of the board.

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8 Until 2004, the Government Accountability Office was known as the General Accounting Office. The new designation is intended to better encapsulate the agency’s main mission, which is to make the operations of the federal government more efficient and effective. GAO officials hope that it will dispel the common, but ill-conceived, image of the agency staff as the nation’s official bean counters.
Because of the unique features of the federal government, federal accounting is addressed in Chapter 17, apart from that pertaining to other governments.

SUMMARY

Governments and not-for-profits need accounting principles and reporting mechanisms that differ from those of businesses. They have objectives other than profit maximization. Therefore, their performance cannot be assessed by the conventional “bottom line” of businesses. Moreover, they are governed by their budgets rather than by the competitive marketplace.

Other characteristics of governments and not-for-profits also have significant accounting and reporting implications. Governments and not-for-profits are extremely diverse, and therefore one set of principles may not fit all entities. Managers tend to have a short-term focus and may strive to delay recognition of expenditures and advance recognition of revenues. Business-type activities may be part of the organization and have to be accounted for differently compared with governmental activities. The distinction between internal accounting and external accounting is often blurred.

Governments, unlike not-for-profits, have the authority to command resources through taxes and other fees. Therefore, a government’s financial wherewithal cannot necessarily be assessed by examining only the resources directly tied to the government itself. Those of its constituents may also have to be taken into account.

The main users of government and not-for-profit financial reports include governing boards, investors and creditors, citizens and organizational members, donors and grantors, regulatory and oversight agencies, and other constituents. Each group may have different information needs.

The GASB and the FASB have established objectives of financial reporting that stress the importance of providing information that enables users to assess interperiod equity and compliance with budgetary (or spending) mandates. Sometimes these objectives are in conflict in that a basis of accounting that satisfies one objective may not satisfy the other.

Choice of accounting principles has no direct effect on an entity’s fiscal history or current status. It might, however, have significant economic consequences if decisions are based on the data as presented.

KEY TERMS IN THIS CHAPTER

accountability 16  
American Institute of Certified Public Accountants (AICPA) 21  
budget 3  
expenditures 2  
Federal Accounting Standards Advisory Board (FASAB) 2  
Financial Accounting Standards Board (FASB) 2  
fiscal compliance 19  
fund accounting 7  
generally accepted accounting principles (GAAP) 21  
Governmental Accounting Standards Board (GASB) 1  
indeedependent, or third, sector 9  
intergenerational equity 9  
interperiod equity 5  
municipality 8  
not-for-profit 1  
revenues 2

QUESTIONS FOR REVIEW AND DISCUSSION

1. What is the defining distinction between for-profit businesses and not-for-profit entities, including governments? What are the implications of this distinction for financial reporting?
2. Why is the budget a far more important document for both governments and not-for-profits than for businesses?
3. How and why might the importance of the budget affect generally accepted accounting principles for external (general-purpose) reports?
4. What is meant by “interperiod equity,” and what is its consequence for financial reporting?
5. Why may the “matching concept” be less relevant for governments and not-for-profits than for businesses?
6. What is the significance for financial reporting of the many restrictions that are placed on a government’s resources?

7. Why is it difficult to develop accounting principles that are appropriate for governments within the same category (e.g., cities, counties) and even more difficult to develop them for governments within different categories?

8. What is the significance for financial reporting of a government’s power to levy a tax? How does it affect the government’s overall fiscal strength?

9. Why has it proven especially difficult to establish accounting principles to satisfy all three elements of GASB’s first objective of financial reporting in a single statement of revenue and expenditures or a balance sheet?

10. Why are measures of “service efforts and accomplishments” of more concern for government and not-for-profits than for businesses?

11. In what key ways does the FASB influence generally accepted accounting principles for governments?

12. Why is it more difficult to distinguish between internal and external users in governments than in businesses?

EX. 1–1

Select the best answer.

1. The traditional business model of accounting is inadequate for governments and not-for-profit organizations primarily because businesses differ from governments and not-for-profit organizations in that
   a. They have different missions
   b. They have fewer assets
   c. Their assets are intangible
   d. Taxes are a major expenditure of businesses

2. If businesses are “governed by the marketplace,” governments are governed by
   a. Legislative bodies
   b. Taxes
   c. Budgets
   d. State constitutions

3. The primary objective of a not-for-profit organization or a government is to
   a. Maximize revenues
   b. Minimize expenditures
   c. Provide services to constituents
   d. All of the above

4. In governments, in contrast to businesses,
   a. Expenditures are driven mainly by the ability of the entity to raise revenues
   b. The amount of revenues collected is a signal of the demand for services
   c. There may not be a direct relationship between revenues raised and the demand for the entity’s services
   d. The amount of expenditures is independent of the amount of revenues collected

5. The organization responsible for setting accounting standards for state and local governments is the
   a. FASB
   b. GASB
   c. FASAB
   d. AICPA
6. The number of governmental units in the United States is approximately
   a. 900
   b. 9,000
   c. 90,056
   d. 900,000

7. Governments differ from businesses in that they
   a. Do not raise capital in the financial markets
   b. Do not necessarily engage in transactions in which they “sell” goods or services
   c. Are not required to prepare annual financial reports
   d. Do not issue common stock

8. Interperiod equity refers to a condition whereby
   a. Total tax revenues are approximately the same from year to year
   b. Taxes are distributed fairly among all taxpayers, regardless of income level
   c. Current-year revenues are sufficient to pay for current-year services
   d. Current-year revenues cover both operating and capital expenditures

9. Which of the following is not one of the GASB’s financial reporting objectives?
   a. Providing information on the extent to which interperiod equity is achieved
   b. Ensuring that budgeted revenues are equal to or exceed budgeted expenses
   c. Reporting on budgetary compliance
   d. Providing information on service efforts and accomplishments

10. Which of the following is not one of the FASB’s financial reporting objectives?
    a. Providing information about economic resources, obligations, and net resources
    b. Providing information to help resource providers make rational decisions
    c. Reporting on budgetary compliance
    d. Providing information on service efforts and accomplishments

EX. 1–2

Select the best answer.

1. Rule 203 of the AICPA’s Code of Professional Conduct pertains to
   a. CPAs’ independence
   b. Authorities designated to establish accounting standards
   c. Standards of competency
   d. Solicitation of new clients by a CPA

2. Which of the following rule-making authorities would establish accounting standards for Stanford University (a private university)?
   a. The AICPA
   b. The FASB
   c. The FASAB
   d. The GASB

3. Which of the following rule-making authorities would establish accounting standards for the University of Wisconsin (a public university)?
   a. The AICPA
   b. The FASB
   c. The FASAB
   d. The GASB

4. If the GASB has not issued a pronouncement on a specific issue, which of the following is true with respect to FASB pronouncements?
   a. They would automatically govern
   b. They could be taken into account but would have no higher standing than other accounting literature
c. They are irrelevant
d. They could be taken into account by the reporting entity but only if disclosure is made in notes to the financial statements

5. The FASB is to the GASB as
   a. A brother is to a sister
   b. A father is to a son
   c. A son is to a father
   d. An aunt is to a niece

6. Standards promulgated by the FASB are most likely to be adhered to by which of the following governmental units?
   a. A police department
   b. A public school
   c. An electric utility
   d. A department of highways

7. Which of the following practices is most likely to undermine interperiod equity?
   a. Paying for a new school building out of current operating funds
   b. Paying the administrative staff of a school out of current operating funds
   c. Issuing 20-year bonds to finance construction of a new highway
   d. Recognizing gains and losses on marketable securities as prices increase and decrease

8. The term “independent sector” refers to
   a. States that have opted not to receive federal funds
   b. Not-for-profit organizations
   c. Churches that are unaffiliated with a particular denomination
   d. Universities that are not affiliated with a particular athletic conference

9. Which of the following is not an objective of external financial reporting by either the GASB or the FASB?
   a. To enable the statement user to detect fraud
   b. To disclose legal or contractual restrictions on the use of resources
   c. To provide information about how the organizations meet their cash requirements
   d. To provide information that would enable a user to assess the service potential of long-lived assets

10. Which of the following is the least appropriate use of the external financial statements of a government?
    a. To assess the entity’s financial condition
    b. To assess whether the compensation of management is reasonable in relation to that of comparable entities
    c. To compare actual results with the budget
    d. To evaluate the efficiency and effectiveness of the entity in achieving its objectives

EX. 1–3 Internet-based exercise

Go to the following websites and answer the questions.

a. Visit the GASB website (www.gasb.org)
   1. What is the GASB?
   2. What is the mission of GASB?

b. Visit the GFOA website (www.gfoa.org)
   1. What is the GFOA, and what role does it play?
   2. Describe briefly the Certificate of Achievement for Excellence in Financial Reporting Program (CAFR Program).
   3. Determine the number of state and local governmental entities that was awarded the CAFR Certificate for the last fiscal year.
Accompanying this text, on its website, is a Comprehensive Annual Financial Report (CAFR) of the city of Austin, Texas. A CAFR includes an entity’s year-end financial statements; it is not the same as its budget. Austin’s CAFR forms the basis of the “continuing problems” of these chapters. Download the CAFR, either from the website of the text or directly from that of the City of Austin (https://assets.austintexas.gov/financeonline/downloads/cafr/cafr2017.pdf) to your computer and practice navigating through it. Alternatively, with the consent of your instructor, you may obtain the CAFR of a different city, town, or county with a population of 100,000 or more.

A CAFR can generally be accessed from the city’s website or by writing to the governmental entity’s controller or finance director. Most institutions will provide the reports at no charge.

This continuing problem, unlike those in other chapters of the text, requires no written responses.

P. 1–1

Budgeting practices that satisfy cash requirements may not promote interperiod equity.

The Burnet County Road Authority was established as a separate government to maintain county highways. The road authority was granted statutory power to impose property taxes on county residents to cover its costs, but it is required to balance its budget, which must be prepared on a cash basis. In its first year of operations, it engaged in the following transactions, all of which were consistent with its legally adopted cash-based budget:

1. Purchased $10 million of equipment, all of which had an anticipated useful life of 10 years. To finance the acquisition, the authority issued $10 million in 10-year term bonds (i.e., bonds that mature in 10 years)
2. Incurred wages, salaries, and other operating costs, all paid in cash, of $6 million
3. Paid interest of $0.5 million on the bonds
4. Purchased $0.9 million of additional equipment, paying for it in cash; this equipment had a useful life of only three years
   a. The authority’s governing board levies property taxes at rates that will be just sufficient to balance the authority’s budget. What amount of tax revenue will it be required to collect?
   b. Assume that in the authority’s second year of operations, it incurs the same costs, except that it purchases no new equipment. What amount of tax revenue will it be required to collect?
   c. Make the same assumption as to the tenth year, when it will have to repay the bonds. What amount of tax revenue will it be required to collect?
   d. Comment on the extent to which the authority’s budgeting and taxing policies promote interperiod equity. What changes would you recommend?

P. 1–2

Financial statements of a government or not-for-profit organization may not provide sufficient information on which to make a loan decision.

Assume that you are a loan officer of a bank. A local church is seeking a $4 million, 20-year loan to construct a new classroom building. Church officers submit a comprehensive financial report that was audited by a reputable CPA firm. In the summary form (the actual statement showed details), the church’s statement of revenues and expenditures indicated the following (in millions):

<table>
<thead>
<tr>
<th>Statement</th>
<th>Amount (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues from dues and contributions</td>
<td>1.8</td>
</tr>
<tr>
<td>Revenues from other sources</td>
<td>0.2</td>
</tr>
<tr>
<td>Total revenues</td>
<td>2.0</td>
</tr>
<tr>
<td>Less: total expenditures</td>
<td>2.0</td>
</tr>
<tr>
<td>Excess of revenues over expenditures</td>
<td>0.0</td>
</tr>
</tbody>
</table>

The church prepared its financial statements on a near-cash basis, accounting for all capital asset acquisitions as expenditures when acquired.
The church’s balance sheet reported assets, mainly cash and investments (at market value), of $0.2 million. In addition, a note to the financial statements indicated that equipment is approximately $3 million. The church has no outstanding debt.

1. Is there any information in the financial statements that would make you reluctant to approve the loan? If so, indicate and explain.

2. Is there any other financial information of the type likely to be reported in a conventional annual report that you would like to review prior to making a loan decision? If so, indicate and explain.

3. Is there any other information, of any type, that you would like to review prior to making a loan decision? If so, indicate and explain.

4. Comment on the inherent limitations of the financial statements of this church, or any comparable not-for-profit organization, as a basis for making loan decisions.

P. 1–3

The dual objectives of assessing interperiod equity and ensuring budgetary compliance may necessitate different accounting practices.

A city engages in the transactions that follow. For each transaction, indicate the amount of revenue or expenditure that it should report in 2020. Assume first that the main objective of the financial statements is to enable users to assess budgetary compliance. Then calculate the amounts, assuming that the main objective is to assess interperiod equity. The city prepares its budget on a “modified” cash basis (that is, it expands the definition of cash to include short-term marketable securities), and its fiscal year ends on December 31.

1. Employees earned $128,000 in salaries and wages for the last five days in December 2020. They were paid on January 5, 2021.

2. A consulting actuary calculated that per an accepted actuarial cost method, the city should contribute $225,000 to its firefighters’ pension fund for benefits earned in 2020. However, the city contributed only $170,000, the amount budgeted at the start of the year.

3. The city acquired three police cars for $35,000 cash each. The vehicles are expected to last for three years.

4. On December 1, 2020, the city invested $99,000 in short-term commercial paper (promissory notes). The notes matured on January 1, 2021. The city received $100,000. The $1,000 difference between the two amounts represents the city’s return (interest) on the investment.

5. On January 3, 2020, the city acquired a new $10 million office building, financing it with 25-year serial bonds. The bonds are to be repaid evenly over the period they are outstanding—that is, $400,000 per year. The useful life of the building is 25 years.

6. On January 4, 2020, the city acquired another $10 million office building, financing this facility with 25-year term bonds. These bonds will be repaid entirely when they mature on January 1, 2042. The useful life of this building is also 25 years.

7. City restaurants are required to pay a $1,200 annual license fee, the proceeds of which the city uses to fund its restaurant inspection program. The license covers the period July 1 through June 30. In 2020, the city collected $120,000 in fees for the license period beginning July 1, 2020.

8. The city borrowed $300,000 in November 2020 to cover a temporary shortage of cash. It expects to repay the loan in February 2021.

P. 1–4

Do conventional financial statements satisfy the objectives of financial reporting?

The financial statements that follow were adapted from those of the University of Arizona. Both the statement of changes in fund balances and the notes to the statements have been omitted. Moreover, the statements show only the combined “totals” columns, whereas the actual statements are multicolumned, indicating the various restrictions placed on the university’s resources. Also, a few of the line items have been aggregated, and the dates have been changed.
The University of Arizona Balance Sheet, as of June 30 (in millions)

<table>
<thead>
<tr>
<th></th>
<th>2021</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and investments</td>
<td>$145</td>
<td>$145</td>
</tr>
<tr>
<td>Donated land</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Notes and accounts receivable</td>
<td>52</td>
<td>47</td>
</tr>
<tr>
<td>(net of allowances for uncollectibles)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventories and supplies</td>
<td>8</td>
<td>8</td>
</tr>
<tr>
<td>Physical properties</td>
<td>995</td>
<td>945</td>
</tr>
<tr>
<td>Total assets</td>
<td>$1,203</td>
<td>$1,148</td>
</tr>
<tr>
<td><strong>Liabilities and net assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$16</td>
<td>$17</td>
</tr>
<tr>
<td>Accrued payroll</td>
<td>12</td>
<td>10</td>
</tr>
<tr>
<td>Deferred revenue and deposits</td>
<td>9</td>
<td>8</td>
</tr>
<tr>
<td>Funds held for others</td>
<td>11</td>
<td>8</td>
</tr>
<tr>
<td>Capitalized lease obligations</td>
<td>36</td>
<td>33</td>
</tr>
<tr>
<td>Bonds payable</td>
<td>241</td>
<td>243</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>$325</td>
<td>$319</td>
</tr>
<tr>
<td>Net assets</td>
<td>$878</td>
<td>$829</td>
</tr>
</tbody>
</table>

The University of Arizona Statement of Revenues, Expenses, and Changes in Net Assets for Year Ending June 30 (in millions)

<table>
<thead>
<tr>
<th></th>
<th>2021</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Operating revenues</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tuition and fees</td>
<td>$112</td>
<td>$111</td>
</tr>
<tr>
<td>Grants and contracts</td>
<td>208</td>
<td>194</td>
</tr>
<tr>
<td>Sales and services of educational departments</td>
<td>8</td>
<td>6</td>
</tr>
<tr>
<td>Sales and services of auxiliary enterprises</td>
<td>69</td>
<td>66</td>
</tr>
<tr>
<td>Others</td>
<td>8</td>
<td>8</td>
</tr>
<tr>
<td>Total operating revenues</td>
<td>$405</td>
<td>$383</td>
</tr>
</tbody>
</table>

1. Based on the information included in the financial statements, respond as best you can to the following questions. If you believe the data in the financial statements are inadequate to answer the questions, then tell what additional information you would like and where you would most likely find it.
   a. Were the accomplishments of the university greater or less in 2021 than in 2020?
   b. Did the university achieve its goals more efficiently in 2021 than 2020?
   c. Are the university’s physical facilities adequate for the next two years? Ten years?
   d. Did the university’s long-term financial position improve or deteriorate between year-end 2020 and year-end 2021, taking account of the fiscal demands that will be placed on it in the future?
   e. Will the university be able to satisfy its short-term demands for cash?

2. Review the GASB and FASB objectives of financial reporting. Are any of the preceding questions inconsistent with those objectives? Comment on the extent to which conventional financial statements
satisfy the GASB and FASB objectives and what additional types of information they will likely have to incorporate to satisfy these objectives.

P. 1–5

The jurisdictional overlap among governments may have significant implications for financial reporting. Suppose that you live on a street adjoining the college in which you are taking this course.

1. List all the governments (e.g., state, county, city) that have jurisdiction over the residents or property of that street.

2. Indicate why it may be difficult to assess the financial wherewithal of one of those governments without taking into account the others. What are the implications for financial reporting of this jurisdictional overlap?

P. 1–6

Choice of accounting principles may have significant economic consequences.

In preparing its budget proposals, a city’s budget committee initially estimated that total revenues would be $120 million and total expenditures would be $123 million.

In light of the balanced budget requirements that the city has to meet, the committee proposed several measures to either increase revenues or decrease expenditures. They included the following:

1. Delay the payment of $0.4 million of city bills from the last week of the fiscal year covered by the budget to the first week of the next fiscal year.

2. Change the way property taxes are accounted for in the budget. Currently, property taxes are counted as revenues only if they are expected to be collected during the budget year. New budgetary principles would permit the city to include as revenues all taxes expected to be collected within 60 days of the following fiscal year in addition to those collected during the year. The committee estimates that the change would have a net impact of $1.2 million.

3. Change the way that supplies are accounted for in the budget. Currently, supplies are recognized as expenditures at the time they are ordered. The proposal would delay recognition of the expenditures until they are actually received. The committee estimates a net effect of $0.8 million.

4. Defer indefinitely $1.5 million of maintenance on city roads. Except as just noted with respect to supplies, the city currently prepares its budget on a near-cash basis, even though other bases are also legally permissible. It prepares its year-end financial statements, however, on an accrual basis.
   a. Indicate the impact that each of the proposals would have on the city’s (1) budget, (2) annual year-end financial statements, and (3) “substantive” economic well-being. Be sure to distinguish between direct and indirect consequences.
   b. It is sometimes said that choice of accounting principles doesn’t matter in that they affect only the way the entity’s fiscal “story” is told; they have no impact on the entity’s actual fiscal history or current status. Do you agree? Explain.

P. 1–7

Should there be differences in the accounting and reporting systems between governments and businesses that provide the same services?

A town privatized its sanitation department, selling all its plant and equipment to a private corporation. The corporation agreed to hire most of the department’s managers and other employees and was given an exclusive franchise, for a limited number of years, to offer the same service as previously provided by the town. When it operated the department, the town charged local residents fees based on the amount of trash collected. It set the scale of fees at a level intended to enable it to break even—to cover all its operating and capital costs, including interest on capital assets.
1. Do you believe that the objectives of financial accounting and external reporting of the private sanitation company should be any different from those of the town? Explain.

2. Do you see any differences in the information requirements of the internal managers now that they are employed by a private corporation rather than a government? If so, what are they?

P. 1–8

Capital acquisition decisions may be far more complex in not-for-profit organizations than in businesses.

The Chicago Youth Association (CYA) and the Palmer Athletic Club (PAC) are each considering purchasing a van.

The CYA is a not-for-profit organization serving at-risk inner-city youth. It operates a center that provides after-school tutoring, counseling, and supervised athletic activities. It would use the van mainly to drive students from their schools to the center and from the center back to their homes. The CYA estimates that the van would enable it to increase by 20 the number of students it serves at any one time. The CYA is supported entirely by contributions from the United Way and other private sources.

The PAC is a private, for-profit, athletic facility serving the youth of a suburban community. It provides access to athletic facilities and instruction in several sports, including swimming, tennis, and gymnastics. It would use the van for the same purpose as the CYA—to transport students to and from the facility. The PAC estimates that the van would enable it to increase center capacity by 20 customers, each of whom pays weekly fees of $65.

Each organization estimates that the incremental cost of serving the additional 20 clients (including the operating costs of the van) would be $50 per client per week. Each operates 50 weeks per year.

The two vans would each cost $30,000 and have estimated useful lives of three years. Each organization estimates that its cost of capital is 10 percent.

1. Should the PAC acquire the van? Explain and show all computations.

2. Should the CYA acquire the van? Explain and show all computations.

3. Comment on any critical differences between capital budgeting in a business and a not-for-profit organization.

P. 1–9

In a government, financial information that is appropriate for some purposes may be inappropriate for others—just as in business.

A city operates a computer service department. The department maintains and repairs the computers of all other city departments, billing them for each job performed. The billing rates are established to cover the repair service’s full cost of carrying out its function.

For the latest year available, the department reported the following (all amounts in millions):

| Revenues from billing other departments | $8.9 |
| Less: Expenditures | |
| Wages and salaries | $4.0 |
| Supplies | 2.6 |
| Other cash expenditures | 1.3 |
| Overhead allocated from other departments | 1.0 |
| Excess of revenues over expenditures | $8.9 |

The allocated overhead consists mainly of city administrative costs, most of which would remain the same even if the department were to cease operations. However, it also includes $0.3 million in rent. Were the department to be eliminated, the city could move its legal department into the space now occupied by the computer repair service department. The move would save the city $0.2 million, the amount currently paid in rent by the legal department.
A private corporation has offered to provide the same repair service as the computer department for $8.5 million.

1. Based on the limited data provided, should the city accept the offer from the private corporation? Comment on the relevance to this decision of the $8.9 million in total cost—the measure used to establish billing rates.

2. Suppose, instead, that the city did not allocate overhead costs, and hence total costs (and billing revenues) were only $7.9 million. Should the city accept the offer? Is the $7.9 million in unallocated costs any more relevant to this decision than the $8.9 million per the allocated statement?

P. 1–10

*Year-end financial accounting and reporting can reveal the economic substance of government actions taken mainly to balance the budget.*

Public officials, it is often charged, promote measures intended to make the government “look good” in the short term but that may be deleterious in the long term. Assume that the following actions, designed to increase a reported surplus, were approved by a city council:

1. It reduced the city’s contributions to the employee “defined benefit” pension plan from the $10 million recommended by the city’s actuary to $5 million to finance benefits earned in the current period. Under a defined benefit plan, the employer promises employees specified benefits on their retirement, and the level of benefits is independent of when and how much the employer contributes to the plan over the employees’ years of service.

2. It reduced by $1 million the city’s cash transfer to a “rainy day” reserve maintained to cover possible future reductions in tax collections attributable to a downturn in the region’s economy.

3. It sold securities that had been held as an investment. The securities had been purchased five years earlier at a cost of $2 million. Market value at the time of sale was $5 million.

4. It delayed until the following year $10 million of maintenance on city highways.

Assume that the city’s budget is on a cash or near-cash basis. Accordingly, each of these measures would, as the council intended, reduce budgetary expenditures or increase budgetary revenues.

a. Suppose you were asked to propose accounting principles for external reporting that would capture the true economic nature of these measures—actions that, in substance, did not improve the city’s fiscal performance or condition. For each measure, indicate how you would require that it be accounted for and reported.

b. Can you see any disadvantages to the principles that you propose?

P. 1–11

*Changes in how amounts are reported must be distinguished from those that affect their economic substance.*

The statement of net position (i.e., a balance sheet) of a midsized city reports outstanding debt of $1,200,000,000. The city has a population of 800,000. The city is about to adopt the provisions of a new GASB pronouncement that changes the way defined benefit pension plans are accounted for and reported. A defined benefit pension plan promises employees a certain amount of income after they retire. The payments to the retirees are dependent on their last years’ salary and the number of years that they have been employed.

Per the new rules the city will have to report on its balance sheet an additional $600,000,000 of pension liabilities. Such an amount was previously reported in the notes to the financial statements but was not accorded accounting recognition on the balance sheet itself. The new accounting rules affect only the way the pension obligation is reported; they have no effect on the actual promises made to current employees or those already retired.

1. Compute the city’s per capita debt (as reported on the statement of net position) prior to the adoption of the new accounting rules.
2. Compute the city’s per capita debt after the city adopts the new accounting rules.

3. In an editorial, the local newspaper wrote, “By increasing per capita debt by more 50 percent, the new rules put the city in a precarious fiscal position. Almost certainly the bond rating agencies will take notice and lower the city’s bond rating, thereby causing interest rates on any new debt that the city issues to increase significantly.”
   a. Do you agree with the newspaper editorial that the change in accounting principles will cause the city’s fiscal position to deteriorate? Explain.
   b. If you were an analyst with the agency that rated the city’s bonds, would the change in accounting principle cause you to lower the city’s credit rating? Explain.

1. This chapter has set forth several distinguishing features of state and local governments, the federal government, not-for-profit organizations, and businesses. Presently, there are separate standard-setting boards for state and local governments (the Governmental Accounting Standards Board) and the federal government (the Federal Accounting Standards Advisory Board). Yet, businesses and nongovernmental not-for-profit organizations are both within the purview of a single board (the Financial Accounting Standards Board). How can you justify such a standard-setting arrangement? Aren’t the characteristics of state and local governments and the federal government at least as similar to one another as those of not-for-profit organizations and businesses? Aren’t the characteristics of not-for-profits more similar to those of governments than to those of businesses?

2. Unquestionably, constituents of both governments and not-for-profits are no less interested in what the organization has accomplished than they are in financial data, such as revenues and expenses. How can you justify an accounting model and the resultant financial statements that fail not only to measure and report accomplishments but also to relate them to an entity’s revenues and expenses?