**CHAPTER ONE**

**INTRODUCTION TO ACCOUNTING AND FINANCIAL REPORTING FOR GOVERNMENTAL AND NOT FOR PROFIT ENTITIES**

Learning Objectives;

After studying this chapter, you should be able to:

* Identify and explain the characteristics that distinguish governmental and not-for-profit entities from for-profit entities.
* Identify the authoritative bodies responsible for setting financial reporting standards for (1) state and local governments, (2) the federal government, and (3) not-for-profit organizations.
* compare and Contrast the objectives of financial reporting for (1) state and local governments, (2) the federal government, and (3) not-for-profit organizations.
* Explain the minimum requirements for general purpose external financial reporting for state and local governments and how they relate to comprehensive annual financial reports.
* Explain the different objectives, measurement focus, and basis of accounting of the government-wide financial statements and fund financial statements of state and local governments.

**INTRODUCTION**

Governmental and not-for-profit organizations are vast in number and range of services provided. In the United States, **governments** exist at the federal, state, and local levels and serve a wide variety of functions. States, counties, municipalities (for example, cities and villages), and townships are **general purpose governments** (governments that provide many categories of services to their residents such as police and fire protection; sanitation; construction and maintenance of streets, roads, and bridges; and health and welfare).

Independent school districts, public colleges and universities, and special districts are **special purpose governments** (governments that provide only a single function or a limited number of functions such as education, drainage and flood control, irrigation, soil and water conservation, fire protection, and water supply). Special purpose governments have the power to levy and collect taxes and to raise revenues from other sources as provided by state laws to finance the services they provide.

**Not-for-profit organizations** also exist in many forms and serve many different functions. These include private colleges and universities, various kinds of health care organizations, certain libraries and museums, professional and trade associations, fraternal and social organizations, and religious organizations.

* 1. **Distinguishing Characteristics of Governmental and Not for Profit Entities**

Governmental and not-for-profit organizations differ in important ways from business organizations. Not surprisingly then, accounting and financial reporting for governmental and not-for-profit organizations are markedly different from accounting and financial reporting for businesses. An understanding of how these organizations differ from business organizations is essential to understanding the unique accounting and financial reporting principles that have evolved for governmental and not-for-profit organizations. In its *Statement of Financial Accounting Concepts No. 4,* the Financial Accounting Standards Board (FASB) noted the following characteristics that it felt distinguished governmental and not-for-profit entities from business organizations:

* Receipts of significant amounts of resources from resource providers who do not expect to receive either repayment or economic benefits proportionate to the resources provided.
* Operating purposes that are other than to provide goods or services at a profit or profit equivalent.
* Absence of defined ownership interests that can be sold, transferred, or redeemed, or that convey entitlement to a share of a residual distribution of resources in the event of liquidation of the organization.

**The Governmental Accounting Standards Board (GASB)** distinguishes governmental entities in the United States from not-for-profit entities and from businesses by underlining that governments exist in an environment in which the power ultimately rests in the hands of the people. Voters delegate that power to public officials through the election process. The power is divided among the executive, legislative, and judicial branches of the government so that the actions, financial and otherwise, of governmental executives are constrained by legislative actions, and executive and legislative actions are subject to judicial review. Further constraints are imposed on state and local governments by the existence of the federal system in which higher levels of government encourage or dictate activities by lower levels and finance the activities (partially, at least) by an extensive system of intergovernmental grants and subsidies that require the lower levels to be accountable to the entity providing the resources, as well as to the citizenry. Revenues raised by each level of government come, ultimately, from taxpayers. Taxpayers are required to serve as providers of resources to governments even though they often have very little choice about which governmental services they receive and the extent to which they receive them.

In the GASB’s view, accounting and financial reporting standards for governments must be separate and distinct from those for business organizations because the needs of users of financial reports are unique and different. This view is clear from a recent GASB white paper which notes that “governments do not operate in a competitive marketplace, face virtually no threat of liquidation, and do not have equity owners.” Consequently, governmental financial reporting focuses on a government’s stewardship of public resources, ongoing ability to raise taxes and manage resources, and compliance with legal spending limits, rather than on information about earnings. More specifically, the white paper states:

*Governmental accounting and financial reporting standards aim to address [the] need for public accountability information by helping stakeholders assess how public resources are acquired and used, whether current resources were sufficient to meet current service costs or whether some costs were shifted to future taxpayers, and whether the government’s ability to provide services improved or deteriorated from the previous year.*

* 1. **Sources of Financial Reporting Standards**

the primary sources of accounting and financial reporting standards for business and not-for-profit organizations, state and local governments, and the federal government are described as follows. Specifically, **the FASB** sets standards for for-profit business organizations and nongovernmental not-for-profit organizations; the **GASB** sets standards for state and local governments, including governmental not-for-profit organizations; and the Federal Accounting Standards Advisory Board **(FASAB)** sets standards for the federal government and its agencies and departments.

Authority to establish accounting and reporting standards for not-for-profit organizations is split between the FASB and the GASB because a sizeable number of not-for-profit organizations are governmentally owned, particularly public colleges and universities and government hospitals. The FASB is responsible for setting accounting and reporting standards for the great majority of not-for-profit organizations, those that are independent of governments. Governmental not-for-profit organizations follow standards established by the GASB.

The GASB and the FASB are parallel bodies under the oversight of the Financial Accounting Foundation. The foundation appoints the members of the two boards and supports the boards’ operations. The federal Sarbanes-Oxley Act greatly enhanced financial support for the FASB by mandating an assessed fee on corporate security offerings. The GASB, on the other hand, relies mainly on contributions from state and local government organizations and sales of publications for financial support of its operations. Because of the breadth of support and the lack of ties to any single organization or governmental unit, the GASB and the FASB are referred to as “independent standards-setting boards in the private sector.” Before the creation of the GASB and the FASB, financial reporting standards were set by groups sponsored by professional organizations: The forerunners of the GASB (formed in 1984) were the National Council on Governmental Accounting (1973–84), the National Committee on Governmental Accounting (1948–73), and the National Committee on Municipal Accounting (1934–41). The forerunners of the FASB (formed in 1973) were the Accounting Principles Board (1959–73) and the Committee on Accounting Procedure (1938–59) of the American Institute of Certified Public Accountants.

Federal statutes assign responsibility for establishing and maintaining a sound financial structure for the federal government to three officials: The Comptroller General, the Director of the Office of Management and Budget, and the Secretary of the Treasury. In 1990, these three officials created the Federal Accounting Standards Advisory Board (FASAB) to recommend accounting principles and standards for the federal government and its agencies. It is understood that, to the maximum extent possible, federal accounting and financial reporting standards should be consistent with those established by the GASB and, where applicable, by the FASB.

In Rule 203 of its Code of Professional Conduct, the American Institute of Certified Public Accountants (AICPA) has formally designated the GASB, the FASAB, the FASB as the authoritative bodies to establish generally accepted accounting principles (GAAP) for state and local governments, the federal government, and business organizations and nongovernmental not-for-profit organizations, respectively.

“Authority to establish accounting principles” is interpreted in practice to mean “authority to establish accounting and financial reporting standards.

* + 1. **Determining Whether a Not-for-Profit Organization Is Governmental**

We have discussed kinds of organizations for which the FASB and GASB are responsible for setting standards. Unfortunately, this is sometimes not the case. In practice, it may be difficult to determine whether some not-for-profits are governmental in nature or not, and thus which standards-setting body to look to for authoritative guidance. Public corporations and bodies corporate and politic are governmental organizations. Other organizations are governmental organizations if they have one or more of the following characteristics:

* Popular election of officers or appointment (or approval) of a controlling majority of the members of the organization’s governing body by officials of one or more state or local governments,
* the potential for unilateral dissolution by a government with the net assets reverting to a government, or
* the power to enact and enforce a tax levy.

Furthermore, organizations are presumed to be governmental if they have the ability to issue directly (rather than through a state or municipal authority) debt that pays interest exempt from federal taxation. However, organizations possessing only that ability (to issue tax-exempt debt) and none of the other governmental characteristics may disprove the presumption that they are governmental if their determination is supported by compelling, relevant evidence. Colleges and universities, hospitals, museums, and social service agencies are examples of organizations that may be either governmental or nongovernmental.

* 1. **Objectives of Financial Reporting**

GASB Concepts Statement No. 1, “Objectives of Financial Reporting,” states that “**Accountability** is the cornerstone of all financial reporting in government. Accountability requires governments to answer to the citizenry—to justify the raising of public resources and the purposes for which they are used.” The board elaborated:

*Governmental accountability 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. Financial reporting plays a major role in fulfilling government’s duty to be publicly accountable in a democratic society.*

Closely related to the concept of accountability as the cornerstone of governmental financial reporting is the concept the GASB refers to as **inter period equity**. The concept and its importance are explained as follows: The Board believes that inter period equity is a significant part of accountability and is fundamental to public administration. It therefore needs to be considered when establishing financial reporting objectives. In short, financial reporting should help users assess whether current-year revenues are sufficient to pay for services provided that year and whether future taxpayers will be required to assume burdens for services previously provided.

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| **State and Local Governments** | **Federal Government** | **Not-for-Profit Organizations** |
| Financial reporting is used in making economic, social, and political decisions and in assessing accountability primarily by:* Comparing actual financial results with the legally adopted budget.
* Assessing financial condition and results of operations
* Assisting in determining compliance with finance-related laws, rules, and regulations.
* Assisting in evaluating efficiency and effectiveness
 | Financial reporting should help to achieve accountability and is intended to assist report users in evaluating:* Budgetary integrity.
* Operating performance.
* Stewardship.
* Adequacy of systems and controls.
 | Financial reporting should provide information useful in:* Making resource allocation decisions.
* Assessing services and ability to provide services.
* Assessing management stewardship and performance.
* Assessing economic resources, obligations, net resources, and changes in them.
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 **Table 1.1. Comparison of Financial Reporting Objectives (State and Local Governments, Federal** **Government, and Not-for-Profit Organizations**

Accountability is also the foundation for the financial reporting objectives the FASAB has established for the federal government. The FASAB’s Statement of Accounting and Reporting Concepts Statement No. 1 identifies four objectives of federal financial reporting (see Table 1.1) focused on evaluating budgetary integrity, operating performance, stewardship, and adequacy of systems and controls. Unlike the FASB and the GASB, which focus their standards on external financial reporting, the FASAB and its sponsors in the federal government are concerned with both internal and external financial reporting. Accordingly, the FASAB has identified four major groups of users of federal financial reports: citizens, Congress, executives, and program managers. Given the broad role the FASAB has been assigned, its standards focus on cost accounting and service efforts and accomplishment measures, as well as on financial accounting and reporting.

Financial reports of not-for-profit organizations such as voluntary health and welfare organizations, private colleges and universities, private health care institutions, religious organizations, and others—have similar uses. However, as Table 1.1 shows, the reporting objectives for not-for-profit organizations emphasize decision usefulness over financial accountability needs, presumably reflecting the fact that the financial operations of not-for-profit organizations—as compared to those of governments— are generally subject to less detailed legal restrictions.

* 1. **Financial Reporting of State and Local Governments**

Like the FASB, the GASB continues to develop concepts statements that communicate the framework within which the Board strives to establish consistent financial reporting standards for entities within its jurisdiction. The GASB, as well as the FASB, is concerned with establishing standards for financial reporting to external users (those who lack the authority to prescribe the information they want and who must rely on the information management communicates to them). The Board does not intend to set standards for reporting to managers and administrators or others deemed to have the ability to enforce their demands for information.

Figure (1.1) displays the minimum requirements for general purpose external financial reporting under the governmental financial reporting model specified by GASB Statement No. 34 (GASBS 34). Central to the model is the **management’s discussion and analysis (MD&A).** The MD&A **is required supplementary information (RSI)** designed to communicate in narrative, easily readable form the purpose of the basic financial statements and the government’s current financial position and results of financial activities compared with those of the prior year. As shown in figure (1.1), GASBS 34 prescribes two categories of basic financial statements, **government-wide** and **fund**. Government-wide financial statements are intended to provide an **aggregated** overview of a government’s net assets and changes in net assets. The government-wide financial statements report on the government as a whole and assist in assessing **operational accountability** (whether the government has used its resources efficiently and effectively in meeting operating objectives).

The GASB concluded that reporting on operational accountability is best achieved by using essentially the same basis of accounting and measurement focus used by business organizations: the accrual basis and flow of economic resources measurement focus. Fund financial statements, the other category of basic financial statements, assist in assessing whether the government has raised and spent financial resources in accordance with budget plans and in compliance with pertinent laws and regulations. Certain funds, referred to as **governmental funds**, focus on the short-term flow of current financial resources or **fiscal accountability**, rather than on the flow of economic resources. Other funds, referred to as **proprietary and fiduciary funds,** account for the business-type and certain fiduciary activities of the government. These funds follow accounting and reporting principles similar to those of business organizations, although a number of GASB standards applicable to these funds differ substantially from FASB standards applicable to business organizations. These differences will be discussed in later chapters.

**Figure 1.1. Minimum Requirements for General Purpose External Financial Reporting—GASB Statement No. 34 Reporting Model**

Management's discussion
and analysis (MD &A)

Government-wide
financial statements Fund financial statements

 Notes to Financial Statements

Required supplementary information
(other than MD&A)