

WHY GOVERNMENTAL ACCOUNTING AND FINANCIAL REPORTING IS—AND SHOULD BE—DIFFERENT

EXECUTIVE SUMMARY

Governments are fundamentally different from for-profit business enterprises in several important ways. They have different purposes, processes of generating revenues, stakeholders, budgetary obligations, and propensity for longevity. These differences require separate accounting and financial reporting standards in order to provide information to meet the needs of stakeholders to assess government accountability and to make political, social, and economic decisions. Although state and local governments in the United States have had separate standards for over 100 years, occasionally the question is raised: Why can't general purpose governments (cities and counties, for example) simply apply the standards established for business enterprises?¹ The following questions and answers briefly address that issue, and the accompanying paper and its appendixes provide an expanded discussion.

WHY ARE SEPARATE ACCOUNTING AND FINANCIAL REPORTING STANDARDS ESSENTIAL FOR GOVERNMENTS?

Separate accounting and financial reporting standards are essential because the needs of users of financial reports of governments and business enterprises differ. Due to their unique operating environment, governments have a responsibility to be accountable for the use of resources that is significantly different from business enterprises. Although businesses receive revenues from a voluntary exchange between a willing buyer and seller, governments obtain resources primarily from the involuntary payment of taxes. Taxes paid by an individual taxpayer often bear little direct relationship to the services received by that taxpayer. Overall, taxpayers collectively focus on assessing the value received from the resources they provide to government. Governmental accounting and financial reporting standards aim to address this need for public accountability information by helping stakeholders assess how public resources are acquired and used, whether

¹ The term *business enterprise* is used to refer to private-sector entities organized for the purpose of earning profit. Business enterprises in the United States apply accounting pronouncements of the Financial Accounting Standards Board. *Business enterprise* does not refer to and should not be confused with business-type activities of governments.

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.

The longevity of government and its role to maintain and enhance the well-being of citizens through the provision of public services also result in information demands that differ from those of business enterprises. For example, governments do not operate in a competitive marketplace, face virtually no threat of liquidation, and do not have equity owners. Consequently, information on fair values of capital assets is of limited value and measures of net income and earnings per share have no meaning to users of governmental financial reports. Instead, users need information to assess the government's stewardship of public resources, including information to evaluate the manner and extent to which resources are devoted to specific services and the costs of providing those services. Users also need information to determine compliance with legally authorized spending authority. Creditors of both businesses and governments are interested in information on the ability to repay debt. However, government creditors focus more on information regarding the government's ongoing ability to raise taxes and the costs of activities that could compete for those resources, rather than on information about how earnings are generated.

HOW DO EXISTING ACCOUNTING AND FINANCIAL REPORTING STANDARDS REFLECT THE DIFFERENT NEEDS OF STAKEHOLDERS?

The needs of the users of governmental financial reports are reflected in differences in the components of the conceptual framework for accounting standards and in individual accounting standards. Although investors and creditors are important constituencies of every standards-setting organization, the Governmental Accounting Standards Board's (GASB) conceptual framework also places priority on addressing the informational needs of citizens and elected representatives, two constituencies not identified as users of business enterprise financial statements by the Financial Accounting Standards Board (FASB). Consequently, the GASB's financial reporting objectives consider public accountability to be the cornerstone on which all other financial reporting objectives should be built.

Some of the most significant GASB standards that address differences in governmental and business financial reporting include (1) the measurement and recognition of certain types of revenues (for example, taxes and grants), (2) the view that capital assets provide services to citizens rather than contribute to future cash flows, (3) the use of fund accounting and budgetary reporting to meet public accountability needs, (4) the use of accountability principles rather than equity control to define the financial reporting entity, and (5) the treatment of pensions and other postemployment benefits to allocate cost of services equitably to applicable periods. These and other accounting and reporting differences are described more fully beginning on page 11 and in Appendix B.

WHY IS THERE AN ONGOING NEED TO SET ADDITIONAL GOVERNMENTAL ACCOUNTING STANDARDS?

Since its inception in 1984, the GASB has strived to meet the needs of the users of governmental financial reports by issuing a number of important standards. Although the GASB has made progress, the need to develop and improve accounting standards for governments still exists. For example, additional components of the conceptual framework, which enhances consistency in setting government standards, are still being addressed. In addition, there are many important types of transactions, such as those associated with derivatives and intangible assets, for which there are no existing standards or for which existing standards are not comprehensive. The GASB's research agenda also includes, for example, a project to address additional ways to communicate results of government activities. Finally, over time governments and the governmental environment continue to change, resulting in an ongoing need to update existing standards and to adopt new standards.

WHY GOVERNMENTAL ACCOUNTING AND FINANCIAL REPORTING IS—AND SHOULD BE—DIFFERENT

INTRODUCTION AND SCOPE

From time to time, the question is raised as to why general purpose state and local governments (herein after referred to as “government”) cannot simply apply the same set of accounting standards that business enterprises² apply. This paper explains why separate standards for governments are needed. It illustrates some of the differences between standards for governments and those for business enterprises using standards for governments issued over the past twenty years, and explains why the process of standards setting for governments is an ongoing process.

In addition to providing greater detail about the questions in the Executive Summary, this paper also presents several appendixes. Appendix A provides an expanded discussion of the environmental differences between governments and business enterprises. Appendix B provides additional examples of standards that illustrate the differences between governments and business enterprises and expands upon the discussion of examples presented in this paper. Appendix C provides a historical perspective on the development of governmental accounting standards. Appendix D provides details on the significance of state and local governments in the United States. A brief glossary of governmental accounting terms is also included and begins on page 33. Terms defined in the glossary are printed in **boldface type** when they first appear.

The scope of this paper is limited to comparing general purpose governments to business enterprises. From time to time, the issue arises as to whether separate accounting standards are needed for other types of organizations, such as not-for-profit organizations. This paper neither supports the existing method of standards setting for other organizations not covered in the scope of this paper nor suggests that standards for those organizations should be set separately.

² See footnote 1 regarding the meaning of the term *business enterprises*.

Furthermore, governments in other countries may have different characteristics than governments in the United States; therefore, the paper does not address international differences.

WHY ARE SEPARATE ACCOUNTING AND FINANCIAL REPORTING STANDARDS ESSENTIAL FOR GOVERNMENTS?

Accounting and financial reporting requirements focus on the needs of the users of financial reports. Citizens and their elected representatives, such as legislatures, and other oversight organizations, as well as creditors, are primary beneficiaries of the information in governmental financial reports. Financial reports of business enterprises generally are used by creditors and by equity investors and their regulators, but not by a type of stakeholder equivalent to citizens and their elected representatives.³ The needs of citizens and oversight organizations emphasize **accountability** for resources entrusted to the government, and the needs of equity investors emphasize information necessary to make rational investment, credit, and similar decisions. Accountability, in a general sense, is a responsibility of stewards or agents to provide relevant and reliable information relating to resources under their control. For governments, accountability is the government's responsibility to justify to its citizenry the raising of public revenues and to account for the use of those public resources. Accountability information can be used to support decision making, but it also fulfills the citizenry's "right to know" how public resources have been spent.

Creditors are a type of user of both governmental and business enterprise financial reports. Although they are generally looking for assurance that sufficient cash flows will be available to meet debt service requirements, certain information they seek from governments and from business enterprises is different because the source of debt repayment is different. Creditors and potential creditors of business enterprises seek information about how earnings are generated. Creditors and potential creditors of governments seek information about the ability and willingness to levy taxes to finance debt repayment and the costs and obligations of those activities that could compete for those resources.

³ Elected representatives, such as legislators, are considered external users of financial reports because in many cases these individuals do not have access to the same internal financial data as do officials in the executive branch.

Although certain types of information in business enterprise financial reports could satisfy some needs of certain governmental financial report users, other users require different information. The accountability focus of governments and the broad range of sources of a government's resources lead to the conclusion that ideally governmental financial report users should be able to find additional information that will help answer questions such as the following:

- Did the government's ability to provide services improve or deteriorate from the previous year?
- Were the government's current-year taxes and other sources of resources sufficient to cover the cost of current-year services? Was part of the burden of paying for current services shifted to future-year taxpayers?
- How did the government finance its activities and meet its cash requirements? Does the government have the capacity to meet future obligations?
- What are the government's spending priorities? What sources of resources support the various programs? Has the government obtained and used resources in accordance with its adopted budget and other legal requirements?
- What resources currently are available for future expenditures and to what extent are resources reserved or restricted for specified uses?
- Has the government provided its services in an efficient and effective manner?

MAJOR ENVIRONMENTAL DIFFERENCES BETWEEN GOVERNMENT AND BUSINESSES

The differing needs of the users of governmental and business enterprise financial reports reflect the different environments in which the organizations operate. Some of the principal environmental differences are:

ORGANIZATIONAL PURPOSES. The purpose of government is to enhance or maintain the well-being of citizens by providing public services in accordance with public policy goals. Major public services provided by state and local governments include public safety, education, health, and transportation. Among other reasons, government provides these services because the economic incentives are not sufficient for business to provide them at the quantity, quality, and

price considered appropriate by public policy. Return on investment is not a goal for governments, so they need to develop and report other measures of accomplishment. The predominant business enterprise performance measures—net income and earnings per share—have no meaning in a governmental environment. Instead, governments focus on providing services and goods to constituents in an efficient, effective, economical, and sustainable manner. A government’s financial reports should give creditors, legislative and oversight officials, citizens, and other stakeholders the information necessary to make assessments and decisions relevant to their interests in the government’s accomplishment of its objectives.

In contrast, business enterprises focus on wealth creation, interacting only with those segments of society that fulfill their mission of generating a financial return on investment for shareholders. Historically, the primary focus of reporting has been on earnings and its components, with little or no explicit focus on nonfinancial measures of performance.

SOURCES OF REVENUE. The principal source of revenue for government is taxation, which is a legally mandated involuntary transaction between individual citizens and businesses and their government. The principal source of revenue of business enterprises is voluntary **exchange transactions** between willing buyers and sellers.

Because the assessment and the collection of taxes are not transactions in which equal values are exchanged at arm’s length and are not the culmination of an earnings process as are most transactions of business enterprises, transactions involving taxes require specialized accounting treatment. For example, governments may collect property taxes in a period prior to the period for which the taxes legally apply. The question then arises whether governments should record the taxes as revenue in the year collected or attribute them to the year for which the taxes apply. The GASB has addressed this issue by requiring that property taxes be reported as revenue in the period for which levied. This promotes assessment of **interperiod equity** by associating costs of services with revenues collected to finance those services.

POTENTIAL FOR LONGEVITY. Because of their ongoing power to tax and because of the ongoing need for public services, governments rarely liquidate. The possibility of achieving longevity, however, is not as likely for business enterprises. Business enterprises will go out of

existence if, for an extended period of time, they are unable to sell their products or services for more than it costs to produce them. Further, a business may also cease to exist if it is acquired by another entity. Financial statements of business enterprises generally are prepared using a “going-concern” assumption, meaning that assets and liabilities are not adjusted to their liquidation values; however, this is not equivalent to a presumption of extended longevity. Users of business enterprise financial statements may use those statements to assess longevity. In financial statements of business enterprises, emphasis is placed on the recoverability of assets, such as through future sales, and on the fair values of certain assets and liabilities. In contrast, the ability of governments to exist in the future generally is not in doubt, but rather the question is the sustainability of the level of services provided and the ability to meet future levels of demand for services. As a result, the emphasis generally has been on the allocation of resources to government programs, the determination of the cost of services (as noted above), and providing a longer term view of operations.

The longer term view of operations of government is consistent with focusing on trends in operations, rather than on short-term fluctuations, such as in fair values of certain assets and liabilities. Immediate recognition of changes in fair values of assets set aside in employee benefit plans is appropriate accountability reporting in the employee benefit plans that hold those assets. However, it is not appropriate for government employers to immediately recognize those fair value changes or changes in accrued actuarial liabilities resulting from a change in benefit plan terms. These short-term fluctuations could produce a measurement of the period’s employee benefit costs, which are included in cost of services, that may be less decision-useful for governmental financial report users. Financial reporting by business enterprises is more likely to recognize such changes in fair value because of the importance of the current value of equity.

RELATIONSHIP WITH STAKEHOLDERS. Individual citizens must pay taxes as agreed to by the citizenry collectively through elections or decisions of elected representatives, and as previously noted, individual taxes paid are not directly correlated with services received. Accordingly, governments should meet a standard of accountability that is broader than for business enterprises. Furthermore, citizens are interested in evaluating interperiod equity by determining whether current taxpayers and users of government services fully financed the costs

of providing current-period services or whether taxes and user fees from prior or future periods were, or will be, needed to finance the current services provided. Consequently, one important focus of governmental financial reporting is on providing systematic and rational cost-of-service information. Additionally, users of financial reports may wish to evaluate the combination of taxes, user fees, grants, and borrowings used to finance current services. In contrast, because business enterprises focus primarily on increasing shareholders' equity, their financial reports show changes in equity of the enterprise during the current period. Except for those with large blocks of shares, public company shareholders typically can easily end their relationship with any individual business enterprise by selling their shares and, consequently, focus on the current and future value per share.

ROLE OF THE BUDGET. For governments, a budget takes on a special legal significance. Governmental budgets are expressions of public policy priorities and legally authorize the purposes for which public resources may be spent. In fact, governmental budgets can be the primary method by which citizens and their elected representatives hold the government's management financially accountable. For business enterprises, the budget represents an internal financial management tool that is controlled entirely by management and is considered proprietary in nature.

HOW DO EXISTING ACCOUNTING AND FINANCIAL REPORTING STANDARDS REFLECT THE DIFFERENT NEEDS OF STAKEHOLDERS?

The differences in the needs of users of financial reports of governments and business enterprises are reflected both in differences in components of the **conceptual framework for accounting standards** and in the individual accounting standards set by the GASB and the FASB.

CONCEPTUAL FRAMEWORK DIFFERENCES

Both the GASB and the FASB have developed Concepts Statements setting forth the objectives of financial reporting. The objectives are the central core of the conceptual

frameworks for standards and reflect the differing needs of users of financial reports of governments and business enterprises.⁴ Reflecting the needs of their stakeholders, including citizens and their elected representatives, governments predominantly focus on accountability in financial reporting. For governments, information necessary to make political and social decisions is as important as information necessary to make economic decisions in shaping accounting and financial reporting objectives. Reflecting the needs of the stakeholders of business enterprises, including equity investors, financial reporting of business enterprises predominantly focuses on financial performance—earnings and its components. For business enterprises, information for making economic decisions is most important in shaping accounting and financial reporting objectives.

In recognizing that users of governmental financial reports are also interested in assessing nonfinancial performance of governments, the GASB recognized the importance of these measures in Concepts Statement No. 1, *Objectives of Financial Reporting*. The objectives, elements, and characteristics of service efforts and accomplishments (SEA) reporting were expanded on in GASB Concepts Statement No. 2, *Service Efforts and Accomplishments Reporting*. The objective of SEA reporting is to provide more complete information about a governmental entity's performance than can be provided by the traditional financial statements and schedules to assist stakeholders in assessing the economy, efficiency, effectiveness, and sustainability of services provided. To promote achievement of the objective of SEA reporting, SEA information focuses primarily on measures of service accomplishments (outputs and outcomes) and measures of the relationships between service efforts and service accomplishments (efficiency). On the other hand, business enterprise financial reporting objectives do not recognize nonfinancial reporting measures. Although some believe that it would be beneficial to require business enterprises to report certain nonfinancial measures, competitive considerations of business enterprises may limit the amount of information that

⁴The conceptual framework of the GASB is not yet complete, although the GASB recently issued Concepts Statement No. 3, *Communication Methods in General Purpose External Financial Reports That Contain Basic Financial Statements*, and is currently developing another Concepts Statement to define the elements of financial statements. The conceptual framework of the FASB is currently being revisited in conjunction with considerations for convergence with the International Accounting Standards Board.

could be provided. Some nonfinancial measures that would provide decision-useful information to financial report users might also be considered “trade secrets” that would threaten the competitiveness of a business.

The GASB’s project to define the elements of financial statements is not yet complete, but even now it is clear that the definition of an asset for governments will differ from the definition for business enterprises. One of the inherent characteristics of an asset is that it provides future benefit. The future benefit that governments recognize is an asset’s ability to contribute to providing the public services and goods that are the mission of government. Assets such as roads, courthouses, libraries, and parks directly provide public services or goods. Other types of assets, such as investments, indirectly contribute to providing public services and goods when they produce cash used to acquire public services and goods. For business enterprises, the only future benefit provided by an asset is its economic benefit—a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows. As the conceptual framework progresses, other differences may well be identified.

ACCOUNTING STANDARDS DIFFERENCES

- ***CAPITAL ASSETS.*** As noted earlier, governments acquire most capital assets because of the asset’s capacity to provide services to the citizenry, whereas business enterprises acquire capital assets with the objective of using them to generate future cash flows. Consequently, GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, prescribes a method of assessing and measuring impairment of capital assets that reflects reductions in service potential of capital assets as a result of impairing events or changes in circumstances because the purpose of government is to provide services. In contrast, business enterprises assess and measure impairment of capital assets by evaluating the future cash flows expected to be produced by the asset because the purpose of business enterprises is to create wealth.
- ***PROPERTY TAXES.*** Generating property tax revenue is a transaction unique to government, and, as previously noted, accounting standards for taxation should reflect reporting of property taxes as revenues in the same period as the cost of the services for

which they were levied to pay in accordance with the need of users of governmental financial statements to assess interperiod equity. For this revenue source, governments control all major events associated with potential points of recognition. Governments establish the assessment dates, the levy dates, the collection or due dates, and the periods for which the taxes are levied.

- **FUND ACCOUNTING.** Fiscal accountability for governmental activities is achieved by preparing financial statements using the **current financial resource flows measurement focus**—the long-standing measurement focus of **governmental funds**—and a **modified accrual basis of accounting**. This measurement focus emphasizes control and accountability over the raising and spending of public moneys. Financial reporting for governmental fund activities allows stakeholders to assess whether sufficient resources (generally cash and other liquid assets) existed to finance the current period’s activities. This assessment is particularly important to those who pay taxes and receive services. Fiscal accountability is demonstrated, for example, when governments prepare fund-based financial statements, which show whether resources were obtained and used in accordance with the legally adopted budget and in compliance with other finance-related legal or contractual requirements. GASB Statement No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, requires governments to report a balance sheet and a statement of revenues, expenditures, and changes in fund balances for their general fund, other major governmental funds, and other governmental funds in the aggregate. Governments also demonstrate accountability through reporting financial statements of fiduciary funds, which are used to report assets held in a trustee or agency capacity for others and therefore cannot be used to support the government’s own programs. These funds are not reported as part of the resources available to finance public services and goods, but rather are reported separately to demonstrate accountability for these resources.
- **PENSIONS AND OTHER POSTEMPLOYMENT BENEFITS (OPEB).** Financial reporting standards for pensions and OPEB for both governments and business enterprises are similar in that they are based on the concept that these benefits are deferred compensation for employee services and should be accounted for in accrual-basis statements as the benefits

are earned, rather than when paid. Moreover, both sets of standards currently include provisions for deferral and amortization for past service costs. Beyond that, however, the measurement approaches adopted for use in the public and private sectors are different, as are many of the specific measurement and presentation choices, for reasons rooted in the different environments and the different information needs of stakeholders.

The longevity of governments, the importance of the cost-of-services information, and the desire of stakeholders to measure interperiod equity all influence the GASB's standards for defined benefit pension and OPEB plans. The focus of business enterprise accounting for pension benefits and OPEB worldwide generally appears to be moving toward the measurement of the fair values of pension or OPEB assets and liabilities.

The pension accounting approach for governments (subsequently adapted for use for OPEB as well) explicitly harmonizes accounting with the actuarial funding characteristics of public pension plans. Governmental accounting standards permit the use of a number of actuarial cost and amortization methods commonly used in actuarial valuations for funding purposes that are also appropriate for accrual accounting purposes. This approach was based on research studies conducted with financial statement users at the time the pension standards were being developed. As long as the individual government's funding approach met established accrual-based parameters, the transparency sought by most governmental financial statement users was achieved. As applied by government employers and pension plans, these parameters make it possible to allocate expenses to periods in a way that charges each period a level percentage of payroll for normal cost. This method equitably spreads the burden of an ongoing benefit program among different generations of taxpayers.

Additional differences in accounting standards that reflect differences in user needs are, for example, seen in: (1) the financial reporting model, (2) the definition of the reporting entity, (3) service-oriented infrastructure assets, (4) grants and gifts, and (5) debt refundings. Additional information about these accounting differences is included in Appendix B.

WHY IS THERE AN ONGOING NEED TO SET ADDITIONAL GOVERNMENTAL ACCOUNTING STANDARDS?

Although much progress has been made, there is a need to set additional accounting standards for governments. For example, the current technical agenda includes projects on derivatives and on pollution remediation obligations. The Derivatives project is expected to determine whether derivatives, such as the floating-to-fixed interest rate swaps that are becoming more prevalent in government, should be displayed at fair value on financial statements, whether hedge accounting (deferring recognition of changes in fair value of certain derivatives) will be permitted, and, if so, what criteria should be met to use hedge accounting, as well as whether current derivative note disclosures are adequate. The project on pollution remediation obligations is expected to provide guidance on which specific events or circumstances give rise to a pollution remediation obligation as well as establish the methods for measuring and reporting these obligations at the various stages throughout a remediation effort.

Over the years, the number of research and potential technical agenda projects has continued to grow. The number of projects in these categories now exceeds the current technical agenda items by more than 2 to 1. Some of these projects and their objectives are briefly described below.

- Electronic Reporting project—to assess the potential effect of electronic media on information delivery and stakeholder needs
- Fiduciary Responsibilities project—to assess whether additional guidance should be developed regarding the application of the criterion “fiduciary responsibility” in deciding whether and how governments should report fiduciary activities, such as employee benefit plans and prepaid tuition arrangements, in their financial reports
- Financial Performance Reporting project—to determine the best method to present changes in fair values in the statement of activities; statement of revenues, expenses, and changes in fund balance; statement of revenues, expenses, and changes in fund net assets; and statement of changes in fiduciary net assets

- Government Combinations project—to determine the financial reporting requirements related to accounting for annexations, consolidations, or other forms of nonpurchase combinations
- In-kind Contributions project—to provide accounting and financial reporting guidance for contributed services received by state and local governments
- Preservation Method of Accounting project—to determine if reported changes in asset condition levels (associated with the modified approach of accounting for infrastructure assets) can be measured in monetary terms that meet the qualitative characteristics for financial reporting
- Service Efforts and Accomplishments Reporting project—to encourage the use and reporting of performance measures and, based on their use, to determine whether performance measures have developed to the point where the GASB will consider establishing a current technical agenda project on SEA reporting.

The environment in which governments operate also fuels the need for new projects. These governments are a significant component of the United States economy, generating 20 percent of gross domestic product, employing 12 percent of the nation's workforce, and issuing of over \$1.7 trillion in bonds. As with other components of the economy, the activities and transactions of the governments continue to change and often increase in complexity. For example, some governments recently issued bonds secured with proceeds from a master settlement agreement with the major tobacco companies. These transactions often involved new and complex legal structures. The GASB issued Technical Bulletin 2004-1, *Tobacco Settlement Recognition and Financial Reporting Entity Issues*, to address accounting for these transactions. As governments have expanded their activities in selling and pledging other types of receivables and future revenues, the GASB has determined that additional and broader standards are necessary. A comprehensive project on sales and pledges of receivables and future revenues was begun that led to an Exposure Draft on this issue in September 2005. Given the increasing complexity of government transactions and the fact that the governmental environment continues to change, such as with growing interdependencies among different levels of government, the number of research and potential projects is expected to continue to grow.

CONCLUSION

Governments are fundamentally different from business enterprises. As a result, separate accounting and financial reporting standards for governments are essential to meet the specific needs of the users of governmental financial reports. The standards for governments need to reflect the unique environment of government, including different organizational purposes and special legal powers, and to effectively address public accountability issues inherently related to the unique government environment.

APPENDIX A

DISTINGUISHING CHARACTERISTICS OF THE GOVERNMENTAL ENVIRONMENT

ORGANIZATIONAL PURPOSES

As stated in GASB Concepts Statement 2 (paragraph 48), the principal purpose of governments is to provide services that enhance or maintain the well-being of their citizens. Government services, such as establishing and maintaining the legal system, and providing public safety, education, health, and transportation services are necessary for enhancing or maintaining the well-being of citizens. However, those services generally would not be provided by the private sector to the populace at the quantity, quality, and price considered appropriate by public policy. The private sector, which focuses primarily on generating a financial return on investment, could not make a profit by providing most of these services, in an equitable manner, to the citizenry. The purpose of government is not to generate a financial return on investment, but rather to provide public services and goods as determined through the political process in an effective and efficient manner. As discussed below, even when governments provide the same type of services as a business enterprise, such as hospital services, the government does not do so with the intention of earning a profit.

Other circumstances that governments are expected to address are when the cost of a service or good is not exclusively borne by the producer or when the benefit of a service or good is not exclusively enjoyed by the purchaser of the service or good. For example, emission of pollutants is a cost that often is borne by society as a whole rather than the individual or business generating the pollutants. Business enterprises that create pollution may appear to be more efficient and may be more competitive because certain costs are passed on to citizens. An example of a service with a benefit that is not exclusively enjoyed by the purchaser is vaccination against communicable disease. This benefits not only the individual vaccinated but also any individuals who might otherwise have contracted the disease through contact with the vaccinated individual. Again, the role of government regarding such circumstances may be to provide the service or good or to regulate it.

The importance of public services and goods to government, and of viewing the benefits and costs of those services and goods from a societal perspective, results in a somewhat different approach to measurement in governmental financial reports.

SOURCES OF REVENUE

Governments receive substantial revenues from **nonexchange** transactions (for example, taxes and grants), also referred to as nonreciprocal transactions in some accounting literature, which are different from exchange transactions, such as sales revenue and debt or equity financing. In a nonexchange transaction, a government either receives value from another party without directly giving equal value in exchange or gives value to another without receiving equal value.

As noted earlier, taxpayers are involuntary resource providers; they cannot legally choose whether to pay taxes, even if they do not receive or take advantage of all services provided. The amount of taxes paid by an individual generally depends on factors such as the value of property owned and income earned, and seldom bears a direct relationship to the cost or value of the services received by that individual from the government.

Both business enterprises and governments borrow funds to finance their operations and capital improvements. Creditors, whether of governments or of business enterprises, have a similar focus in using financial reports—evaluating the cash flows of an organization to assess the ability of the organization to meet its obligations on a timely basis. However, as noted above, how those cash flows are generated is quite different. GASB Concepts Statement 1 describes the needs of creditors in paragraph 35:

Investors and creditors* need information about available and likely future financial resources, actual and contingent liabilities, and the overall debt position of a government to evaluate the government's ability to continue to provide resources for long-term debt service. They review operating results and cash flow data (both currently and over time) to look for trends that may indicate strengths and weaknesses in the ability of the government to repay debt. Trend analysis helps investors and creditors project future revenues and predict possible allocation of those revenues.

*Note that the GASB defined *investors and creditors* in paragraph 30 to be those who lend or who participate in the lending process. *Investors* is not used to mean equity owners

Government operations are not financed through equity ownership. Ownership interest in business enterprises may be bought and sold, but this is not so in government. Therefore, governments have no compelling reason to frame or orient financial statements in a way that is primarily focused on facilitating decisions of an equity market or of equity investors, which typically use financial reporting to assess the value of their ownership interest and whether that value is increasing or decreasing.

POTENTIAL FOR LONGEVITY

Governments typically have greater longevity than business enterprises. For example, some governments trace their roots to the original thirteen colonies. As a result of a combination of factors, including the power to tax, the nature of the services provided, and a lack of market competition, governments rarely liquidate. From time to time, governments may be merged or reorganized, but basic services will continue to be provided. Provisions for municipal bankruptcy are found in Chapter 9 of the federal bankruptcy code, which provides for reorganization, but not liquidation, of municipalities. Additionally, the provisions of Chapter 9 can be invoked only at the discretion of qualifying municipalities, not by creditors. Historically, the number of municipal bankruptcy filings has been approximately .02% of the number of business bankruptcy filings.⁵ Because governments have the power to tax—a right in perpetuity to impose charges on persons or property—they have the ability to continue operating in perpetuity. In contrast,

⁵ According to data available on <http://www.uscourts.gov/bnkrpctystats/bankruptcystats.htm>, viewed on September 15, 2005, 148 municipalities filed under chapter 9 during the period 1989 through 2003. 640,375 businesses filed under either chapter 7 or 11 during the same period.

business enterprises are at risk of going out of business because they are dependent upon market-determined demand for their goods and services to generate revenues. If they cannot produce products or services efficiently and at a cost less than the price the market will pay for the product or service, they will lose money and eventually leave that market or go out of business. They may also go out of existence if they are acquired by another entity. The relative longevity of government is reflected in the long-term view applied in governmental financial reporting.

RELATIONSHIP WITH STAKEHOLDERS

Governments in the United States employ the principles of representative democracy. The power of citizens to participate in most decision making regarding the operations of their government is delegated to public officials through the election process. Accompanying this delegation of power is a system of separation of powers among the executive, legislative, and judicial branches of government—a system intended to provide “checks and balances” over the potential abuse of power by the citizens’ representatives. Government can be viewed as being “owned” by the public similar to how business enterprises are owned by their shareholders. However, the public’s “ownership” is on an involuntary basis through paying taxes and receiving certain services from their government as determined collectively through elections or decisions of elected representatives. Shareholders voluntarily choose to invest in a business enterprise and do not demand services from the business enterprise. Shareholders typically can easily end their relationship with any individual business enterprise by selling their shares. In contrast, citizens typically can end their relationship with any particular government only by moving to another jurisdiction.

Although the shareholders of a business enterprise have great interest in the value of their ownership interest, the public as owners of a government do not share that interest. Because revenues raised through governments’ power to tax are expected to be used to advance the public interest, the public is entitled to hold governments to a standard of accountability that is broader than for business enterprises. The notion of accountability permeates the GASB’s conceptual framework and its individual standards. GASB Concepts Statement 1 states that accountability is the cornerstone of all financial reporting in a representative democracy, and that government

must answer to its citizens to justify its raising of public resources and the purposes for which the resources are used. Further, GASB Concepts Statement 1 (paragraph 56) states:

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.

The concept of interperiod equity is inextricably linked with accountability in government. Interperiod equity measures whether current-year revenues were sufficient to pay for the services provided that year, thereby avoiding shifting a burden to future taxpayers for services previously provided. GASB Concepts Statement 2, (paragraph 20), provides insight into the breadth and complexity of the concept of accountability by describing several aspects of accountability:

Governmental accountability can be viewed from several perspectives. For example, from an accounting perspective, in 1970 the American Accounting Association's (AAA) Committee on Concepts of Accounting Applicable to the Public Sector divided what entities are accountable for into four parts:

- a. Financial resources.
- b. Faithful compliance or adherence to legal requirements and administrative policies.
- c. Efficiency and economy in operations.
- d. The results of government programs and activities, as reflected in accomplishments, benefits, and effectiveness.

Demonstrating accountability necessarily takes many forms. For example, financial reporting should provide information regarding government’s stewardship responsibilities, in addition to information about interperiod equity. Stewardship responsibilities are reflected in fund reporting and in budgetary reporting, which are addressed subsequently. A budget does not demonstrate interperiod equity in that, for example, it is possible to have a balanced budget that meets legal requirements, yet employs deficit financing or deferred maintenance, which would not promote interperiod equity. However, the budget serves a crucial role of documenting short-term financial plans. Furthermore, additional types of reporting to assess the performance of government programs and activities also are needed.

Financial reporting standards for business enterprises do not emphasize accountability to the same extent.⁶ Reflective of the commercial environment, the FASB has determined that financial reporting for business enterprises primarily has an investor and creditor focus, as indicated in paragraph 32 of FASB Concepts Statements No. 1, *Objectives of Financial Reporting*:

The objectives begin with a broad focus on information that is useful in investment and credit decisions; then narrow that focus to investors' and creditors' primary interest in the prospects of receiving cash from their investments in or loans to business enterprises and the relation of those prospects to the enterprise's prospects; and finally focus on information about an enterprise's economic resources, the claims to those resources, and changes in them, including measures of the enterprise's performance, that is useful in assessing the enterprise's cash flow prospects.

ROLE OF THE BUDGET

Instead of market forces, which exert a level of control over the operations in business enterprises, the budget is the principal source of control over operations in government. The budget generally is a legal document that authorizes the government to utilize its resources to conduct operations and provide services. In contrast with budgets of business enterprises, which are internal, proprietary documents, budgets of governments are public documents that express public policy priorities and financial intent. In the U.S. system of government, based on checks and balances among the three branches of government, the budget is uniquely important because it is the practical means used by the legislative branch to set limits on the power of the executive branch. The citizenry often has an opportunity to provide input into the formation of the budget by commenting on an openly publicized proposed budget or, in some jurisdictions, voting on a proposed budget. Citizens and their elected representatives have the right to know whether the government actually used funds and resources in accordance with the approved budget.

⁶ Undeniably, the Sarbanes-Oxley Act has increased the requirements of public business enterprises to focus on stewardship and to be more accountable, in a general sense, to their shareholders. For example, officers of public business enterprises now are required to make certifications with respect to their business enterprise's GAAP financial reports and internal control structure, and may suffer substantial penalties for noncompliance. This provides an important incentive for adherence to existing GAAP, but does not impose additional financial reporting requirements.

Demonstrating accountability for compliance with budget authority is a distinguishing objective of governmental financial reporting.

APPENDIX B

ADDITIONAL EXAMPLES OF HOW GOVERNMENTAL ACCOUNTING DIFFERS FROM BUSINESS ENTERPRISE ACCOUNTING

The unique characteristics of government affect the substance and form of information communicated through external governmental financial reports. The driving force for governmental financial reporting is accountability—accountability to citizens and taxpayers, legislative and oversight bodies, and holders of government debt. Each of these stakeholders has information that he or she needs to derive from a government’s financial report. For example, when deciding where to live and how to vote, citizens may wish to compare their local government with other governments to assess the range of services provided and the cost of those services. Business people may wish to compare the cost of local governments and the services provided in competing jurisdictions when assessing where to locate a new business or relocate an existing business because it may affect their overall cost of conducting business. Legislative and governmental oversight bodies may wish to gain insight into how efficiently a government is using its resources and whether a government is complying with budgetary and contractual provisions. Holders of governmental debt may wish to determine whether a government is able to repay its debt in both the short and the long term. Governmental financial reports provide all this information and more.

The following discussion reviews selected governmental financial reporting standards, highlights how standards address some of the distinguishing characteristics of government, and discusses how the information provided in the standards benefits users of governmental financial reports. Appendix C includes a brief history of governmental accounting standards setting, which highlights the evolution of governmental financial reporting.

THE FINANCIAL REPORTING MODEL. The financial reporting model for governments has many unique features, including:

Contents of Basic Financial Statements. A government's basic financial statements present information about fiscal and **operational accountability**. The financial statements of governments present operational accountability information in the form of statements of financial position, changes in financial position, and cash flows. In addition, fiscal accountability is demonstrated by governmental fund financial statements, as described in the main body of this paper.

Operational accountability goes beyond fiscal accountability by examining management decisions from a long-term perspective rather than the short-term focus inherent to fiscal accountability. Instead of focusing on whether sufficient resources exist to *pay* for services provided during a period, operational accountability considers whether sufficient resources exist to cover the *cost* of providing services in the long term, and it is measured using the **economic resource flows measurement focus**. Operational accountability is demonstrated when governments issue accrual-based financial statements for the entire government. GASB Statement 34 requires reporting on operational accountability for all activities, including governmental activities, in consolidated government-wide statements.

Statement of Activities. Unlike an income statement of a business enterprise, the statement of activities focuses on the cost of services provided by function or program and the extent to which they either contribute to, or draw from, the general revenues of the government. The statement serves as the basis for beginning an analysis of management's performance, but for a more complete assessment of effectiveness and efficiency, additional performance measures would need to be considered.

Budgetary Reporting. GASB standards require governments to report budgetary comparison schedules, either as a basic financial statement or as required supplementary information. The involuntary nature of tax collection creates a responsibility on the part of the government to be accountable to stakeholders for the use of those taxes. The

budget is the mechanism for documenting public policy choices and authorizing the allocation and use of these resources. Unlike business enterprises for which budgets are an internal planning tool, evidence of compliance with the legally adopted budget is necessary for publicly demonstrating accountability. GASB Statement 34 requires that governments present budgetary comparison schedules including both the original and the revised budget in the interest of accountability to those who are aware of, and perhaps made decisions based on, the original budget.

REPORTING ENTITY ISSUES. A fundamental decision regarding financial reporting is determining which entities should be presented together in the same financial report. Combinations of business enterprises are based upon control obtained through acquisition of net assets or equity interest, both forms of ownership and the financial benefits and burdens that accompany that ownership interest. The standard for determining the reporting entity for governments reflects a difference of the governmental environment—the lack of equity ownership. Consequently, control through equity ownership is not the starting point for the governmental reporting entity standard. Governmental combinations principally are based upon control over other governments through complex relationships of accountability, which is a broader concept than that of business enterprises. Therefore, the GASB issued Statement No. 14, *The Financial Reporting Entity*, which addresses these issues based upon the notion of accountability, which is described in paragraph 56 of GASB Concepts Statement 1 as the “cornerstone of all financial reporting in government.”

SERVICE-ORIENTED INFRASTRUCTURE ASSETS. Governments provide some services through acquisition and maintenance of **infrastructure**, such as roads, bridges, and water systems. The accounting methods used for these assets reflect the long-lived nature of these assets and the perpetual existence of government. Although the GASB and the FASB apply the same basic historical cost/depreciation approach to reporting most capital assets, the GASB allows an optional **modified approach** for accounting for infrastructure that recognizes a government’s long-term commitment to provide service through maintenance and preservation of infrastructure at a specified condition level. The disclosures associated with the use of the

modified approach provide forward-looking data, including indicators of potential future demands on resources and information about deferred maintenance.

GRANTS AND GIFTS. As noted earlier, business enterprises only infrequently engage in nonexchange transactions, such as grants and gifts, (except as payer to a unit of government), and when they do so, the amounts involved generally are relatively insignificant. However, for many governments, grants and gifts are a significant source of revenue, and GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, provides guidance in this area. For grants and gifts, characteristics such as time restrictions and eligibility requirements are critical to determining when a transaction should be recognized.

Governments often receive pass-through grants—grants and other financial assistance to transfer to or spend on behalf of a secondary recipient. GASB Statement No. 24, *Accounting and Financial Reporting for Certain Grants and Other Financial Assistance*, requires reporting all cash pass-through grants in a government’s financial statements. They are recognized as revenues and expenditures or expense unless the government acts strictly as a cash conduit. (That is, the government only transmits the grantor-supplied money without having administrative or direct financial involvement.) This reporting requires governments to demonstrate accountability for resources for which the government is responsible. In contrast, business entities apply the guidance in FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, which excludes reporting certain pass-through grants as revenues and expenses.

DEBT REFUNDINGS. Similar to pensions and OPEB, both governments and business enterprises engage in refundings of debt—that is, the issuance of new debt whose proceeds are used to repay previously issued (“old”) debt. The reason that both governments and business enterprises typically enter into refundings is to secure economic gains. In most refundings, a difference exists between the reacquisition price for the old debt and the net carrying amount of the old debt. These differences either are accounted for as accounting gains or losses immediately in the period of extinguishment or can be deferred and recognized as adjustments to interest expense over the shorter of the life of the old or new debt. When determining how these differences should be accounted for in a governmental environment (for proprietary funds), the decision was made that the differences should be deferred and recognized as adjustments to

interest expense. Deferral and amortization is consistent with the fact that government refundings generally are current or advance refundings, and rarely or never are funded through existing resources or equity issuance. This accounting is also consistent with the concept that the economic gain from the refunding generally is used to reduce the interest costs of future taxpayers and, consequently, should be reported as an adjustment to future interest expense. This was different from the then-applicable business enterprise accounting standards because it was believed that immediate recognition would produce operating results in the period the debt is refunded and in subsequent periods that were less decision-useful for users of governmental financial reports. The GASB was concerned then, as it was later when developing GASB Statement 34, that governmental financial reports present the most relevant measure of the cost of providing services for a period.

APPENDIX C

BRIEF HISTORY OF GOVERNMENTAL ACCOUNTING STANDARDS SETTING

Systematic governmental financial reporting in the United States traces its beginnings to the last decade of the nineteenth century and early part of the twentieth century. At that time, the growth in the number and size of cities, coupled with corruption in municipalities, led to a demand for financial accountability.⁷ Many of the features of modern-day governmental financial reporting can be seen in the *Handbook of Municipal Accounting* (1913) prepared by the Metz Fund and the writings of Francis Oakey, whose book *Principles of Government Accounting and Reporting* (1921) was considered authoritative, and Lloyd Morey, whose popular textbook, *Introduction to Governmental Accounting*, was published in 1927. Oakey and Morey were concerned that the then “commercial accounting” was not entirely adequate for governments.

Morey identified the lack of a profit motive as one important factor that would affect financial reporting for governments; there was no need for governments to report on profit and loss. Oakey stated that cities financed their operations through taxes, miscellaneous revenue, and borrowing for the purpose of raising sufficient amounts to meet total anticipated expenditures, including capital items. He believed financial reporting should show a government’s fund surplus (or balance) that represents the resources currently available for expenditure. Oakey and Morey advocated financial reporting using funds, which would allow readers to assess whether an executive officer of a city had properly discharged his or her duties in accordance with legal requirements. The writings of Oakey and Morey contributed to the formation of the National Committee on Municipal Accounting (NCMA) that began to promulgate standards in 1934.⁸

⁷Frederick A. Cleveland, *Chapters on Municipal Administration and Accounting* (New York: Longmans, Green and Co., 1909).

⁸James H. Potts, “An Analysis of the Evolution of Municipal Accounting to 1935 with Primary Emphasis on the Developments in the United States” (Ph.D. dissertation, University of Alabama, 1976). Marcel G. Hebert, “An Investigation of the Effect of Alternative Presentation Formats on Preparers and Users of City Financial Reports” (Ph.D. dissertation, Texas Tech University, 1987).

To ensure that governmental accounting issues received appropriate attention, the NCMA was formed as an ad-hoc committee of the Municipal Finance Officers Association (MFOA) of the United States and Canada. It and successor bodies formed under the MFOA formulated municipal accounting principles, developed standard classification and terminology for municipal reports, and promulgated standards that reflect the unique or distinguishing characteristics of government. The NCMA believed that reporting budgetary information compared to actual information in financial statements was important to demonstrate compliance with legal provisions and to show proper administration of finances. Therefore, they recommended that governments present statements that would compare estimated revenues with actual revenues, and appropriations with expenditures and encumbrances.

Through the efforts of the NCMA and the National Committee on Governmental Accounting (NCGA), a successor committee of the MFOA, including publication of the authoritative guidance in the 1968 “blue book” titled *Governmental Accounting, Auditing, and Financial Reporting*, governmental financial reporting evolved from reporting on individual funds to reporting combined and combining financial statements for governmental, proprietary, and fiduciary funds. Concomitant with changing the name of the NCGA to the National Council on Governmental Accounting, the NCGA was reorganized as a standards-setting body that followed due process procedures and continued to focus governmental fund financial reporting on the flow of current financial resources using the modified accrual basis of accounting.

Subsequently, critics of governmental financial reporting called for governments to report more like businesses. Criticisms were leveled at the differences between financial reporting by business enterprises and governments, citing lack of understandability because government financial statements used the modified accrual basis of accounting and reported a number of funds without consolidation. The recommendation was not that governments and business enterprises should report using the same set of accounting standards or that a single standards setter should be responsible for both types of organizations. Rather, the recommendation primarily was to bring the benefits of accrual accounting—full cost of services information and consolidated financial statements—to governments. Through issuance of many standards

including GASB Statement 34, the GASB has addressed these criticisms while not ignoring the distinctive characteristics of government that are a key part of its reporting objectives.

As already noted, the Financial Accounting Foundation established the Governmental Accounting Standards Board in 1984 as the independent standards setter for state and local governments. The decision to establish a separate standards board reflects the sovereign nature of state governments and their desire to have a standards setter that focused on the needs of the state and local financial statement users. State governments are not creations of the federal government. Rather, the federal government was created by the states upon ratification of the United States Constitution, with certain aspects of states' sovereign powers transferred to the federal government, and with all other powers retained by states. Establishment of accounting standards for themselves (and local governments, which were created by states) is a power retained by the states. Like Oakey, Morey, the NCMA, and the NCGA, the GASB recognizes the unique and distinguishing features of government and reflects them in its standards setting.

APPENDIX D

SIGNIFICANCE OF STATE AND LOCAL GOVERNMENTS

By any measure of size, state and local governments are a substantial part of the U.S. economy. According to the 2002 Census of Governments, there are 87,525 local governments in the United States. Revenue collected by state and local governments totals \$1.8 trillion—\$6,433 for every person in the United States. Expenditures, taking into account capital outlays often financed through borrowings (which are not reported as revenues in these statistics), of state and local governments are even larger, at \$2.0 trillion—\$7,287 per capita. For comparison purposes, these state and local government expenditures represent almost 20 percent of the 2002 U.S. gross domestic product of \$10.5 trillion as reported by the Bureau of Economic Analysis of the U.S. Department of Commerce. Debt outstanding owed by state and local governments totals \$1.7 trillion—\$6,000 per capita. The 2002 Census of Governments reports that the labor force of state and local governments totaled 15.6 million employees on a full-time-equivalent basis, or 12 percent of total employment of 127.5 million for the United States as reported by the Bureau of Labor Statistics of the U.S. Department of Labor for 2002.

Not only do state and local governments constitute a significant proportion of the U.S. economy, they also have a pervasive effect on society because they provide a broad variety of vital services, including education, public safety, transportation, social services, environmental services, housing, utility services, and administrative services. Education includes primary, secondary, and higher education. Public safety includes police and fire protection, correctional facilities, and regulation and licensing of businesses. Transportation includes highways, airports, ports, parking facilities, and transit systems. Social services include income maintenance and healthcare. Environmental services include protection of natural resources and park and recreation services. Utilities include electric power, gas, water, sewer, and solid waste disposal. Administrative services include judicial and legal services, financial administration, and governance.

GLOSSARY

Accountability—A government’s responsibility to justify to its citizenry the raising of public revenues and to account for the use of those public resources.

Conceptual framework for accounting standards—A high-level set of principles that guide a standards setter when deliberating future standards and evaluating existing standards and practices.

Current financial resource flows measurement focus—The focus of governmental fund financial statements, which is on inflows of financial resources and on outflows of financial resources that generally arise when liabilities become due and are expected to be paid using available financial resources.

Economic resource flows measurement focus—The focus of government-wide and proprietary fund financial statements, which is on in flows and outflows of economic resources.

Exchange transaction—A transaction in which each party receives and gives up essentially equal values.

Fiscal accountability—The responsibility of governments to justify that their actions in the current period have complied with public policy decisions concerning the raising and spending of public moneys in the short term (usually one budgetary cycle or one year).

Governmental activities—Activities of government that generally are financed through taxes, intergovernmental revenues, and other nonexchange revenues. These activities are usually reported in governmental funds and internal service funds. In contrast, business-type activities of governments are financed in whole or in part by fees charged to external parties for goods or services.

Governmental funds—Self-balancing sets of accounts that are maintained for governmental activities. Financial statements of governmental funds are prepared on the modified accrual basis of accounting and the current financial resource flows measurement focus.

Infrastructure—Long-lived capital assets that normally are stationary in nature and normally can be preserved for a significantly greater number of years than most capital assets.

Interperiod equity—The state in which a government is neither deferring costs to the future nor using accumulated resources to provide current-period services.

Modified approach—A method of accounting for qualifying infrastructure networks and subsystems in which depreciation expense is not reported and maintenance and preservation costs are expensed. A network or subsystem qualifies for this method of accounting when, among other conditions, management has committed to maintain the network or subsystem approximately at or above a specific condition level.

Modified accrual basis of accounting—The basis of accounting in which transactions are recognized when they occur with specifically identified modifications to reflect the current financial resource flows measurement focus. These modifications include the fact that expenditures are recognized in the period in which they are expected to require to use current financial resources, revenue is not recognized until it is available to pay current obligations, and certain long-term liabilities are not recognized until due and payable.

Nonexchange transaction—A transaction in which a government gives (or receives) value without directly receiving (or giving) equal value in return. Nonreciprocal transactions in some accounting literature.

Operational accountability—Governments' responsibility to report the extent to which they have met their operating objectives efficiently and effectively, using all resources available for that purpose, and whether they can continue to meet their objectives for the foreseeable future.