**Chapter One**

**Financial Reporting of Government and Not for Profit Entities**

Accounting and financial reporting for governments and nonprofit organizations are based on distinctive concepts, standards, and procedures designed to accommodate their environments and the needs of their financial report users. This chapter describes about the major environmental characteristics of governmental and nonprofit organizations. It also describes about users, standard-setters, the characteristics of accounting and financial reporting for governmental and nonprofit organizations and objectives of financial reporting. The chapter ends with a brief discussion of the financial reporting of state and local governments.

**1.1 Distinguishing Characteristics of G&NFP Entities**

Governments and other nonprofit organizations are unique in that:

* **They do not attempt to earn a profit− and most are exempt from income taxes** − so typical business accounting, income tax accounting, usually is not appropriate.
* They are owned collectively by their constituents; and because ownership is not evidenced by equity shares that can be sold or traded, residents who are dissatisfied with their government must await a change in its elected governing body or move elsewhere.
* **Those contributing financial resources to the organizations do not necessarily receive a direct or proportionate share of their services.** For example, homeowners pay property taxes to finance public schools even if they do not have children in school or **the welfare recipient (probably) did not pay the taxes from which welfare benefits are paid.**
* **Their major policy decisions, and perhaps some operating decisions, typically are made by majority vote of an elected or appointed governing body** − for example, a state legislature, a city council, or a hospital board of directors − whose members serve part time, receive modest or no compensation, and have diverse backgrounds, philosophies, capabilities, and interests.
* Decisions usually must be **“in the sunshine”** − is meetings open to the public, including the news media − and most have “open records” laws that make their accounting and other records open to the public.

A G&NP organization exists because a community or society decides to provide certain goods or services to its group as a whole. Often these goods or services are provided regardless of whether costs incurred will be recovered through charges for the goods or services or whether those paying for the goods or services are those benefiting from them. Indeed, many G&NP services could not be provided profitably through private enterprise. In addition, the community or society may consider these services so vital to the public well-being that they should be supervised by its elected or appointed representatives.

**The major types of government and nonprofit organizations may be classified as:**

* 1. **General government:** federal, state, county, municipal, township, village, and other local governmental authorities and special districts.
	2. **Educational:** kindergarten, elementary and secondary schools, vocational and technical schools, and colleges and universities.
	3. **Health and welfare:** hospitals, nursing homes, child protection agencies, the American red Cross, and United Service Organizations (USO)
	4. **Religious:** Young Men’s Christian Association (YMCA), Young Women’s Christian Association (YWCA), Salvation Army, and other church-related organizations.
	5. **Charitable:** United Way, Community Chest, and similar fund-raising agencies; related charitable agencies; and other charitable organizations.
	6. **Foundations:** private trusts and corporations organized for educational, religious, or charitable purposes.

This general classification scheme has much overlap among the classifications. Many charitable organizations are operated by churches, for example, and governments are deeply involved in education, health, and welfare activities.

**The G&NP Environment**

**G&NP organizations are similar in many ways to profit-seeking enterprises. For example:**

1. They are **integral parts of the same economic system** and use financial, capital, and human resources to accomplish their purposes.
2. Both must acquire and convert scarce resources into their respective goods and services.
3. Both must have viable information systems, including excellent accounting systems to assure that managers, governing bodies, and others receive relevant and timely information for planning, directing, controlling, and evaluating the sources, uses, and balances of their scarce resources.
4. Because their resources are scarce, **cost analysis and other control and evaluation techniques** are essential to ensure that resources are utilized economically, effectively, and efficiently.
5. **In some cases, both produce similar products.** For example, both governments and private enterprises may own and operate transportations systems, sanitation services, and electric or gas utilities.

**1.2 Sources of Financial Reporting Standards**

Figure 1.1 shows the primary sources of accounting and financial reporting standards for business and not-for-profit organizations, state and local governments, and the federal government. 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 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 by obtaining contributions from business corporations; professional organizations of accountants, financial analysts, and other groups concerned with financial reporting; CPA firms; debt-rating agencies; and state and local governments (in the case of the GASB). The federal Sarbanes-Oxley Act greatly enhanced financial support for the FASB by mandating an assessed fee on corporate security offerings. 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.”**

**Figure 1.1: Primary Sources of Accounting and Financial Reporting Standards for Businesses, Governments, and Not-for-Profit Organizations.**  (Source: Statement on Auditing Standards (SAS) 69, amended by SAS 91, April 2000, AICPA Professional Standards, v.1, Au Sec. 411.)

Financial Accounting

Standards Board

(FASB)

Governmental

Accounting Standards

Board (GASB)

Nongovernmental

not-for-profit

organizations

Business

(for-profit)

organizations

State and local

governmental

organizations

Governmental

not-for-profit

organizations

Financial Accounting

Foundation

Federal Accounting

Standards Advisory Board (FASAB)

• Comptroller General

• Director of the office of Management and Budget

• Secretary of the Treasury

Federal government

and its agencies and departments

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, and 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.”

***Summary of Standard Setting Organizations***

|  |  |
| --- | --- |
| Reporting Organization | Standard Setting Board |
| Federal GovernmentState & Local GovernmentsPublic not for profitsPrivate not profitInvestor owned business | [Federal Accounting Standards Advisory Board](http://en.wikipedia.org/wiki/Financial_Accounting_Standards_Board) (FASAB)Governmental Accounting Standards Board (GASB)Governmental Accounting Standards Board (GASB)[Financial Accounting Standards Board](http://en.wikipedia.org/wiki/Financial_Accounting_Standards_Board) (FASB)[Financial Accounting Standards Board](http://en.wikipedia.org/wiki/Financial_Accounting_Standards_Board) (FASB) |

**1.3 Objectives of Financial Reporting**

In its Concepts Statement No. 1, “Objectives of Financial Reporting,” the Governmental Accounting Standards Board stated 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.

Table 1.1 shows several ways that state and local governmental financial reporting is used in making economic, social, and political decisions and assessing accountability. 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.

Accountability is also the foundation for the financial reporting objectives the Federal Accounting Standards Advisory Board (FASAB) has developed 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.

**Table 1.1: Comparison of Financial Reporting Objectives- State and Local Governments, Federal Government, and Not-for-Profit Organizations**

|  |  |  |
| --- | --- | --- |
| **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 to:* Comparing actual financial results with 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
 |

Unlike the **FASB and the GASB**, which base 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 board 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⎯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 are generally not subject to as detailed legal restrictions as those of governments.

Note that the objectives of financial reporting for governments and not-for-profit entities stress the need for the public to understand and evaluate the financial activities and management of these organizations. Readers will recognize the impact on their lives, and on their bank accounts, of the activities of the layers of government they are obligated to support and of the not-for-profit organizations they voluntarily support. Since each of us is vitally affected, it is important that we be able to read intelligently the financial reports of governmental and not-for-profit entities. In order to make informed decisions as citizens, taxpayers, creditors, and donors, readers should make the effort to learn the accounting and financial reporting standards developed by authoritative bodies.

**1.4 Financial Reporting of Governmental Entities**

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 1.2** 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. **The MD&A** should provide an overview of the governments financial activities and financial highlights for the year. **The MD&A** should provide a narrative explanation of the contents of the CAFR, including the nature of the government-wide and fund financial statements, and the distinctions between those statements. The remainder of the **MD&A** should describe the governments financial condition, financial trends of the government as a whole and of its major funds, budgetary highlights, and activities affecting capital assets and related debt. Finally, the **MD&A** should discuss economic factors and budget and tax rates for the next year.

**GASBS 34** prescribes **two categories of basic financial statements, government-wide and fund. Government-wide financial statements** are intended to provide an aggregate 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 of accounting and flow of economic resources measurement focus.**

(Note: **Measurement focus**⎯refers the nature of the resources, claims against resources, and flow of resources that are measured and reported by a fund or other entity. For example, governmental funds currently measure and report available financial resources, whereas proprietary and fiduciary funds measure and report economic resources. **Basis of accounting**⎯refers the standards used to determine the point in time when assets, liabilities, revenues, and expenses (expenditures) should be measured and recorded as such in the accounts of an entity).

**Fund financial statements**, the other category of basic financial statements, assist in assessing **fiscal accountability**⎯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 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.

The notes to the financial statements are considered integral to the financial statements. In addition, governments are required to disclose certain RSI other than MD&A.

**Figure 1.2 Minimum Requirement for General Purpose External Financial Reporting⎯GASB Statement No. 34 Reporting Model**

**Management’s discussion and analysis**

**Government-wide Fund financial**

**financial statements statements**

**Notes to the financial statements**

**Required supplementary information (other than MD&A)**

**Comprehensive Annual Financial Report (CAFR)**

Serious users of governmental financial information need much more detail than is found in the MD&A, basic financial statements, and RSI (other than MD&A). For state and local governments, much of that detail is found in the governmental reporting entity’s **comprehensive annual financial report (CAFR).** Although governments are not required to prepare a CAFR, most do so as a matter of public record and to provide additional financial details beyond the minimum requirements. As such the GASB provides standards for the content of a CAFR in its annually updated publication Codification of Governmental Accounting and Financial Reporting Standards. A CAFR prepared in conformity with these standards should contain the following sections.

1. **Introductory section**

The **introductory section** typically includes items such as a title page and contents page, a letter of transmittal, a description of the government, and other items deemed appropriate by management (e.g., list of principal officials, organization chart, location, etc). The letter of transmittal may be literally that – a letter from the chief financial officer addressed to the chief executive and governing body of the governmental unit – or it may be a narrative over the signature of the chief executive. In either event, the letter or narrative material should cite legal and policy requirements for the report. The introductory section may also include a summary discussion of factors relating to the government’s service programs and financial matters. Matters discussed in the introductory section should not duplicate those discussed in the MD&A. because the MD&A is part of the information reviewed (but not audited) by the auditor, it presents information based only on facts known to exist as of the reporting date since the introductory section is generally not covered by the auditor’s report, it may present information of a more subjective nature, including prospective information such as forecasts or expenditures.

1. **Financial section**

The financial section of comprehensive annual financial report should include **(1) an auditor’s report, (2) management’s discussion and analysis (MD&A), (3) basic financial statements, (4) required supplementary information (other than MD&A), and (5) other supplementary information, such as combining statements and individual fund statements and schedules.** Items (2), (3), and (4) represent minimum requirements for general purpose external financial reporting. So, it should be apparent that a CAFR provides additional supplementary financial information beyond the minimum amount required by generally accepted accounting principles.

The financial section should contain sufficient information to disclose fully and present fairly the financial position and results of financial operations during the fiscal year. Laws of higher jurisdictions, actions of the legislative branch of the governmental unit itself, and agreements with creditors and others impose constraints over governments` financial activities and create unique financial accountability requirements.

Governmental financial reporting has evolved to meet the unique needs of citizens and other financial statement users. It should not be surprising that these financial statements are quite different from those prepared by business organizations.

1. **Statistical section**

In addition to the introductory and financial sections of the CAFR, A CAFR should contain a statistical section. The statistical section typically presents tables and charts showing social and economic data, financial trends, and the fiscal capacity of the government in detail needed by readers who are more than casually interested in the activities of the governmental unit.

GASB Statement No. 44 indicates that generally the statistical section should present information in five categories to assist the user in understanding and assessing a government`s economic condition. The five categories are:

1. Financial trends information
2. Revenue capacity information
3. Debt capacity information
4. Demographic and economic information
5. Operating information