**Chapter 1**

**The Government and Not-For-Profit Environment**

**Questions for Review and Discussion**

1. The critical distinction between for-profit businesses and not-for-profits including governments is that businesses have profit as their main motive whereas the others have service. A primary purpose of financial reporting is to report on an entity’s accomplishments — how well it achieved its objectives. Accordingly, the financial statements of businesses measure profitability, their key objective. Financial reports of governments and other not-for-profits should not focus on profitability, since it is not a relevant objective. Ideally, therefore, they should focus on other performance objectives, such as how well the organizations met their service goals. In reality, however, the goal of reporting on how well they have achieved such goals has proven difficult to attain and the financial reports have focused mainly on financially-related data.

2. Governments and not-for-profits are “governed” by the budget, whereas businesses are governed by the marketplace. The budget is the key political and fiscal document of governments and not-for-profits. It determines how an entity obtains its resources and how it allocates them. It encapsulates most key decisions of consequence made by the organization. In a government the budget is not merely a managerial document; it is the law.

3. Owing to the significance of the budget, constituents want assurance that the entity achieves its revenue estimates and complies with its spending mandates. They expect the financial statements to report on how the budget was administered.

4. *Interperiod equity* is the concept that taxpayers of today pay for the services that they receive and not shift the payment burden to taxpayers of the future. Financial reporting must indicate the extent to which interperiod equity has been achieved. Therefore, it must determine and report upon the economic costs of the services performed (not merely the cash costs) and of the taxpayers’ contribution toward covering those costs.

5. The *matching concept* may be less relevant for governments and not-for-profits than for businesses because there may be no connection between revenues generated and the quantity, quality or cost of services performed. An increase in the demand for, or cost of, services provided by a homeless shelter would not necessarily result in an increase in the amount of donations that it receives. Of course, governments and not-for-profits are concerned with measuring interperiod equity and for that purpose the matching concept may be very relevant.

6. Governments must maintain an accounting system that assures that restricted resources are not inadvertently expended for inappropriate purposes. Moreover, statement users may need separate information on the restricted resources by category of restriction and the unrestricted resources. In practice, these requirements have led governments to adopt a system of “fund” accounting and reporting.

7. Even governments within the same category may engage in different types of activities. For example, some cities operate a school system whereas others do not. Those that are not within the same category may have relatively little in common. For example, a state government shares few characteristics with a city.

8. If a government has the power to tax, then it has command over, and access to, resources. Therefore, its fiscal well-being cannot be assessed merely by measuring the assets that it “owns.” For example, the fiscal condition of a city should incorporate the wealth of the residents and businesses within the city, their earning capacity, and the city’s willingness to exploit its tax base.

9. Many governments budget on a cash or near-cash basis. However, the cash basis of accounting does not provide adequate information with which to assess interperiod equity. Financial statements that satisfy the objective of reporting on *interperiod equity* may not satisfy that of reporting on *budgetary compliance*. Moreover, statements that report on either interperiod equity or budgetary compliance are unlikely to provide sufficient information with which to assess *service efforts and* *accomplishments.*

10. Measures of service efforts and accomplishments are more significant in governments and not-for-profits because their objectives are to provide service. By contrast, the objective of businesses is to earn a profit. Therefore, businesses can report on their accomplishments by reporting on their profitability. Governments and not-for-profits must report on other measures of accomplishment.

11. The FASB influences generally accepted accounting principles of governments in two key ways. First, FASB pronouncements are included in the GASB “hierarchy” of GAAP. FASB pronouncements that the GASB has specifically made applicable to governments are included in the highest category; those that the GASB has not specifically adopted are included in the lowest category. Second, the business-type activities of governments are required (with a few exceptions) to follow the business accounting principles as set forth by the FASB.

12. It is more difficult to distinguish between internal and external users in governments than in businesses because constituents, such as taxpayers, may play significant roles in establishing policies that are often considered within the realm of managers. Also, legislators are internal to the extent they set policy, but external insofar as the executive branch must account to the legislative branch.

**Exercises**

#### EX 1-1

1. a
2. c
3. c
4. c
5. b
6. c
7. d
8. c
9. b
10. c

EX 1-2

1. b
2. b
3. d
4. b
5. a
6. c
7. a
8. b
9. a
10. b

**Problems**

P. 1-1.

a. The authority’s cash requirements in Year 1 would be as follows (in millions):

Wages, salaries and other operating costs $6.0

Purchase of equipment $10.0

Less: Issuance of bonds 10.0 0.0

Interest on bonds 0.5

Purchase of additional equipment 0.9

Total cash outlays (revenue requirements) $7.4

b. In Year 2, they would be:

Wages, salaries and other operating costs $6.0

Interest on bonds 0.5

Total cash outlays (revenue requirements) $6.5

c. In Year 10, they would be:

Wages, salaries and other operating costs $6.0

Interest on bonds 0.5

Repayment of bonds 10.0

Total cash outlays (revenue requirements) $16.5

d. The budgeting and taxing policies fail to promote interperiod equity. The economic costs incurred by the authority — the wages, salaries, other operating costs, and portion of equipment consumed — were the same each year. Yet, tax payments will depend on when the equipment was purchased and when the debt was repaid. Taxpayers of Year 10 will have to pay for equipment that provided services to the taxpayers of the previous nine years.

Interperiod equity could be achieved by budgeting on an accrual rather than a cash basis. The budget would then include an annual charge of $1.3 million for depreciation — $1 million on the ten-year equipment; $0.3 million on the three-year equipment. Annual required revenues would be $7.8 million:

Wages, salaries and other operating costs $6.0

Interest on bonds 0.5

Depreciation on equipment 1.3

Total revenue requirements $7.8

This practice might, however, be objectionable to some taxpayers because it requires that they contribute cash to the authority in years prior to those in which it will actually be expended. Thus, for example, at the end of Year 1 the authority will have a cash “reserve” of $0.4 million — the difference between the $7.8 million in taxes collected and the $7.4 million in cash outlays. The authority could also achieve interperiod equity by issuing serial bonds (those in which a portion of the principal matures each year over the life of the issue) or by establishing and contributing to a debt service “sinking fund.” By taking either of these approaches, the authority would, in effect, be repaying the bonds over the period in which the equipment is used and thereby matching equipment costs with equipment benefits.

P. 1-2

1. The information provided should, by itself, pose no obstacle to approving the loan. For sure, revenues just cover expenditures, allowing for no excess to cover the debt service on the loan and the additional operating expenditures that will be incurred when the classroom building is put into use. The key issue facing a loan officer, however, is whether the church members are both willing and fiscally able to pay for the new facility and to cover the additional operating costs. The fiscal capacity of the church cannot be assessed independently of that of its members.

The financial statements reveal that the church’s assets will have a market value of $7.2 million (new and old facilities plus cash and investments) when the classroom building is complete. If some or all of these assets are used to secure the loan, then the bank may have a reasonable cushion against default. However, market values of churches or other special-purpose facilities are notoriously unreliable. Moreover, for obvious reasons, banks are reluctant to foreclose on local churches.

2. The loan officer may wish to review the financial statements for “smoking guns” such as contingent liabilities, litigation, or unusual transactions. However, assuming that none are found, there is likely to be little in the financial statements to provide the basis for a loan decision.

3. If the loan officer were to approve the loan, he would likely do so in large measure because he has had a business relationship with members of the church and has confidence in their ability to manage the church and assure that the loan is repaid. Accordingly, he would probably want to review whatever information is available as to the character and credit worthiness of key church members and officers.

4. As implied in part a, as a matter of policy the church, like many not-for-profit organizations, generates only enough revenues to meet its expenditures. If the members opt to enhance the level of services provided by the church by building a new facility — and thereby increase expenditures — then presumably they will also increase their dues and contributions.

Financial statements of many not-for-profits are inadequate for making loan decisions because they report only on the entities themselves. However, the entities’ true fiscal condition cannot be determined apart from that of their constituents.

P. 1-3

The objective of budgetary compliance can best be served by recording each transaction on the same basis as it is budgeted — in this case, on a *modified cash* basis. That of interperiod equity can best be achieved by identifying the economic substance of each transaction and recording it when it has its substantive economic impact — that is, on an *accrual* basis.

1. Budgetary compliance: No expenditure recognized in 2011. Recognize the $128,000 in wages and salaries as an expenditure entirely when paid in 2012.

Interperiod equity: Recognize the amounts when earned, entirely in 2011.

2. Budgetary compliance: Recognize cost of the pension contribution when the $170,000 payment was made in 2011.

Interperiod equity: Recognize the actuarially required pension contribution of $225,000 in 2011, the year the employees earned the benefits, irrespective of the city’s actual cash contribution.

3. Budgetary compliance: Recognize the vehicle cost when the cars were paid for, $105,000 in 2011.

Interperiod equity: Recognize the vehicle cost over the three-year period in which the vehicles will be used, $35,000 per year.

4. Budgetary compliance: Recognize the $1,000 in interest revenue when received in 2012, inasmuch as the interest revenue would increase the value of the marketable securities and marketable securities are included within the government’s definition of cash.

Interperiod equity: Recognize the interest when earned, in 2011.

5. Budgetary compliance: Recognize the expenditure for use of the building as the building is paid for, $400,000 per year for 25 years.

Interperiod equity: Recognize the cost of the building as it is used, irrespective of when it is paid for; in this case $400,000 per year for 25 years.

6. Budgetary compliance: Recognize the issuance of the bonds and the purchase of the building in 2011. Recognize the expenditure for use of the building when it is paid for, $10 million in 2036.

Interperiod equity: As previously stated, recognize the cost of the building as it is used, irrespective of when it is paid for, in this case $400,000 per year for 25 years.

7. Budgetary compliance: Recognize the entire $120,000 in license fee revenue in 2011, as cash is received.

Interperiod equity: Recognize the license fee revenue over the period covered by the license and in which the related inspections will be carried out, thus $60,000 for the half-year of 2011 and $60,000 for 2012.

8. Budgetary compliance: Recognize the $300,000 borrowed as a revenue when received in 2011, and then as an expenditure when repaid in 2012. Note that in this example, the increase in cash may be considered “other sources of funds” rather than as revenue. The impact on fund balance is the same, however.

Interperiod equity: This transaction would result in an increase in cash and an offsetting increasing in a payable. No recognition would be given as a revenue or an expenditure to either the receipt of the amount borrowed or its subsequent repayment.

**P. 1-4**

1. a. The statements are clearly silent as to the accomplishments of the university. Indeed, they give no indication either as to what the university’s objectives are or whether they have been met.

b. Efficiency is a ratio of inputs to outputs (resources to results). Inasmuch as the statements do not report on results, the user can make no assessments as to efficiency.

c. The statements give no information as to the nature, condition or market value of the university’s physical properties. Equally significant they give no clues as to what the university’s plant requirements are for the present, let alone what they will be in the future.

d. The statements provide no indication as to what the university’s fiscal requirements will be in the future. They say nothing, for example, about anticipated student enrollments, state appropriations, research grants, program requirements, etc. Accordingly, no comparison can be made between 2011 and 2012.

e. The statements indicate that the ratio of cash to both short and long-term obligations is approximately the same in 2012 as it was in 2011. Assuming that the cash balance was adequate for 2012 it appears that it will be adequate for 2013. However, the statements give no indication as to whether cash inflows can be expected to be the same in the future as they were in the past or whether there will be new demands for cash (e.g., for maintenance and repairs or for new facilities or programs).

2. Each of the questions is consistent with the objectives. They demonstrate that the financial statements of not-for-profits, if limited to the types of data included in business-type statements, cannot possibly fulfill all the GASB or FASB objectives. These statements provide insufficient information to assess past performance or the adequacy of current resources to meet future requirements. At the very least they would have to contain information on the entity’s goals and accomplishments.

**P. 1-5**

1. Among governments that should be considered are towns, townships, cities, school districts, utility districts, road districts, library districts, hospital districts, community college districts, airport authorities and transportation districts.

2. The overlapping governments may rely on the same property or citizens for their tax revenues. Thus, to determine the “fiscal capacity” of one government it may be necessary to assess that of the others. For example, the outstanding debt of the school district must be taken into account in evaluating the borrowing capacity of the overlapping city, because the debt of both governments will have to be repaid from taxes on the same property.

**P. 1-6**

a. (1) Inasmuch as the city budgets on a cash basis, delaying the payment of bills by one week would reduce the budget deficit, shifting cost to the next year. It would have no impact on the accrual-based financial statements and only a very minor direct impact on the city’s substantive economic well-being (i.e., the city would have the use of the required cash for an additional few days).

(2) Speeding-up recognition of property taxes would also reduce the budget deficit but have no impact on the financial statements and would shift revenue from one year to another. It would have no direct impact on the city’s substantive economic well-being as it would not affect the timing of actual cash collections.

(3) Delaying the recognition of expenditures would also reduce the budget deficit, have no impact on the financial statements and have no impact on the city’s substantive economic well-being. Like speeding-up recognition of property taxes, it would not affect the timing of actual cash collections.

(4) Deferring maintenance would reduce the budget deficit and reduce the expenditures reported in the accrual-based financial statements. Assuming that the initially planned maintenance expenditures were necessary (and that the city’s maintenance schedule was optimal), the change would have a negative effect on the city’s substantive well-being. It would likely result in increased expenditures in the future.

Each of these proposals may substantively affect the city’s financial well-being indirectly in that they would enable the city to legally balance its budget and thereby avoid the adverse consequences of a deficit. Of course, sophisticated analysts might recognize the city’s measures as gimmicks and “one-shots” that would create fiscal pressures in the future. They might thereby downgrade the city’s credit rating or take other actions that would have a negative impact on the city’s fiscal well-being.

b. Accounting principles do not directly affect an entity’s economic well-being. However, if they change the data presented in budgets or other financial reports that are relied upon to make legal determinations, credit assessments, or other decisions, their indirect impact can be profound. As a consequence of those decisions the city can be denied loans or grants (or have to incur higher interest costs) or alter the allocation of its resources.

**P. 1-7**

There are no clear-cut answers to these questions. It addresses an issue that has been on the GASB’s agenda since the board was first established and will be dealt with in greater depth later in the text in the chapter on business-type activities.

1. In a broad sense, the financial reporting objectives of the private company are likely to be similar to those of the government. Financial reporting should provide information on the past performance and current financial condition of the department. To be sure, the owners of the private company measure performance in terms of profitability, whereas the citizens of the town are concerned mainly with “service” (subject to the constraint that costs are covered by fees). This difference alone may have important implications as to the types of data that are collected and how they are reported. From a practical perspective, however, the “traditional” information requirements — data on revenues, expenditures, assets and liabilities — are likely to be the same.

2. In light of the requirement that the department was expected to break-even, there are likely to be few operating differences between the information needs of the managers of the department as owned and operated by the private company as opposed to the town.

**P. 1-8**

1. Assuming that the PAC is profit oriented and is thereby interested in maximizing the present value of incremental cash flows, the decision is straight-forward:

Additional annual net cash flows: 20 students x

50 weeks x incremental revenues of $15 ($65 less $50) $15,000

Present value of an annuity of $1 for 3 periods at 10 percent 2.4869

Present value of net cash flows $37,304

Because the present value of the incremental cash inflows exceeds the asset cost of $30,000, the PAC should acquire the asset.

2. The CYA, by contrast has no such convenient algorithm to rely upon. The key question faced by the CYA is whether alternative uses of the $30,000 would better enable it to fulfill its mission. The limited information provided is inadequate to make a decision.

3. The objective of not-for-profits such as the CYA is to serve their communities, not to earn profits or maximize cash flows. Hence, the conventional discounted cash flow capital budgeting model is not appropriate because it focuses on cash flows. To be appropriate for a not-for-profit, a capital budgeting model would have to take into account the benefits that relate specifically to the organizations’ unique objectives.

Nevertheless, for some capital budgeting decisions, the conventional discounted cash flow approaches may be appropriate. These would include purchase decisions, for example, when the benefits to be derived from the asset under consideration are cash savings rather than enhanced service.

**P. 1-9**

1. Were the city to accept the offer, its total savings would be only $8.1 million.

Wages and salaries $4.0

Supplies 2.6

Other cash expenditures 1.3

Rent 0.2

Total savings $8.1

The cost of obtaining the service from the private company would be $8.5 million. Hence the offer should be rejected.

For purposes of this decision, the cost of $8.9 million used to establish billing rates is not relevant. It includes allocated overhead costs, some of which could not be reduced were the city to accept the offer.

2. The total savings to the city would be unaffected by its allocation policy. They would remain at $8.1 million. Therefore, if the offer were rejected when costs were allocated, it should also be rejected when costs were not allocated. The $7.9 million is no more relevant than the $8.9 million. The relevant amount is still the $8.1 million in expected savings.

There may be sound reasons for the city to allocate overhead costs for purposes of establishing billing rates. However, the allocated costs are not relevant for the decision whether to perform a service internally or acquire it externally.

**P. 1-10**

a.

1. The reported pension cost should be based on the actuarially required contribution, not on the actual cash contribution.

2. The contribution to the rainy-day reserve should be accounted for as an internal designation of resources. The accounting should make clear that total assets of the government are not affected by the arbitrary, nonbinding management decision to set aside cash for a particular purpose. Thus, the transfer should affect only asset accounts, not revenues or expenditures.

3. The securities should be accounted for at market value. In that way the gain would not be recognized entirely in the year of sale — a year in which increase in market price did not necessarily take place — and management could not pick the year to enhance its revenues.

4. The city could automatically report an annual maintenance expenditure equal to some predetermined amount (perhaps an average of expenditures over the previous five years.) The charge would be offset by a liability (e.g., “deferred maintenance”), which would be reduced only by actual maintenance outlays.

b. A fundamental objective of financial reporting is to report on budgetary compliance. To the extent that the financial reports are on an accrual basis whereas the budget is on a cash basis, they would not achieve this objective. Moreover, the reported expenditures, for both maintenance and (though to a lesser extent) pensions could be considered arbitrary — that is, not based on specific transactions.

**Questions for Research, Analysis and Discussion**

1. The GASB in 2006 issued a “white paper,” “Why Governmental Accounting and Financial Reporting Is—and Should Be—Different,” which as implied by the title sets forth numerous reasons as to why governments are unique and therefore justify their own standard-setting organization. The characteristics identified include:
   * Organizational purposes
   * Sources of revenue
   * Relations with stakeholders
   * Potential for longevity
   * Role of the budget

In addition the report points to several other differences in how governmental accounting differs from business accounting:

* The reporting model has several unique features.
* There are special issues of how to define the reporting entity.
* Long-lived assets have different purposes (e.g., in governments they are not intended to generate cash flows).
* They engage in numerous types of nonexchange transactions.

The GASB white paper is available on the organization’s web site.

Not-for-profit entities, obviously have many of the characteristics of both governments and businesses. Some, like agricultural cooperatives, country clubs or hospitals, are virtually the same as businesses. Others, such as health and welfare organizations have more of the characteristics of governments. In reality, not-for-profit entities could legitimately be placed within the purview of either the GASB or the FASB. The decision to place not-for-profits within the purview of the FASB was influenced more by “political” considerations than by any fundamental organizational characteristics.

1. The GASB in its Concepts Statement No. 1, *Objectives of Financial Reporting,* explicitly recognizes that “Financial reporting should provide information to assist users in assessing the service efforts, costs, and accomplishments of the governmental entity.” Moreover, it had devoted Concepts Statement No. 2, Service Efforts and Accomplishments (SEA) Reporting entirely to this objective. After 20 years of conducting research and constituent outreach on SEA reporting, GASB issued in 2009 the revised and updated version of its Concepts Statement No. 2, *Service Efforts and Accomplishments Reporting As Amended by GASB Concepts Statements No. 3 and No. 5* and offers the strongest endorsement to date of enhanced SEA reporting. It has long been the position of many GASB members and constituents that information on service efforts and accomplishments (SEA) should indeed be incorporated into comprehensive annual financial reports. Nevertheless, many other constituents of the GASB believe that, even though, information on SEA is important, it does not relate directly to *financial* reporting and should be reported in separate statements. Accordingly, the GASB has not yet formally proposed incorporating SEA information in the Comprehensive Annual Financial Report (CAFR).
2. GASB Statement No. 53 Accounting and Financial Reporting for Derivative Instruments issued in June 2008 addresses the recognition, measurement, and disclosure of information regarding derivative instruments entered into by state and local governments. GASB 53 proposes that the fair value of derivatives be reported in the financial statements, as well as the change in that fair value from year to year.

From the outset it was evident that GASB attempted to ensure that this standard was consistent with the related standards issued by the FASB. Accordingly, GASB 53 is broadly consistent with SFAS 133 (and later amendment of SFAS 149).

The following major principals are introduced by SFAS 133 with respect to accounting for derivatives.

1. Derivative instruments are recognized at fair value
2. Fair value changes of derivative instruments used for purposes other than hedging are recognized in the income statement
3. A detailed criteria needs to be met in order to for a derivative qualify as a hedge
4. Fair value changes arising from ineffective hedging are reported in income statement similar to non-hedging derivatives
5. Affect of fair value changes of effective hedging will not affect income statement. This can be because the fair value changes of both the derivative and underlying are recognized in the income statement, but they offset each other (Fair value hedges) or the fair value change in derivative is recognized directly in other comprehensive income, thereby bypassing income statement (Cash flow hedges)

The below quote from the Plain Language Supplement to Preliminary Views on Accounting and Financial Reporting of Derivatives (2006), issued by GASB makes it very clear that all above principles are covered in GASB standard as well.

“In general, the fair value of a derivative as of the end of the fiscal year covered by the financial statements would be reported in the balance sheets (such as the statement of net assets). Provided a derivative is not a hedging derivative, the increase or decrease in the fair value of the derivative would be reported in the change statements (such as the statement of revenues, expenditures, and changes in fund balances) as an increase or decrease in investment income, respectively. However, if a derivative is effectively hedging (reducing) the risk it was created to address, then the annual changes in the derivative’s fair value generally would be deferred.” (Page 4)

However, as GASB 53 was issued after a considerable time had passed since the issuing of SFAS 133, it attempted to refine and improve upon some of the subsequently discussed ambiguities of SFAS 133.

One main area of improvement is with regard to the determination of hedge effectiveness. According to SFAS 133 a firm may use statistical or other means to assess whether a hedge is “highly effective” for it to qualify for hedge accounting. However SFAS 133 does not specify which methods should be used for testing hedge effectiveness (SFAS 133 – Paragraph 62). Moreover, the meaning of “highly effective” is not defined and is a matter of judgment (Finnerty and Grant 2002). GASB 53 attempts to overcome these ambiguities by specifying criteria for hedge effectiveness clearly.

If the critical terms of the potential hedging derivative instrument and the terms of the item it is hedging are the same the derivative is assumed to be effective hedge under the “Consistent critical terms criteria.” If this is not the case the hedge effectiveness should be established through “Quantitative methods.” Three such methods and the thresholds to qualify as an ‘effective hedge’ are specified in the standard.

1. Synthetic instruments method – If the synthetic rate is between 90 and 111 percent of the fixed rate (where 100 percent relates to a perfect hedge), the hedge is deemed effective
2. Dollar-offset method – If the fair value change in derivative falls within the range of 80 to 125 percent of the fair value change in underlying (in the opposite direction), the hedge is deemed effective
3. Regression analysis – If a statistical regression between the fair value changes of derivative and the underlying results in a R-squared of at least 0.80, F statistic that is significant at 95% confidence level, and a regression coefficient between -1.25 and -0.80, the hedge is deemed effective

GASB 53 allows that use of other quantitative methods as long as they are “established principals of financial economic theory,” but the provision of specific methods and guidelines substantially eliminates ambiguities associated with the determination of hedge effectiveness