PacificCPE

COURSE
21151A

The Government and Not-for-Profit Environment

Get grounded in the unique world of government and not-for-profit accounting. This chapter-level course explores how public sector entities differ from their commercial counterparts, covering the regulatory environment, reporting objectives, and the stakeholders who rely on governmental financial information. Whether you're new to government accounting or need a solid refresher, this course sets the stage for understanding why public sector accounting follows its own distinct set of rules and standards.

CREDIT HOURS 2 | FIELD OF STUDY ACCOUNTING | EXAM QUESTIONS 10

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Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

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

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Chapter 1: THE GOVERNMENT AND NOT-FOR-PROFIT ENVIRONMENT

Chapter Objective

After completing this chapter, you should be able to:

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

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

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

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

HOW DO GOVERNMENTS AND NOT-FOR-PROFITS COMPARE WITH BUSINESSES?

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

Different Missions

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

The financial reports of governments and not-for-profits can provide information about an organization's inflows (revenues) and outflows (expenditures) of cash and other resources[1]. As a general rule, an excess of expenditures over revenues, particularly for an extended period of time, signals financial distress or poor managerial performance. However, an excess of revenues over expenditures is not necessarily commendable. An excess of revenues over expenditures may be achieved, for example, merely by reducing the services provided to constituents, which may be at odds with the entity's objectives.

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

Budgets, Not the Marketplace, Govern

Governments and not-for-profits are governed mainly by their budgets, not by the marketplace. These organizations control or strongly influence both their revenues and expenditures through the budgetary process.

The revenues of a government may be determined by legislative action, and if they are, the government may not be subject to the forces of competition faced by businesses. Those of the not-for-profits, although they cannot be established by legal mandate, may be obtained from contributions, dues, tuition, or user charges—none of which are comparable to the sales revenue of a business[2].

Expenditures May Drive Revenues

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

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

The Budget, Not the Annual Report, Is the Most Significant Financial Document

For businesses, the annual report is the most significant financial document. A major company's announcement of annual earnings (the preview of the annual report) makes front-page news. By contrast, its annual budget is nothing more than an internal document, seldom made available to investors or the general public. A government or not-for-profit's release of its annual report is customarily ignored by both organizational insiders and outsiders. Seldom does the report contain surprises, for if revenues and expenditures were markedly different from what were initially budgeted, the entity probably was required to amend the budget during the year.

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

Because it is so important, the budget, unlike the annual report, is a source of constituent concern and controversy. Government budget hearings often draw standing-room-only crowds to the legislative chambers. The budget debates of religious organizations such as churches and synagogues are frequently marked by fervor more intense than that found in the congregants' worship services. A government's budget may be backed by the force of law. State and local government officials are ordinarily *prohibited* from spending more than what was budgeted. Indeed, they can be sanctioned for sizable violations of budgetary mandates. The budget is not a document to be taken casually. In light of the significance of the budget relative to the annual report, it is ironic that the standards-setting agencies focus exclusively on the annual report. Except insofar as governments—such as states— establish rules for cities or other governments within their jurisdiction, or parent not-for-profits—such as national fraternities—set guidelines for local affiliates, budgetary practices are within the discretion of the individual entity. Neither the GASB nor the FASB or FASAB has been granted the kind of statutory authority over budgets that it has over annual reports. As a consequence—which shall be made evident in discussions to follow—annual reports are in fact better than budgets at capturing the economic substance of the transactions and are far less subject to preparer efforts to artificially boost revenues or reduce expenditures.

Budgets Drive Accounting and Financial Reporting

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

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

A post-period assessment can then focus not only on whether the entity met its revenue and expenditure projections but also, equally important, on whether it attained what was expected of it. Evaluators can then assess organizational efficiency by comparing inputs (such as dollar expenditures) with outcomes (results). The accounting system should be fashioned to facilitate this comparison, ensuring that the organization reports and categorizes both revenues and expenditures in a way that is consistent with the budget. Currently, few governments and not-for-profits have established budgetary and accounting systems to measure and report adequately on the

nonmonetary aspects of their performance. However, accounting standards-setting authorities have recognized the importance of performance measures and have taken steps to encourage the entities under their purview to provide them.

Need to Ensure Interperiod Equity

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

The concept that constituents pay for the services that they receive and do not shift the burdens to their children has traditionally been labeled as **intergenerational equity**. To emphasize that entities should not transfer the costs even to future years, to say nothing of future generations, the term interperiod equity has been accepted as more appropriate.

To maintain interperiod equity, the accounting systems of governments and not-for-profits must provide information about whether this objective is being attained. Table 1-1 compares fiscal practices that promote interperiod equity with those that do not.

TABLE 1-1. FISCAL PRACTICES THAT PROMOTE OR UNDERMINE INTERPERIOD EQUITY

Promote	Undermine
1. Setting aside resources for employee pensions during the years in which the employees provide their services.	1. Paying the pensions of retired employees out of current operating funds.
2. Issuing conventional 30-year bonds to finance the purchase of a new building that is expected to have a useful life of 30 years; repaying the bonds, along with appropriate amounts of interest, over the 30-year period.	2. Financing the purchase of the new building with 30-year zero-coupon bonds that permit the entire amount of principal and interest to be paid upon maturity of the bonds; making no provision to set aside resources for payment of principal and interest on the bonds until the year they mature.
3. Paying the current-year costs of an administrative staff out of current operating funds.	3. Issuing 30-year bonds to finance the current-year operating costs of an administrative staff.
4. Charging payments of wages and salaries made in the first week of the current fiscal year to the previous fiscal year, that in which the employees actually provided their services.	4. Charging wages and salaries applicable to services provided in the last week of the current fiscal year to the following fiscal year, that in which the payments were made.
5. Charging the cost of supplies as expenditures in the year in which they were used rather than when they were purchased.	5. Charging the cost of supplies as expenditures in the year they were purchased or paid for, irrespective of the year in which they were used.
6. Recognizing interest on investments in the year in which it is earned, irrespective of when it is received.	6. Recognizing interest in the year in which it is received, irrespective of when it is earned.
7. Setting aside resources each year to pay for an anticipated 20-year renovation of a college dormitory.	7. Paying for an anticipated 20-year renovation of a college dormitory out of current revenues in the year the work is performed.