

Chapter 1

Governmental and Nonprofit Accounting Environment and Characteristics

QUESTIONS

Q1-1. Not-for-profit organizations: (a) receive contributions of significant amounts of resources from resource providers who do not expect equivalent pecuniary return; (b) operate for purposes other than to provide goods and services at a profit; and (c) lack ownership interests like those of a business enterprise.

Q1-2. Governmental entities include the federal government; general-purpose political subdivisions (such as states, counties, cities, and towns); special-purpose political subdivisions (such as school districts); and public corporations and bodies corporate and politic (such as state-operated toll roads and toll bridges).

Other organizations created by governments by statute or under not-for-profit corporation laws are governmental if they possess one or more of the following characteristics:

- a. Their officers are popularly elected or a controlling majority of their governing body is appointed or approved by governmental officials;
- b. They have the power to enact and enforce a tax levy;
- c. They have the power to directly issue debt whose interest is exempt from federal tax; or
- d. There is a potential for a government to dissolve them unilaterally and assume their assets and liabilities.

Q1-3. Major environmental characteristics of governmental and not-for-profit organizations are:

- a. Organizational purposes. Governmental and not-for-profit entities exist to provide services to their constituents, not to generate profits. A reported excess of revenues over expenditures does not mean that they have made a profit, have operated efficiently, or have served their constituents effectively. Therefore, financial reporting for these entities requires an emphasis on accountability.
- b. Sources of revenue and relationship with stakeholders. Governments derive revenues primarily from taxpayers. Individual taxpayers are involuntary resource providers whose tax payments may or may not bear a direct relationship to the services they want or need. Not-for-profit entities obtain significant resources from donors who receive no service or product in exchange, but who nonetheless are concerned with whether their donations are achieving the intended purposes. These relationships again emphasize a need for reporting models that emphasize accountability.
- c. Potential for longevity. Business enterprises are at risk of going out of business or being bought out. Governments, on the other hand, tend to exist in perpetuity because of the nature of the services they provide. This has caused governmental accounting standards-setters to take a longer term perspective regarding certain measurements.

- d. Role of the budget and legal requirements. Governmental entities are required by law to provide certain services. Their budgets are legal documents and generally cannot be exceeded without specific legislative approval. Their borrowings are also constrained by law as to purpose. Some not-for-profit entities obtain significant resources from contributions that are subject to specific restrictions as to how they may be used. This has led to standards that take account of the need for demonstrating budgetary and legal compliance.

Q1-4. Regarding government: Budgets generally cannot be exceeded without specific legislative approval; borrowings are generally specifically limited as to the purposes for which they may be used; and grants from higher level governments are generally specifically limited as to purpose.

Regarding not-for-profit entities: Donors often place specific restrictions on contributions as to what they may be used for and when they may be used.

Q1-5. Users of governmental and not-for-profit entity accounting information are both internal and external. Major external users are:

- a. Resource providers (taxpayers, donors and potential donors, investors and potential investors, bond-rating agencies, and grant-providing organizations)
- b. Oversight bodies (higher-level governments, regulatory bodies)
- c. Service recipients (citizen advocate groups)

Users might use accounting information to:

- a. see if the entity has sufficient financial resources to cushion against economic contraction.
- b. determine the likelihood of repaying short-term and long-term financial obligations;
- c. determine the likelihood of continuing to provide a particular level of service;
- d. see if the entity uses resources consistent with budget limits; donor restrictions, legal limits;
- e. see if financial data shows evidence of inefficiency, such as slow collection of receivables;
- f. see if restrictions on use of resources is reducing flexibility in meeting program goals.

Q1-6. The three ways identified by the GASB in which financial reporting can assist users in assessing governmental accountability are:

- a. by showing if current-year revenues were sufficient to pay for current-year services;
- b. by showing whether resources were obtained and used in accordance with the legally adopted budget; and
- c. by providing data to help users assess the entity's service efforts, costs and accomplishments.

Q1-7. State and local governments use fund accounting; incorporate budgetary accounting into their accounting systems; use modified accrual accounting (rather than full accrual accounting) for certain activities; use a two-level system of financial reporting; and report extensively on restricted resources.

Q1-8. The GASB is responsible for establishing and improving accounting and financial reporting standards for all state and local governmental entities (including government-sponsored colleges and universities, health care providers, and utilities). The FASAB establishes accounting standards for the federal government. The FASB establishes standards for all other entities, including not-for-profit colleges and universities and health care providers.

Q1-9. As business practices and new financial instruments continue to evolve, financial statement preparers may encounter transactions not specifically addressed by their standards-setting body. To deal with these situations, practitioners may be helped by documents issued by the staff of the standards-setting body or by other organizations that issue relevant professional guidance. They, therefore, need to know the relationships various sources of professional guidance have with each other. A hierarchy of generally accepted accounting principles allows a practitioner to look to the guidance of other bodies in the event the Board with jurisdiction has not issued a standard on a particular matter.

MULTIPLE CHOICE QUESTIONS

MC1-10. c

MC1-11. a

MC1-12. c

MC1-13. b

MC1-14. d

MC1-15. e

MC1-16. a

MC1-17. a

MC1-18. c

MC1-19. b

EXERCISES

E1-20. The CYO is a not-for-profit organization, rather than a governmental entity. Even though its activities are financed by governmental grants and its programs are held in a local high school, its day-to-day operations are controlled by a group of citizens, rather than by governmental officials. To be a governmental entity, the CYO would need to possess one of the characteristics of a governmental entity. For example, if the mayor appointed a majority of the board of directors and approved the hiring of the executive director, the CYO would be a governmental entity.

E1-21. The major argument in favor of having a single body establish accounting and financial reporting standards for hospitals is that it enables those interested in comparing financial performance among the three hospitals to have reasonable assurance that similar transactions and events are reported in a similar manner.

The major arguments in favor of having separate standards-setting bodies relate to issues of sovereignty and environment. There is a fundamental issue concerning the way in which the members of a single standards-setting body would be appointed. Would the governmental sovereignty issues be satisfied if all the members of the standards-setting body were appointed by private sector persons? Is it likely that a single standards-setting body would have sufficient concern for the unique environmental issues (such as budgetary controls) affecting some of the entities?

E1-22. (a) Accounting standards-setting bodies are needed to resolve differences of opinion regarding the way in which specific transactions and events are accounted for and reported. Many accounting issues are controversial and honest persons can disagree on the way in which they ought to be accounted for and reported. The treatment of pledges is an example of such an issue. A standards-setting body, with appropriate authority, can develop a single solution even though not everyone may agree with it. This enables financial statement users to have reasonable assurance that all not-for-profit organizations will report similar transactions and events in a similar manner.

(b) Members of an accounting standards-setting body need to have integrity; sufficient training and experience to understand the operating environment of the entities and the accounting issues they face; and a judicial temperament such that they can participate in debate, weigh the competing issues, compromise when appropriate, and reach supportable conclusions.

(c) A standards-setting body needs to engage in appropriate *due process* so that all interested persons have an opportunity to be heard before standards are promulgated. Accounting standards-setting bodies engage in due process through the appointment of task forces, issuing discussion memorandums and exposure drafts for comment by interested parties, holding public hearings, engaging in debate on the issues in meetings open to the public, and explaining the basis for conclusions in the final standard.

E1-23. (a) Without accruing for items applicable to a particular year, but not paid in that year, one cannot demonstrate whether “current year revenues were sufficient to pay for current-year services.” Hence, the first assertion is not logical.

(b) The answer to the second question depends on how one defines “performance” in governments. From a financial perspective, a government should at least break even for a given year and accumulate a reasonable cushion (financial surplus) against revenue shortfalls due to economic contraction or emergency expenditure need. But a government can break even by not providing needed services or by providing them inefficiently. Hence, a strong argument can be made for supplementing financial reporting with reporting on efficiency and effectiveness.

E1-24. The village manager’s instructions are probably illegal. The proposition explicitly requires the bond proceeds to be used for building a new fire house. Statutes generally provide for disposition of proceeds from bond sales that were not needed for the purposes for which the bonds were sold. Very often, unused proceeds of bond sales are required to be used to help pay the debt service on the bonds. Use of a separate fund (that is, a fund other than the General Fund) helps demonstrate accountability for the resources.