

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.