

WHY GOVERNMENTAL ACCOUNTING AND FINANCIAL REPORTING IS—AND SHOULD BE—DIFFERENT

INTRODUCTION AND SCOPE

From time to time, the question is raised as to why general purpose state and local governments (herein after referred to as “government”) cannot simply apply the same set of accounting standards that business enterprises² apply. This paper explains why separate standards for governments are needed. It illustrates some of the differences between standards for governments and those for business enterprises using standards for governments issued over the past twenty years, and explains why the process of standards setting for governments is an ongoing process.

In addition to providing greater detail about the questions in the Executive Summary, this paper also presents several appendixes. Appendix A provides an expanded discussion of the environmental differences between governments and business enterprises. Appendix B provides additional examples of standards that illustrate the differences between governments and business enterprises and expands upon the discussion of examples presented in this paper. Appendix C provides a historical perspective on the development of governmental accounting standards. Appendix D provides details on the significance of state and local governments in the United States. A brief glossary of governmental accounting terms is also included and begins on page 33. Terms defined in the glossary are printed in **boldface type** when they first appear.

The scope of this paper is limited to comparing general purpose governments to business enterprises. From time to time, the issue arises as to whether separate accounting standards are needed for other types of organizations, such as not-for-profit organizations. This paper neither supports the existing method of standards setting for other organizations not covered in the scope of this paper nor suggests that standards for those organizations should be set separately.

² See footnote 1 regarding the meaning of the term *business enterprises*.

Furthermore, governments in other countries may have different characteristics than governments in the United States; therefore, the paper does not address international differences.

WHY ARE SEPARATE ACCOUNTING AND FINANCIAL REPORTING STANDARDS ESSENTIAL FOR GOVERNMENTS?

Accounting and financial reporting requirements focus on the needs of the users of financial reports. Citizens and their elected representatives, such as legislatures, and other oversight organizations, as well as creditors, are primary beneficiaries of the information in governmental financial reports. Financial reports of business enterprises generally are used by creditors and by equity investors and their regulators, but not by a type of stakeholder equivalent to citizens and their elected representatives.³ The needs of citizens and oversight organizations emphasize **accountability** for resources entrusted to the government, and the needs of equity investors emphasize information necessary to make rational investment, credit, and similar decisions. Accountability, in a general sense, is a responsibility of stewards or agents to provide relevant and reliable information relating to resources under their control. For governments, accountability is the government's responsibility to justify to its citizenry the raising of public revenues and to account for the use of those public resources. Accountability information can be used to support decision making, but it also fulfills the citizenry's "right to know" how public resources have been spent.

Creditors are a type of user of both governmental and business enterprise financial reports. Although they are generally looking for assurance that sufficient cash flows will be available to meet debt service requirements, certain information they seek from governments and from business enterprises is different because the source of debt repayment is different. Creditors and potential creditors of business enterprises seek information about how earnings are generated. Creditors and potential creditors of governments seek information about the ability and willingness to levy taxes to finance debt repayment and the costs and obligations of those activities that could compete for those resources.

³ Elected representatives, such as legislators, are considered external users of financial reports because in many cases these individuals do not have access to the same internal financial data as do officials in the executive branch.

Although certain types of information in business enterprise financial reports could satisfy some needs of certain governmental financial report users, other users require different information. The accountability focus of governments and the broad range of sources of a government's resources lead to the conclusion that ideally governmental financial report users should be able to find additional information that will help answer questions such as the following:

- Did the government's ability to provide services improve or deteriorate from the previous year?
- Were the government's current-year taxes and other sources of resources sufficient to cover the cost of current-year services? Was part of the burden of paying for current services shifted to future-year taxpayers?
- How did the government finance its activities and meet its cash requirements? Does the government have the capacity to meet future obligations?
- What are the government's spending priorities? What sources of resources support the various programs? Has the government obtained and used resources in accordance with its adopted budget and other legal requirements?
- What resources currently are available for future expenditures and to what extent are resources reserved or restricted for specified uses?
- Has the government provided its services in an efficient and effective manner?

MAJOR ENVIRONMENTAL DIFFERENCES BETWEEN GOVERNMENT AND BUSINESSES

The differing needs of the users of governmental and business enterprise financial reports reflect the different environments in which the organizations operate. Some of the principal environmental differences are:

ORGANIZATIONAL PURPOSES. The purpose of government is to enhance or maintain the well-being of citizens by providing public services in accordance with public policy goals. Major public services provided by state and local governments include public safety, education, health, and transportation. Among other reasons, government provides these services because the economic incentives are not sufficient for business to provide them at the quantity, quality, and

price considered appropriate by public policy. Return on investment is not a goal for governments, so they need to develop and report other measures of accomplishment. The predominant business enterprise performance measures—net income and earnings per share—have no meaning in a governmental environment. Instead, governments focus on providing services and goods to constituents in an efficient, effective, economical, and sustainable manner. A government’s financial reports should give creditors, legislative and oversight officials, citizens, and other stakeholders the information necessary to make assessments and decisions relevant to their interests in the government’s accomplishment of its objectives.

In contrast, business enterprises focus on wealth creation, interacting only with those segments of society that fulfill their mission of generating a financial return on investment for shareholders. Historically, the primary focus of reporting has been on earnings and its components, with little or no explicit focus on nonfinancial measures of performance.

SOURCES OF REVENUE. The principal source of revenue for government is taxation, which is a legally mandated involuntary transaction between individual citizens and businesses and their government. The principal source of revenue of business enterprises is voluntary **exchange transactions** between willing buyers and sellers.

Because the assessment and the collection of taxes are not transactions in which equal values are exchanged at arm’s length and are not the culmination of an earnings process as are most transactions of business enterprises, transactions involving taxes require specialized accounting treatment. For example, governments may collect property taxes in a period prior to the period for which the taxes legally apply. The question then arises whether governments should record the taxes as revenue in the year collected or attribute them to the year for which the taxes apply. The GASB has addressed this issue by requiring that property taxes be reported as revenue in the period for which levied. This promotes assessment of **interperiod equity** by associating costs of services with revenues collected to finance those services.

POTENTIAL FOR LONGEVITY. Because of their ongoing power to tax and because of the ongoing need for public services, governments rarely liquidate. The possibility of achieving longevity, however, is not as likely for business enterprises. Business enterprises will go out of

existence if, for an extended period of time, they are unable to sell their products or services for more than it costs to produce them. Further, a business may also cease to exist if it is acquired by another entity. Financial statements of business enterprises generally are prepared using a “going-concern” assumption, meaning that assets and liabilities are not adjusted to their liquidation values; however, this is not equivalent to a presumption of extended longevity. Users of business enterprise financial statements may use those statements to assess longevity. In financial statements of business enterprises, emphasis is placed on the recoverability of assets, such as through future sales, and on the fair values of certain assets and liabilities. In contrast, the ability of governments to exist in the future generally is not in doubt, but rather the question is the sustainability of the level of services provided and the ability to meet future levels of demand for services. As a result, the emphasis generally has been on the allocation of resources to government programs, the determination of the cost of services (as noted above), and providing a longer term view of operations.

The longer term view of operations of government is consistent with focusing on trends in operations, rather than on short-term fluctuations, such as in fair values of certain assets and liabilities. Immediate recognition of changes in fair values of assets set aside in employee benefit plans is appropriate accountability reporting in the employee benefit plans that hold those assets. However, it is not appropriate for government employers to immediately recognize those fair value changes or changes in accrued actuarial liabilities resulting from a change in benefit plan terms. These short-term fluctuations could produce a measurement of the period’s employee benefit costs, which are included in cost of services, that may be less decision-useful for governmental financial report users. Financial reporting by business enterprises is more likely to recognize such changes in fair value because of the importance of the current value of equity.

RELATIONSHIP WITH STAKEHOLDERS. Individual citizens must pay taxes as agreed to by the citizenry collectively through elections or decisions of elected representatives, and as previously noted, individual taxes paid are not directly correlated with services received. Accordingly, governments should meet a standard of accountability that is broader than for business enterprises. Furthermore, citizens are interested in evaluating interperiod equity by determining whether current taxpayers and users of government services fully financed the costs

of providing current-period services or whether taxes and user fees from prior or future periods were, or will be, needed to finance the current services provided. Consequently, one important focus of governmental financial reporting is on providing systematic and rational cost-of-service information. Additionally, users of financial reports may wish to evaluate the combination of taxes, user fees, grants, and borrowings used to finance current services. In contrast, because business enterprises focus primarily on increasing shareholders' equity, their financial reports show changes in equity of the enterprise during the current period. Except for those with large blocks of shares, public company shareholders typically can easily end their relationship with any individual business enterprise by selling their shares and, consequently, focus on the current and future value per share.

ROLE OF THE BUDGET. For governments, a budget takes on a special legal significance. Governmental budgets are expressions of public policy priorities and legally authorize the purposes for which public resources may be spent. In fact, governmental budgets can be the primary method by which citizens and their elected representatives hold the government's management financially accountable. For business enterprises, the budget represents an internal financial management tool that is controlled entirely by management and is considered proprietary in nature.

HOW DO EXISTING ACCOUNTING AND FINANCIAL REPORTING STANDARDS REFLECT THE DIFFERENT NEEDS OF STAKEHOLDERS?

The differences in the needs of users of financial reports of governments and business enterprises are reflected both in differences in components of the **conceptual framework for accounting standards** and in the individual accounting standards set by the GASB and the FASB.

CONCEPTUAL FRAMEWORK DIFFERENCES

Both the GASB and the FASB have developed Concepts Statements setting forth the objectives of financial reporting. The objectives are the central core of the conceptual

frameworks for standards and reflect the differing needs of users of financial reports of governments and business enterprises.⁴ Reflecting the needs of their stakeholders, including citizens and their elected representatives, governments predominantly focus on accountability in financial reporting. For governments, information necessary to make political and social decisions is as important as information necessary to make economic decisions in shaping accounting and financial reporting objectives. Reflecting the needs of the stakeholders of business enterprises, including equity investors, financial reporting of business enterprises predominantly focuses on financial performance—earnings and its components. For business enterprises, information for making economic decisions is most important in shaping accounting and financial reporting objectives.

In recognizing that users of governmental financial reports are also interested in assessing nonfinancial performance of governments, the GASB recognized the importance of these measures in Concepts Statement No. 1, *Objectives of Financial Reporting*. The objectives, elements, and characteristics of service efforts and accomplishments (SEA) reporting were expanded on in GASB Concepts Statement No. 2, *Service Efforts and Accomplishments Reporting*. The objective of SEA reporting is to provide more complete information about a governmental entity's performance than can be provided by the traditional financial statements and schedules to assist stakeholders in assessing the economy, efficiency, effectiveness, and sustainability of services provided. To promote achievement of the objective of SEA reporting, SEA information focuses primarily on measures of service accomplishments (outputs and outcomes) and measures of the relationships between service efforts and service accomplishments (efficiency). On the other hand, business enterprise financial reporting objectives do not recognize nonfinancial reporting measures. Although some believe that it would be beneficial to require business enterprises to report certain nonfinancial measures, competitive considerations of business enterprises may limit the amount of information that

⁴The conceptual framework of the GASB is not yet complete, although the GASB recently issued Concepts Statement No. 3, *Communication Methods in General Purpose External Financial Reports That Contain Basic Financial Statements*, and is currently developing another Concepts Statement to define the elements of financial statements. The conceptual framework of the FASB is currently being revisited in conjunction with considerations for convergence with the International Accounting Standards Board.

could be provided. Some nonfinancial measures that would provide decision-useful information to financial report users might also be considered “trade secrets” that would threaten the competitiveness of a business.

The GASB’s project to define the elements of financial statements is not yet complete, but even now it is clear that the definition of an asset for governments will differ from the definition for business enterprises. One of the inherent characteristics of an asset is that it provides future benefit. The future benefit that governments recognize is an asset’s ability to contribute to providing the public services and goods that are the mission of government. Assets such as roads, courthouses, libraries, and parks directly provide public services or goods. Other types of assets, such as investments, indirectly contribute to providing public services and goods when they produce cash used to acquire public services and goods. For business enterprises, the only future benefit provided by an asset is its economic benefit—a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows. As the conceptual framework progresses, other differences may well be identified.

ACCOUNTING STANDARDS DIFFERENCES

- ***CAPITAL ASSETS.*** As noted earlier, governments acquire most capital assets because of the asset’s capacity to provide services to the citizenry, whereas business enterprises acquire capital assets with the objective of using them to generate future cash flows. Consequently, GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, prescribes a method of assessing and measuring impairment of capital assets that reflects reductions in service potential of capital assets as a result of impairing events or changes in circumstances because the purpose of government is to provide services. In contrast, business enterprises assess and measure impairment of capital assets by evaluating the future cash flows expected to be produced by the asset because the purpose of business enterprises is to create wealth.
- ***PROPERTY TAXES.*** Generating property tax revenue is a transaction unique to government, and, as previously noted, accounting standards for taxation should reflect reporting of property taxes as revenues in the same period as the cost of the services for

which they were levied to pay in accordance with the need of users of governmental financial statements to assess interperiod equity. For this revenue source, governments control all major events associated with potential points of recognition. Governments establish the assessment dates, the levy dates, the collection or due dates, and the periods for which the taxes are levied.

- **FUND ACCOUNTING.** Fiscal accountability for governmental activities is achieved by preparing financial statements using the **current financial resource flows measurement focus**—the long-standing measurement focus of **governmental funds**—and a **modified accrual basis of accounting**. This measurement focus emphasizes control and accountability over the raising and spending of public moneys. Financial reporting for governmental fund activities allows stakeholders to assess whether sufficient resources (generally cash and other liquid assets) existed to finance the current period’s activities. This assessment is particularly important to those who pay taxes and receive services. Fiscal accountability is demonstrated, for example, when governments prepare fund-based financial statements, which show whether resources were obtained and used in accordance with the legally adopted budget and in compliance with other finance-related legal or contractual requirements. GASB Statement No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, requires governments to report a balance sheet and a statement of revenues, expenditures, and changes in fund balances for their general fund, other major governmental funds, and other governmental funds in the aggregate. Governments also demonstrate accountability through reporting financial statements of fiduciary funds, which are used to report assets held in a trustee or agency capacity for others and therefore cannot be used to support the government’s own programs. These funds are not reported as part of the resources available to finance public services and goods, but rather are reported separately to demonstrate accountability for these resources.
- **PENSIONS AND OTHER POSTEMPLOYMENT BENEFITS (OPEB).** Financial reporting standards for pensions and OPEB for both governments and business enterprises are similar in that they are based on the concept that these benefits are deferred compensation for employee services and should be accounted for in accrual-basis statements as the benefits

are earned, rather than when paid. Moreover, both sets of standards currently include provisions for deferral and amortization for past service costs. Beyond that, however, the measurement approaches adopted for use in the public and private sectors are different, as are many of the specific measurement and presentation choices, for reasons rooted in the different environments and the different information needs of stakeholders.

The longevity of governments, the importance of the cost-of-services information, and the desire of stakeholders to measure interperiod equity all influence the GASB's standards for defined benefit pension and OPEB plans. The focus of business enterprise accounting for pension benefits and OPEB worldwide generally appears to be moving toward the measurement of the fair values of pension or OPEB assets and liabilities.

The pension accounting approach for governments (subsequently adapted for use for OPEB as well) explicitly harmonizes accounting with the actuarial funding characteristics of public pension plans. Governmental accounting standards permit the use of a number of actuarial cost and amortization methods commonly used in actuarial valuations for funding purposes that are also appropriate for accrual accounting purposes. This approach was based on research studies conducted with financial statement users at the time the pension standards were being developed. As long as the individual government's funding approach met established accrual-based parameters, the transparency sought by most governmental financial statement users was achieved. As applied by government employers and pension plans, these parameters make it possible to allocate expenses to periods in a way that charges each period a level percentage of payroll for normal cost. This method equitably spreads the burden of an ongoing benefit program among different generations of taxpayers.

Additional differences in accounting standards that reflect differences in user needs are, for example, seen in: (1) the financial reporting model, (2) the definition of the reporting entity, (3) service-oriented infrastructure assets, (4) grants and gifts, and (5) debt refundings. Additional information about these accounting differences is included in Appendix B.

WHY IS THERE AN ONGOING NEED TO SET ADDITIONAL GOVERNMENTAL ACCOUNTING STANDARDS?

Although much progress has been made, there is a need to set additional accounting standards for governments. For example, the current technical agenda includes projects on derivatives and on pollution remediation obligations. The Derivatives project is expected to determine whether derivatives, such as the floating-to-fixed interest rate swaps that are becoming more prevalent in government, should be displayed at fair value on financial statements, whether hedge accounting (deferring recognition of changes in fair value of certain derivatives) will be permitted, and, if so, what criteria should be met to use hedge accounting, as well as whether current derivative note disclosures are adequate. The project on pollution remediation obligations is expected to provide guidance on which specific events or circumstances give rise to a pollution remediation obligation as well as establish the methods for measuring and reporting these obligations at the various stages throughout a remediation effort.

Over the years, the number of research and potential technical agenda projects has continued to grow. The number of projects in these categories now exceeds the current technical agenda items by more than 2 to 1. Some of these projects and their objectives are briefly described below.

- Electronic Reporting project—to assess the potential effect of electronic media on information delivery and stakeholder needs
- Fiduciary Responsibilities project—to assess whether additional guidance should be developed regarding the application of the criterion “fiduciary responsibility” in deciding whether and how governments should report fiduciary activities, such as employee benefit plans and prepaid tuition arrangements, in their financial reports
- Financial Performance Reporting project—to determine the best method to present changes in fair values in the statement of activities; statement of revenues, expenses, and changes in fund balance; statement of revenues, expenses, and changes in fund net assets; and statement of changes in fiduciary net assets

- Government Combinations project—to determine the financial reporting requirements related to accounting for annexations, consolidations, or other forms of nonpurchase combinations
- In-kind Contributions project—to provide accounting and financial reporting guidance for contributed services received by state and local governments
- Preservation Method of Accounting project—to determine if reported changes in asset condition levels (associated with the modified approach of accounting for infrastructure assets) can be measured in monetary terms that meet the qualitative characteristics for financial reporting
- Service Efforts and Accomplishments Reporting project—to encourage the use and reporting of performance measures and, based on their use, to determine whether performance measures have developed to the point where the GASB will consider establishing a current technical agenda project on SEA reporting.

The environment in which governments operate also fuels the need for new projects. These governments are a significant component of the United States economy, generating 20 percent of gross domestic product, employing 12 percent of the nation's workforce, and issuing of over \$1.7 trillion in bonds. As with other components of the economy, the activities and transactions of the governments continue to change and often increase in complexity. For example, some governments recently issued bonds secured with proceeds from a master settlement agreement with the major tobacco companies. These transactions often involved new and complex legal structures. The GASB issued Technical Bulletin 2004-1, *Tobacco Settlement Recognition and Financial Reporting Entity Issues*, to address accounting for these transactions. As governments have expanded their activities in selling and pledging other types of receivables and future revenues, the GASB has determined that additional and broader standards are necessary. A comprehensive project on sales and pledges of receivables and future revenues was begun that led to an Exposure Draft on this issue in September 2005. Given the increasing complexity of government transactions and the fact that the governmental environment continues to change, such as with growing interdependencies among different levels of government, the number of research and potential projects is expected to continue to grow.

CONCLUSION

Governments are fundamentally different from business enterprises. As a result, separate accounting and financial reporting standards for governments are essential to meet the specific needs of the users of governmental financial reports. The standards for governments need to reflect the unique environment of government, including different organizational purposes and special legal powers, and to effectively address public accountability issues inherently related to the unique government environment.