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

Executive Summary

Governments are fundamentally different from for-profit business enterprises in several important ways. Their organizational purposes, processes of generating revenues, stakeholders, budgetary obligations, and propensity for longevity differ. These differences require separate accounting and financial reporting standards in order to provide information to meet the needs of stakeholders to assess government accountability and to make political, social, and economic decisions. Although state and local governments (herein after referred to as "governments") in the United States have had separate standards for over 100 years, the question is sometimes asked: Why can't general purpose governments (cities and counties, for example) simply apply the standards established for business enterprises?[1] The following questions and answers briefly address that issue, and the accompanying paper and its appendices provide an expanded discussion.

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

Separate accounting and financial reporting standards are essential because the needs of users of financial reports of governments and business enterprises differ. Due to their unique operating environment, governments have a responsibility to be accountable for the use of resources that differs significantly from that of business enterprises. Although businesses receive revenues from a voluntary exchange between a willing buyer and seller, most governments obtain resources primarily from the involuntary payment of taxes. Taxes paid by an individual taxpayer often bear little direct relationship to the services received by that taxpayer. Overall, taxpayers collectively focus on assessing the value received from the resources they provide to a government. Governmental accounting and financial reporting standards aim to address this need for public

[1] The term *business enterprise* is used to refer to private-sector entities organized for the purpose of earning profit. Business enterprises in the United States apply accounting pronouncements of the Financial Accounting Standards Board. *Business enterprise* does not refer to and should not be confused with business-type activities of governments.

accountability information by helping stakeholders assess how governments acquired public resources and used them during the period or are expected to use them in the future. Such reporting also helps users to assess whether current resources were sufficient to meet current service costs (or whether some costs were shifted to future taxpayers) and whether the government's ability to provide services improved or declined from the previous year.

The longevity of most governments and their role to maintain and enhance the well-being of citizens through the provision of public services also result in information demands that differ from those of business enterprises. For example, most governments do not operate in a competitive marketplace, face little or no threat of liquidation, and do not have equity owners. Consequently, measures of net income and earnings per share have no meaning to users of governmental financial reports. Instead, users need information to assess a government's stewardship of public resources, including information to evaluate the manner and extent to which it devotes resources to specific services and the costs of providing those services. Users also need information to determine compliance with legally authorized spending authority. Creditors of both businesses and governments are interested in information on the ability to repay debt. However, government creditors do not focus primarily on a government's "profitability" per se. Instead, they are concerned with (1) the government's ongoing ability and willingness to generate sufficient resources each year to cover its costs and repay its debts and (2) how service provision and other activities compete with debt repayment for those resources.

How Do Existing Accounting and Financial Reporting Standards Reflect the Different Needs of Stakeholders?

Differences in the components of the conceptual framework for setting accounting and financial reporting standards and differences in specific accounting and financial reporting standards themselves reflect the particular needs of the users of governmental financial reports. Although investors and creditors are important constituencies of every standards-setting organization, the Governmental Accounting Standards Board's (GASB) conceptual framework also places priority on addressing the informational needs of citizens and elected representatives, two constituencies not identified as users of business enterprise financial statements by the Financial Accounting Standards Board (FASB). Consequently, the GASB's financial reporting objectives consider accountability to be the cornerstone on which all other financial reporting objectives should be built.

Some of the most significant examples of how GASB standards address differences between governmental and business financial reporting include:

(1) The view that capital assets are primarily used to provide services to citizens rather than to contribute to future cash flows
(2) The measurement and recognition of certain types of revenues (for example, taxes and grants)
(3) The use of fund accounting and budgetary reporting to meet public accountability needs
(4) The use of accountability notions rather than equity control to define the financial reporting entity
(5) The view that governments and their pension and retiree healthcare plans generally are ongoing entities with the ability to take a career-long view of the employment exchange.

These and other accounting and reporting differences are described more fully beginning on page 12 and in Appendix B.

Why Is There an Ongoing Need to Set Additional Governmental Accounting and Financial Reporting Standards?

Since its inception in 1984, the GASB has strived to meet the needs of the users of governmental financial reports by issuing standards that reflect their particular concerns and the unique features of the government environment. Although the GASB has established a substantial body of standards, the need to develop and improve accounting and financial reporting standards for governments still exists. For example, the GASB continues to address additional components of the conceptual framework, which enhances consistency in setting government standards. In addition, governments and the governmental environment continue to evolve over time and new types of transactions or variations on existing transactions continue to arise, resulting in an ongoing need to update existing standards and to adopt new ones.

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

Introduction and Scope

From time to time, people ask why state and local governments (hereinafter referred to as "governments") cannot simply apply the same set of accounting and financial reporting standards that business enterprises[2] 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 and explains why standards setting for governments is an ongoing process.

In addition to answering the questions posed in the Executive Summary in greater depth, this paper also presents several appendices. Appendix A provides an expanded discussion of the environmental differences between governments and business enterprises. Appendix B provides additional examples of standards that differ for governments and business enterprises and expands upon the examples discussed in this paper. Appendix C provides historical perspective on the development of governmental accounting and financial reporting standards. Appendix D provides background information on the significance of state and local governments in the United States. A brief glossary of governmental accounting terms also is included and begins on page 34. Terms defined in the glossary appear in **boldface type** when first used in this paper.

The scope of this paper is limited to comparing accounting and financial reporting standards for state and local governments to those required for business enterprises. It does not specifically address the standards set for organizations other than business enterprises, such as not-for-profit organizations or the federal government, nor does it suggest that standards for those entities should not be set separately. 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, their elected representatives (such as legislatures and other oversight

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

organizations), and creditors are the primary beneficiaries of the information in governmental financial reports. Financial reports of business enterprises primarily serve the needs of current and potential creditors and equity investors and their regulators, but generally not a type of stakeholder that is equivalent to citizens and their elected representatives.[3]

The needs of citizens and oversight organizations emphasize **accountability** for resources entrusted to the government, whereas the needs of investors primarily 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 resources—most notably, taxes—and to account for the stewardship and 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 creditors generally are looking for assurance that sufficient cash flows will be available to make payments on outstanding debt and accounts payable, certain information they seek from governments and from business enterprises is different because the source of repayment is different. Creditors and potential creditors of business enterprises seek information about how entities generate their earnings. Creditors and potential creditors of governments seek information about how governments raise their resources in order to evaluate (1) the government's ongoing ability and willingness to generate sufficient resources each year to cover its costs and to repay debts and payables and (2) how service provision and other activities compete with debt repayment for those resources.

Certain types of information found in business enterprise financial reports could satisfy some needs of certain governmental financial report users. However, other users require different information. The focus on government accountability and the broad range of sources of government resources mean that governmental financial report users ideally should be able to find information that will help answer questions such as:

- Did the government's ability to provide services improve or decline from the previous year?

[3] Although they are employed by a government, elected representatives (such as legislators) and oversight bodies are considered *external* users of financial reports because, in many cases, these individuals do not have access to the same internal financial data as officials in the executive branch.

- 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 taxpayers in future years, or is the government exhausting its reserves or rainy day funds?
- How did the government finance its activities and meet its cash requirements? Does the government have the capacity to meet future financial 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 limited to specified uses? Does the government have the capacity to meet future service obligations?
- Has the government provided its services in an efficient and effective manner?
- Does the government have sufficient resources and flexibility to weather the drop in revenues that accompanies economic downturns and still meet its core commitments?

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, sources of revenue, potential for longevity, relationship with stakeholders, and the role of the budget. (An expanded discussion of the unique aspects of the government environment is included in Appendix A.)

Organizational Purposes

The purpose of governments 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, social services, and transportation. Governments provide 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, among other reasons.

By contrast, financial return on investment is not a primary goal for governments (with the exception of certain entities, such as employee benefit plans and investment pools), so they need to develop and report other measures of accomplishment. The predominant performance measures of business enterprises—net income and earnings per share—generally have little or no meaning in the governmental environment. Instead, governments focus on providing services and goods to constituents efficiently, effectively, and sustainably. A government's financial reports should give investors and 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.

Sources of Revenue

Taxes are the principal source of revenue for general purpose and many special-purpose governments. Taxation is a **nonexchange transaction** between individual citizens and businesses and their government. From the perspective of citizens and businesses, tax transactions are legally mandated and involuntary—it is very difficult for them to avoid being involved in the transaction and paying the taxes. The principal source of revenue of business enterprises, on the other hand, is voluntary **exchange transactions** between willing buyers and sellers.

Furthermore, the levying of taxes is not a transaction in which equal values are exchanged at arm's length and is not part of an earnings process, as are most transactions of business enterprises. Consequently, transactions involving taxes require specialized accounting standards. For example, governments may levy or collect property taxes in a period prior to the period for which the taxes legally apply. Should governments record the taxes as revenue in the year levied or collected, or should they record the revenue in the year to which the taxes apply? The GASB has addressed this issue by requiring that property taxes be reported as revenue in *the period for which* they are levied, regardless of *when* they are levied. This promotes assessment of **interperiod equity** by associating revenues with the periods in which they finance the cost of services.

Potential for Longevity

Governments rarely need to consider liquidation because of their ongoing power to tax and the ongoing need for public services. Similar 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.[4]

Financial statements of a business enterprise generally are prepared using a "going-concern" assumption. This means that there is not substantial doubt that, one year from the date the financial statements are issued, the business enterprise will continue to meet its obligations as they become due. Based on this assumption, the business' 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. Financial statements of business enterprises emphasize the recoverability of assets, such as through future sales, and on the fair values of certain assets and liabilities.

By contrast, the ability of governments to exist in the future generally is not in doubt (even in the extreme case of municipal bankruptcy). Rather, the issues for governments are the sustainability of the level of services provided and the ability to meet future demand for services. As a result, governmental financial statements generally emphasize the allocation of resources to government programs, the determination of the cost of services, and 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 the 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 and in the calculation of the employer's net pension liability or net other postemployment benefit (OPEB) liability. However, it is not appropriate for government employers to recognize the difference between projected and actual earnings on investments for pension and OPEB plans immediately in pension expense and OPEB expense. Doing so would introduce short-term fluctuations that could produce a measurement of the fiscal year's employee benefit costs—which would be included in overall cost of services—that might be less useful to governmental financial report users.

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[4] For instance, only half of new employer firms last 5 years and one-third last 10 years or more (https://www.sba.gov/sites/default/files/FAQ_Sept_2012.pdf, accessed on July 1, 2016). By contrast, the number of general purpose governments remains steady—38,910 in 2012 versus 38, 463 in 1957 (http://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?src=bkmk, accessed on February 9, 2016).

The difference between projected and actual earnings on investments for pension and OPEB plans are required to be reported as either a deferred inflow of resources or a deferred outflow of resources and recognized in expense over a five-year closed period (the equivalent to traditional market cycle) in order to mitigate the effects of short-term market changes on the reported costs of providing career-long benefits to government employees. Business enterprises would recognize these changes as part of net periodic pension cost or as increases or decreases in other comprehensive income (which then is recognized as net periodic pension costs in future periods).

Relationship with Stakeholders

Individual citizens must pay taxes as agreed to by the citizenry collectively through elections or decisions of elected representatives. However, the amount of taxes paid by an individual does not directly correlate with the level of services they received, nor does the timing of the payment relate to when taxpayers receive services. Accordingly, governments should meet a benchmark of accountability that is broader than for business enterprises (whose transactions generally involve a simultaneous exchange of equal value with customers). Furthermore, citizens are interested in interperiod equity—evaluating whether current taxpayers and users of government services fully financed the costs of providing current-year services or whether taxes and user fees from prior or future years were, or will be, needed to finance the services provided this year.

Consequently, it is important for governmental financial reporting to provide systematic and rational cost-of-service information. Additionally, users of governmental financial reports may wish to evaluate the combination of taxes, user fees, grants, and borrowing that financed current services. In contrast, business enterprise financial reports show changes in equity of the enterprise during the current period because business enterprises focus primarily on increasing shareholders' equity. 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. Consequently, shareholders focus on current and future value per share. Lastly, creditors of governments and of business enterprises often look to different information, as previously noted.

Role of the Budget

For governments, a budget has special legal significance. Governmental budgets are expressions of public policy priorities: They legally authorize the raising of public resources and constrain 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 different needs of users of financial reports of governments and business enterprises are reflected both in differences in components of the **conceptual framework for accounting and financial reporting standards** and in the specific accounting and financial reporting standards set by the GASB and the FASB.

Differences in Conceptual Frameworks

Both the GASB and the FASB have developed Concepts Statements setting forth the objectives of financial reporting. The objectives are the core of the conceptual frameworks and reflect the differing needs of users of financial reports of governments and business enterprises.[5] Reflecting the needs of their stakeholders, including citizens and their elected representatives, governments predominantly focus on accountability in financial reporting. For governments, information that is necessary to make political and social decisions is as important in shaping accounting and financial reporting objectives as information that is needed to make economic decisions. Financial reporting of business enterprises predominantly focuses on financial performance—earnings and its components—reflecting the needs of the stakeholders of business enterprises, including equity investors. For business enterprises, information for making economic decisions is most important in shaping accounting and financial reporting objectives.

GASB Concepts Statement No. 4, *Elements of Financial Statements*, defines the items that are reported in governmental financial statements, such as assets and outflows of resources. Although some definitions of elements have similarities to those in the FASB's Conceptual Framework, the GASB's definitions of the elements of financial statements reflect the unique characteristics of government. Interwoven throughout the GASB's definitions is the common thread of providing public service. Central to most of the definitions is a *resource*, which is

[5] The conceptual framework of the GASB is not yet complete. As of September 2017, the GASB is developing an additional Concepts Statement to identify recognition criteria for whether and when information should be reported in state and local governmental financial statements.

something a government can use to provide services. For example, an asset is a resource with present service capacity that the government presently controls. The present service capacity of a resource is its existing capability to enable the government to provide services, which in turn enables the government to fulfill its mission. Assets such as roads, school buildings, courthouses, libraries, and parks directly provide present service capacity in that the citizenry or public directly uses the asset. Other types of assets, such as investments, indirectly contribute to present service capacity because a government can hold or sell them to produce cash used to acquire public services and goods. For business enterprises, the 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.

GASB Concepts Statement 4 also identifies and defines deferred inflows of resources and deferred outflows of resources as elements of financial statements. A deferred inflow of resources is an acquisition of net assets by a government that does not meet the definition of a liability *and is applicable to a future reporting period*. A deferred outflow of resources is a consumption of net assets by a government that does not meet the definition of an asset and is applicable to a future reporting period. In the government environment, deferred inflows of resources and deferred outflows of resources inherently have different characteristics from assets and liabilities. Further, GASB Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, requires governments to report these financial statement elements separately from assets and liabilities. In contrast, business enterprises do not distinguish deferred inflows and outflows of resources from assets or liabilities.

The GASB also recognized in Concepts Statement No. 1, *Objectives of Financial Reporting*, that users of governmental financial reports also are interested in assessing nonfinancial performance of governments. 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*, and subsequently amended in GASB Concepts Statement No. 5, *Service Efforts and Accomplishments Reporting*.

Further, the GASB issued Suggested Guidelines for Voluntary Reporting, *SEA Performance Information*, which provide a common framework for the effective external communication of SEA performance information. This framework establishes that the objective of an SEA report is to assist a government in meeting its responsibility to be accountable by providing stakeholders with information to assist them in assessing the government's performance in providing services.

On the other hand, business enterprise financial reporting objectives typically do not encompass nonfinancial reporting measures. Some business enterprises may voluntarily report nonfinancial measurements in U.S. Securities and Exchange Commission filings or annual reports to shareholders, but that information usually is incidental to the financial information and not consistent between businesses. 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 and type of information that could be provided (in contrast with governmental information, which generally is in the public domain). Some nonfinancial measures that would provide decision-useful information to financial report users also could be "trade secrets" that would threaten the competitiveness of a business.

Differences in Accounting and Financial Reporting Standards

Capital Assets—Governments acquire most capital assets because of their 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 the service potential of capital assets as a result of impairing events or changes in circumstances. In contrast, business enterprises assess and measure impairment of capital assets by evaluating the future cash flows that are expected to be produced by the asset.

Property Taxes—Generating property tax revenue is a transaction unique to government. As previously noted, accounting and financial reporting standards for taxation require governments to report property taxes as revenues in the same period as the cost of the services the taxes were levied to pay for. This requirement is 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 resources measurement focus** and a **modified accrual basis of accounting.** This measurement focus emphasizes control and accountability over the raising and spending of public money. Financial reporting for governmental funds allows stakeholders to assess whether sufficient resources (generally cash and other liquid assets) existed to finance the current year's activities. This assessment is particularly important to those who pay taxes and receive services.

Governments demonstrate fiscal accountability, for example, when they prepare governmental fund 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 nonmajor governmental funds in the aggregate. GASB Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, establishes a reporting hierarchy for fund balance—the difference between assets and liabilities in the governmental funds—based primarily on the extent to which a government is bound to observe constraints imposed upon the use of governmental fund resources.

Governments also demonstrate accountability through reporting financial statements for fiduciary funds, which (1) are used to report assets held for others in a trustee or custodial capacity and, therefore, (2) cannot be used to support the government's own programs. These funds are reported separately to demonstrate accountability for these resources, not as part of the resources available to finance public services in the government-wide financial statements. (See the section below on fiduciary activities for further discussion.)

Postemployment Benefits—Accounting and financial reporting standards for pensions, retiree healthcare, and other forms of postemployment benefits for both governments and business enterprises are similar in that they are based on the notion 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. 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 the degree to which interperiod equity has been achieved all influenced the GASB's standards on postemployment benefits:

- Statement No. 67, *Financial Reporting for Pension Plans*

- Statement No. 68, *Accounting and Financial Reporting for Pensions*
- Statement No. 73, *Accounting and Financial Reporting for Pensions and Related Assets That Are Not within the Scope of GASB Statement 68, and Amendments to Certain Provisions of GASB Statements 67 and 68*
- Statement No. 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*
- Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*.[6]

The measurement of a government's obligation for defined benefit pensions and other postemployment benefits (OPEB) represents a career-long view of the employment exchange. Two differences with business enterprises that result from this career-long view are the rate used to discount future pension and OPEB benefit payments to their present value and the method used to attribute pension and OPEB liabilities to specific periods.

First, for governments, the selection of a discount rate for determining the actuarial present value of projected pension and OPEB benefit payments depends on the amount of resources available in the pension or OPEB plan for paying those benefits (from contributions and earnings related only to current active employees and retirees, not to future employees). As long as (1) the plan is projected to have these resources invested in a manner consistent with the long-term expected rate of return and (2) those resources are greater than or equal to the projected benefit payments for current employees and retirees, the discount rate is entirely based on the long-term expected rate of return on pension plan investments. However, if the projections show that a time will come when those conditions are no longer met (for instance, projected benefit payments are greater than projected plan resources), the discount rate should be based on a rate that reflects the effects of discounting benefit payments in that period and beyond using a municipal bond index rate or yield—for 20-year tax-exempt bonds rated AA or higher (or equivalent ratings). This approach reflects a change in the nature of the postemployment benefit obligation for governments—from one expected to be satisfied, in part, through the accumulation of investment returns to one similar to a more typical government liability—when the plan assets are projected not to be sufficient to pay projected benefits.

[6] These pronouncements represent the foundational accounting and financial reporting standards for postemployment benefits. Related pronouncements include Statement No. 71, *Pension Transition for Contributions Made Subsequent to the Measurement Date*, Statement No. 78, *Pensions Provided through Certain Multiple-Employer Defined Benefit Pension Plans*, Statement No. 82, *Pension Issues*, and Statement No. 85, *Omnibus 2017*.

Business enterprises are required to use a discount rate that reflects the rate at which pension and OPEB benefits could be settled. In estimating that rate, FASB guidance allows businesses to look to available information about rates implicit in current prices of annuity contracts that could be used to settle the obligation or rates of return on high-quality fixed-income investments currently available and expected to be available during the period to maturity of the pension benefits.

Second, the effects of government employment exchange transactions on pension and OPEB obligations is represented in a level manner as a percentage of projected pay over the entire projected career of the employee. In contrast, the accrual of a pension or OPEB obligation for business enterprises reflects a pattern based primarily on the benefit formula as it relates to the assignment of benefits to each unit of service credit.

One can see additional differences in accounting and financial reporting standards that reflect differences in user needs, for example, 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 AND FINANCIAL REPORTING STANDARDS?

The significance of state and local governments in the United States economy and the dynamic nature of their activities and transactions fuel the need for new standards-setting projects. These governments generate 19.8 percent of gross domestic product, employ 13.4 percent of the nation's workforce, and owe more $3.6 trillion in municipal debt. (See Appendix D, Significance of State and Local Governments.) As with other components of the economy, the activities and transactions of governments continue to change and often increase in complexity. For example, in the time leading up to and following the economic recession in 2008, instances of governments filing for federal bankruptcy protection appeared to be on the rise. The GASB issued Statement No. 58, *Accounting and Financial Reporting for Chapter 9 Bankruptcies*, to provide guidance to these governments on how to account for the effects of a bankruptcy on reported liabilities and on what information about bankruptcies should be disclosed in the notes to the financial statements.

Several types of transactions have occurred with greater frequency as governments have sought ways to deal with the financial repercussions of the economic downturn. Governments have increasingly entered into service concession arrangements (a type of public-private partnership). The GASB determined that additional guidance was necessary to enhance the consistency and comparability in reporting these types of arrangements and issued Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*. To assist governments that were pursuing mergers with other governments to achieve economies of scale or the disposal of some of their operations, the GASB issued Statement No. 69, *Government Combinations and Disposals of Government Operations*. Finally, changes in the municipal bond insurance industry made it more difficult for governments to insure the municipal bonds they were issuing. Some state governments were filling that need by providing guarantees for bonds and other financial obligations of counties, localities, and school districts—but they were charging little or nothing in return. GASB Statement No. 70, *Accounting and Financial Reporting for Nonexchange Financial Guarantees,* clarified how these transactions should be accounted for—both for the providers and recipients of the guarantees—and what information governments should be disclosing about them.

Given the emergence of new government transactions, increasing complexity of existing government transactions, financial innovations, and changes within the governmental environment, such as with growing interdependencies among different levels of government, new standards-setting projects likely will continue to arise.

Conclusion

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

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, social services, and transportation services, are necessary for achieving that purpose. However, the private sector generally would not provide those services 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 to provide public services and goods as determined through the political process in an effective and efficient manner, not to generate a financial return on investment. As discussed below, even when governments provide the same type of services as a business enterprise, such as hospital services, they do not do so with the intention of earning a profit (although they do seek to obtain sufficient resources each year to cover costs and, perhaps, to raise additional resources to invest in their capital assets).

It is expected that governments also will address circumstances in which (1) the cost of a service or good is not exclusively borne by the producer or recipient or (2) the benefit of a service or good is not exclusively enjoyed by the purchaser or recipient. 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 they pass certain costs on to citizens. Vaccination against communicable disease is an example of a service with a benefit that is not exclusively enjoyed by the purchaser or recipient. Vaccination benefits not only the individual vaccinated but also any individuals who might otherwise have contracted the disease through contact with the vaccinated individual. The role of government regarding such circumstances may be to directly provide the public service or good or to regulate its provision.

The prevalence of public services and goods in government, combined with 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 often receive substantial revenues from nonexchange transactions (also referred to as nonreciprocal transactions in some accounting literature), such as taxes and grants. Nonexchange transactions are different from exchange transactions such as sales revenue and debt or equity financing. In a nonexchange transaction, a government either (1) receives value from another party without directly giving equal value in exchange or (2) gives value to another without receiving equal value in exchange.

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 or the amount of 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, how those cash flows are generated is quite different. GASB Concepts Statement 1 describes the needs of creditors in paragraph 35: [7]

> 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.

Government operations generally are not financed through equity ownership. Ownership interests in business enterprises may be bought and sold, but this is uncommon 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,

[7] 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.

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 origins to the original 13 colonies. Governments rarely need to consider liquidating because of a combination of factors, including the power to tax, the nature of and need for the services provided, and a lack of market competition (with the exception of certain entities such as public hospitals and universities). From time to time, governments may combine through a merger or acquisition, but they continue to provide basic services. The laws for municipal bankruptcy, found in Chapter 9 of the federal bankruptcy code, provides for *reorganization* of municipalities, but not for their *liquidation*. Additionally, only qualifying municipalities—not creditors—can invoke the provisions of Chapter 9. Historically, the number of municipal bankruptcy filings has been approximately 0.023 percent of the number of business bankruptcy filings.[8]

Because governments often 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, business enterprises are at risk of going out of business because their ability to generate revenues depends upon market-determined demand for their goods and services. 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, go out of business, or be acquired by another entity. The long-term view applied in governmental financial reporting reflects the relative longevity of governments.

Relationship with Stakeholders

Governments in the United States employ the principles of representative democracy. Citizens delegate their power to participate in most decision-making regarding the operations of their governments 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

[8] According to data available on http://www.uscourts.gov/statistics-reports/caseload-statistics-data-tables, accessed on August 4, 2017, 138 governments filed under chapter 9 during 2001–2016, whereas 592,801 businesses filed during the same period. (The earliest year available on this website was 2001.)

of government—a system intended to provide “checks and balances” over the potential abuse of power by the citizens’ representatives. One can view governments 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 on the other hand, voluntarily choose to invest in a business enterprise and do not demand services from the business enterprise; rather, they demand a financial return on their investment. 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, which can be very expensive to accomplish.

Although the shareholders of a business enterprise place high importance on and are concerned with the value of their ownership interest, the public as owners of a government do not share that same concern. 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 degree of accountability that is broader than for business enterprises. The notion of accountability permeates the GASB’s conceptual framework and its 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 (1) its raising of public resources and (2) the purposes for which the resources are used (paragraph 56). GASB Concepts Statement 1, paragraph 56, further 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 either consuming accumulated reserves or 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 further below. A balanced budget that meets legal requirements does not promote interperiod equity if, for example, it employs deficit financing. However, the budget serves the crucial role of documenting short-term financial plans. Furthermore, assessing the performance of government programs and activities requires additional types of reporting.

Accounting and financial reporting standards for business enterprises do not emphasize accountability to the same extent.[9] 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 FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting,* Chapter 1, "The Objective of General Purpose Financial Reporting":

> The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit. [paragraph 2]

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

[9] 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 are required to make certifications with respect to their business enterprise's financial reports prepared in conformity with Generally Accepted Accounting Principles (GAAP) and their 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.

is a legal document that authorizes a government to obtain resources and utilize them to conduct operations, pay financial obligations, 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, by directly 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. Demonstrating accountability for compliance with budget authority is a distinguishing objective of governmental financial reporting.

APPENDIX B

ADDITIONAL EXAMPLES OF HOW GOVERNMENTAL ACCOUNTING DIFFERS FROM BUSINESS ENTERPRISE ACCOUNTING

The unique characteristics of government affect the substance and form of information communicated through external governmental financial reports. The driving force for governmental financial reporting is accountability—to citizens and taxpayers, legislative and oversight bodies, and current or potential investors in government debt. Each of these stakeholders seeks information that he or she expects to derive from a government's financial report. For example, when deciding where to live and how to vote, citizens may wish to compare governments to assess the range of services they provide and the cost of those services. Business owners may wish to compare the costs imposed by local governments and the services provided in competing jurisdictions when assessing where to locate a new business or relocate an existing business because it may affect their overall cost of conducting business. Legislative and governmental oversight bodies may wish to gain insight into how efficiently a government is using its resources and whether a government is complying with budgetary and contractual provisions. Current or potential investors in governmental debt may wish to determine whether a government is able to repay its debt in both the short term and the long term. Governmental financial reports provide all this information and more.

This appendix reviews selected governmental accounting and financial reporting standards, highlights how those standards address some of the distinguishing characteristics of government, and identifies how the information provided as a result of the standards benefits users of governmental financial reports. Appendix C includes a brief history of governmental accounting and financial reporting standards setting, which highlights the evolution of governmental accounting and financial reporting.

THE FINANCIAL REPORTING MODEL

The financial reporting model for governments has many unique features, including:

Contents of Basic Financial Statements

A government's basic financial statements present information about fiscal and **operational accountability**. The financial statements of governments present operational accountability information in the form of statements of financial position and statements of resource flows. In addition, governmental fund financial statements demonstrate fiscal accountability, as described in the main body of this paper.

Operational accountability goes beyond fiscal accountability by examining management decisions from a long-term perspective rather than the short-term focus inherent to fiscal accountability. Instead of focusing on whether sufficient resources exist to pay for services provided during a period, operational accountability considers whether sufficient resources exist to cover the cost of providing services in the long term, and it is measured using the **economic resources flows measurement focus**. Operational accountability is demonstrated when governments issue accrual-based financial statements for the entire government. GASB Statement 34 requires reporting on operational accountability for all governmental activities and business-type activities in consolidated government-wide statements.

Statement of Net Position

The statement of net position reports five elements—a government's assets, deferred outflows of resources, liabilities, deferred inflows of resources, and net position, which is the residual of the other four elements. In contrast, a business enterprise's balance sheet reports assets, liabilities, and equity or partners' capital, which is the residual interest in the assets of an entity that remains after deducting its liabilities.

Deferred inflows of resources and deferred outflows of resources relate to a future reporting period and, therefore, are not yet recognizable as revenues or expenses. They also do not meet the definitions of assets and liabilities and, therefore, cannot be recognized as those elements, either. The GASB specifically provides guidance for the recognition and measurement of deferred inflows of resources and deferred outflows of resources in the following pronouncements, as amended:

- Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*
- Statement 60 on service concession arrangements
- Statement No. 65, *Items Previously Reported as Assets and Liabilities*
- Statements 67, 68, 73, 74, and 75 on pensions and OPEB
- Statement 69 on government combinations
- Statement No. 81, *Irrevocable Split-Interest Agreements*
- Statement No. 83, *Certain Asset Retirement Obligations*
- Statement No. 87, *Leases*.

Statement of Activities

Unlike an income statement of a business enterprise, the statement of activities focuses on the cost of services provided, by function or program, and the extent to which they either contribute to or draw from the general revenues of the government. The statement serves as the basis for beginning an analysis of management's performance, but a more complete assessment of effectiveness and efficiency would require consideration of additional performance measures.

Budgetary Reporting

GASB standards require governments to report budgetary comparisons, either as required supplementary information or as a basic financial statement. The involuntary nature of tax collection creates a responsibility on the part of the government to be accountable to stakeholders for the use of those taxes. The budget is the mechanism for documenting public policy choices and authorizing the allocation and use of taxes and other resources. Unlike business enterprises, for which budgets are an internal planning tool, evidence of compliance with the legally adopted budget is necessary for demonstrating public accountability. Statement 34 requires that governments present budgetary comparison schedules, including the original budget, the final revised budget, and actual results for the year.

REPORTING ENTITY ISSUES

A fundamental decision regarding financial reporting is determining which entities should be presented together in the same financial report. Consolidations of business enterprises are generally based upon control obtained through acquisition of equity interests, a form of ownership and the financial benefits and burdens that accompany ownership.

The standards for determining the reporting entity for governments reflects a difference of the governmental environment—the general lack of equity ownership. Consequently, control through equity ownership is not the starting point for the governmental reporting entity standards. Governmental combinations principally are based upon control over other governments through relationships of accountability, which is a broader concept than that of business enterprises. Therefore, the GASB addressed financial reporting entity issues based upon the notion of accountability, as embodied in Statement No. 14, *The Financial Reporting Entity*, which was subsequently amended by Statements No. 39, *Determining Whether Certain Organizations Are Component Units,* and No. 61, *The Financial Reporting Entity: Omnibus.*

SERVICE-ORIENTED INFRASTRUCTURE ASSETS

Governments provide some services through acquisition and maintenance of **infrastructure**, such as roads, bridges, and water systems. The accounting methods used for these assets reflect their long-lived nature and the virtually perpetual existence of government. Although the GASB and the FASB apply the same basic historical cost/depreciation approach to reporting most depreciable capital assets, the GASB allows an optional **modified approach** for accounting for infrastructure that recognizes a government's long-term commitment to provide service through maintenance and preservation of infrastructure at a specified condition level. Instead of reporting depreciation expense as part of the cost of services, the modified approach allows a government to recognize the amounts expended to maintain and preserve infrastructure assets at a specified condition as expense.

LEASES

One common approach to acquiring the right to use capital assets—such as buildings and equipment—that governments employ is via lease transactions. Many governments are a party to a large number of lease arrangements, some of them as both lessee and lessor. In recent years, both the GASB and the FASB have substantially revised the accounting and financial reporting standards for leases.

The revamped GASB and FASB lease standards agree on a fundamental premise that leases result in the acquisition of the right to use another entity's asset and a related liability.

GASB Statement 87 established a single approach to reporting leases (all leases are financings), with limited exceptions.[10] Broadly, the standards require lessees to report an intangible capital asset representing the right to use the leased asset and a long-term liability to reflect the obligation to make future payments under the lease agreement. Governmental lessors are required to report a lease receivable related to the future payments it will receive under the lease agreement and a deferred inflow of resources reflecting that those payments will be revenue of future periods. Lessors also continue to report the leased capital asset. This foundational concept necessitated an end to the longstanding distinction in governmental standards between "operating" leases and "capital" leases.

[10] Those exceptions, such as for **short-term leases,** were made based on cost-benefit and other considerations, rather than a view that those transactions were *not* financings.

The FASB's lease standards distinguish between financing leases and operating leases primarily for purposes of determining whether interest expense associated with lease transactions should be reported, based on factors that generally are not prevalent in the government sector. The GASB standards do not contain that distinction for that reason, as well as because of the benefits of consistency with established recognition and measurement requirements in other GASB standards, and less complexity for governments by requiring a single approach to reporting. Statement 87 also introduced significant changes to lessor reporting in order to maintain a parallel relationship between government lessee and government lessor reporting. The FASB also made changes to its lessor accounting standards to align with its new lessee accounting requirements.

Fiduciary Activities

As previously mentioned, the GASB's conceptual framework considers accountability to be the objective of financial reporting from which all other objectives of financial reporting derive. That objective is not included in the FASB conceptual framework. A key area for which governments utilize financial reporting to demonstrate their accountability relates to their fiduciary activities. In addition to providing services directly to the public and funding the provision of public services by other governments and not-for-profit organizations, many governments also serve in a trustee or custodial capacity for assets that belong to individuals or entities other than the government. Fiduciary activities are pervasive among state and local governments and, in some cases, involve considerable amounts of money.[11]

Under the provisions of Statement No. 84, *Fiduciary Activities*, if a government meets certain criteria related to financial accountability for the activity, or to control over the assets in question and who benefits from the assets, the activities are considered fiduciary activities and the government reports them in fiduciary fund financial statements, which are included in a government's basic financial statements. Again, based on the objectives set forth in its conceptual framework, the FASB arrived at a different conclusion.

[11] Public employee defined benefit pension plans alone held assets of about $3.7 trillion in 2016. Source: Federal Reserve, Financial Accounts of the United States—Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts: First Quarter 2017, Table L120.b, https://www.federalreserve.gov/releases/z1/current/z1.pdf, accessed August 7, 2017.

Grants and Gifts

As noted earlier, business enterprises only infrequently engage in nonexchange transactions, such as grants and gifts (except as payer) and, when they do so, the amounts involved generally are relatively insignificant to the business. However, for many governments, grants and gifts are a significant source of revenue, and GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions,* provides guidance in this area. For grants and gifts, characteristics such as time restrictions and eligibility requirements are critical to determining when to recognize a transaction.

Governments often receive pass-through grants—grants and other financial assistance to transfer to or spend on behalf of a secondary recipient. GASB Statement No. 24, *Accounting and Financial Reporting for Certain Grants and Other Financial Assistance,* requires reporting all cash pass-through grants in a government's financial statements. Governments recognize pass-through grants as revenues and expenditures or expenses unless the government acts strictly as a cash conduit. (That is, the government only transmits the grantor-supplied money without having administrative or direct financial involvement.) This reporting requires governments to demonstrate accountability for resources for which the government is responsible. In contrast, business entities apply the guidance in FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made,* which excludes reporting certain pass-through grants as revenues and expenses.

Debt Refundings

Similar to pensions and OPEB, both governments and business enterprises engage in refundings of debt—that is, the issuance of new debt whose proceeds are used to repay previously issued ("old") debt. The reason that both governments and business enterprises typically enter into refundings is to secure financial gains. In most refundings, a difference exists between the reacquisition price for the old debt (the amount required to repay the old debt, including any call premiums) and the net carrying amount of the old debt (the amount reported in the financial statements). An entity would account for that difference either (1) by recognizing it as accounting gains or losses immediately in the period of extinguishment or (2) by deferring it and recognizing it as annual adjustments to interest expense over the shorter of the life of the old or new debt.

When determining how to account for the difference between reacquisition price and net carrying amount in a governmental environment, the GASB decided on deferring and recognizing it as adjustments to interest expense. Deferred recognition is consistent with the fact that government refundings generally are current or advance refundings; governments are much less likely to refund debt with existing resources, and rarely or never do so with equity issuance. This accounting also is consistent with the concept that governments generally use the economic gain from the refunding to reduce the interest costs of future taxpayers and, consequently, the gain should be reported as an adjustment to future interest expense.

This was different from the then-applicable business enterprise accounting and financial reporting standards because it was believed that immediate recognition would produce operating results in the period the debt is refunded and in subsequent periods that were less decision-useful for users of governmental financial reports. The GASB was concerned at that time—as it was later when developing Statement 34—that governmental financial reports present the most relevant measure of the cost of providing services for a period. However, when governments do refund debt with only existing resources, there is no deferred recognition—GASB standards require that the gain or loss be recognized in the period of the refunding. This is consistent with business enterprise accounting and financial reporting standards.

APPENDIX C

BRIEF HISTORY OF GOVERNMENTAL ACCOUNTING AND FINANCIAL REPORTING STANDARDS SETTING

Systematic governmental financial reporting in the United States traces its beginnings to the last decade of the nineteenth century and early part of the twentieth century. At that time, the growth in the number and size of cities, coupled with corruption in municipalities, led to a demand for financial accountability.[12] Many of the features of modern-day governmental financial reporting can be seen in the Handbook of Municipal Accounting (1913) prepared by the Metz Fund and in the writings of Francis Oakey (whose book *Principles of Government Accounting and Reporting* [1921] was considered authoritative) and Lloyd Morey (whose popular textbook, *Introduction to Governmental Accounting*, was published in 1927). Oakey and Morey were concerned that the "commercial accounting" of the time was not entirely adequate for governments.

Morey identified the lack of a profit motive as one important factor that would affect financial reporting for governments; there was no need for governments to report on profit and loss. Oakey stated that cities financed their operations through taxes, miscellaneous revenue, and borrowing in order to raise sufficient amounts to meet total anticipated expenditures, including capital items. He believed financial reporting should show a government's fund surplus (or balance) that represents the resources currently available for expenditure. Oakey and Morey advocated financial reporting using funds, which would allow readers to assess whether an executive officer of a city had properly discharged his or her duties in accordance with legal requirements. The writings of Oakey and Morey contributed to the formation of the National Committee on Municipal Accounting (NCMA).[13]

To ensure that governmental accounting issues received appropriate attention, the Municipal Finance Officers Association (MFOA) formed the NCMA as an ad-hoc committee. It and successor bodies formed under the MFOA formulated municipal accounting principles, developed common classification and terminology for municipal reports, and promulgated standards that reflected

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[12] Frederick A. Cleveland, *Chapters on Municipal Administration and Accounting* (New York: Longmans, Green and Co., 1909).

[13] James H. Potts, "An Analysis of the Evolution of Municipal Accounting to 1935 with Primary Emphasis on the Developments in the United States" (Ph.D. dissertation, University of Alabama, 1976). Marcel G. Hebert, "An Investigation of the Effect of Alternative Presentation Formats on Preparers and Users of City Financial Reports" (Ph.D. dissertation, Texas Tech University, 1987).

the unique or distinguishing characteristics of government. The NCMA believed that comparing budgetary information to actual information in financial statements was important to demonstrate compliance with legal provisions and to show proper administration of finances. Therefore, they recommended that governments present statements that would compare estimated revenues with actual revenues, and appropriations with expenditures and encumbrances.

Through the efforts of the NCMA and the National Committee on Governmental Accounting (NCGA), a successor committee of the MFOA, governmental financial reporting evolved from reporting on individual funds to reporting combined and combining financial statements for governmental, proprietary, and fiduciary funds. This included publishing the authoritative guidance in the 1968 "blue book" titled *Governmental Accounting, Auditing, and Financial Reporting*. Concomitant with changing the name of the NCGA to the National Council on Governmental Accounting, the MFOA reorganized the NCGA as a standards-setting body that followed due process procedures and continued to focus governmental fund financial reporting on the flow of current financial resources using the modified accrual basis of accounting.

Subsequently, critics of governmental financial reporting called for governments to report more like businesses. They leveled criticisms at the differences between financial reporting by business enterprises and governments, citing lack of understandability because government financial statements used the modified accrual basis of accounting and reported a number of funds without consolidation. Their recommendation was not that governments and business enterprises should report using the same set of accounting and financial reporting standards or that a single standards setter should be responsible for both types of organizations. Rather, their recommendation primarily was to bring the benefits of accrual accounting—full cost-of-services information and consolidated financial statements—to governments. Through issuance of many standards including Statement 34, the GASB has addressed these criticisms while acknowledging the distinctive characteristics of government that are a key part of its reporting objectives.

The Financial Accounting Foundation established the Governmental Accounting Standards Board in 1984 as the independent standards setter for state and local governments. The decision to establish a separate standards board reflects the sovereign nature of state governments and their desire to have a standards setter that focused on the needs of the users of state and local government financial statements. State governments are not creations of the federal government. Rather, the states created the federal government upon ratification of the United States Constitution, with certain aspects of states' sovereign powers transferred to the federal government, and with all other powers retained by states. Establishment of accounting and financial reporting standards for themselves (and local governments, which are created by states) is a power retained by the states. Like Oakey, Morey, the NCMA, and the NCGA, the GASB recognizes the unique and distinguishing features of government and reflects them in its standards setting.

APPENDIX D

SIGNIFICANCE OF STATE AND LOCAL GOVERNMENTS

By any measure of size, state and local governments are a substantial part of the U.S. economy. According to the 2012 Census of Governments, there are 90,107 state and local governments in the United States.[14] Revenue collected by state and local governments in 2012 totaled $3.4 trillion—$10,849 for each person in the United States.[15] Expenditures, taking into account capital outlays often financed through borrowings (which are not reported as revenues in these statistics), of state and local governments in 2012 were $3.2 trillion—$10,166 per capita. For the purposes of perspective, these state and local government expenditures represent almost 19.8 percent of the 2012 U.S. gross domestic product of $16.2 trillion as reported by the Bureau of Economic Analysis of the U.S. Department of Commerce.[16]

Municipal debt outstanding owed by state and local governments totals over $3.8 trillion[17]—approximately $11,830 per capita.[18] As of April 2017, the labor force of state and local governments totaled 19.5 million employees, or 13.4 percent of total employment of the 146.0 million workers in the United States.[19]

Not only do state and local governments constitute a significant proportion of the U.S. economy, they also have a pervasive effect on society because they provide a broad variety of vital services, including education, public safety, transportation, social services, environmental services, housing, utility services, and administrative services. Education includes primary, secondary, and higher education. Public safety includes police and fire protection, correctional

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[14] 2012 Census of Governments, accessed at http://www.census.gov/govs/cog/ on February 22, 2016.

[15] US population as of December 1, 2012, was 315.2 million. Source: http://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?src=bkmk, accessed on February 22, 2016.

[16] Source: http://www.bea.gov/National/index.htm#gdp accessed on February 22, 2016.

[17] Securities Industry and Financial Markets Association, US Bond Market Issuance and Outstanding, http://www.sifma.org/uploadedFiles/Research/Statistics/StatisticsFiles/CM-US-Bond-Market-SIFMA.xls?n=30213, accessed July 31, 2017.

[18] US population as of December 1, 2016, was estimated at 324.4 million. Source: https://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=PEP_2016_PEPMONTHN&prodType=table, accessed on July 31, 2017.

[19] U.S. Department of Labor, Bureau of Labor Statistics, Current Employment Statistics: http://www.bls.gov/web/empsit/ceseeb1a.htm, accessed on July 31, 2017.

facilities, and regulation and licensing of businesses. Transportation includes highways, airports, ports, parking facilities, and transit systems. Social services include income maintenance and healthcare. Environmental services include protection of natural resources and parks and recreation services. Utilities include electric power, gas, water, sewer, and solid waste disposal. Administrative services include judicial and legal services, financial administration, and governance.

Appendix E

GLOSSARY

Accountability—A government's responsibility to justify to its citizenry the raising of public resources and the purposes for which the resources are used.

Conceptual framework for accounting and financial reporting standards—A high-level set of concepts that guide a standards setter when deliberating future standards and evaluating existing standards and practices.

Current financial resources flows measurement focus—The focus of governmental fund financial statements, which is on inflows of financial resources that are available for use to pay current obligations and on outflows of financial resources that generally arise when liabilities become due and are normally expected to be paid using available financial resources.

Economic resources flows measurement focus—The focus of government-wide, proprietary fund, and fiduciary fund financial statements, which is on inflows and outflows of economic resources.

Exchange transaction—A transaction in which each party receives and gives up essentially equal values.

Fiscal accountability—The responsibility of governments to justify that their actions in the current period have complied with public policy decisions concerning the raising and spending of public moneys in the short term (usually one budgetary cycle or one year).

Governmental activities—Activities of government that generally are financed through taxes, intergovernmental revenues, and other nonexchange revenues. These activities usually are reported in governmental funds and internal service funds. In contrast, business-type activities of governments are financed in whole or in part by fees charged to external parties for goods or services.

Governmental funds—Self-balancing sets of accounts that are maintained for governmental activities. Governmental fund types include the general fund, special revenue funds, capital projects funds, debt service funds, and permanent funds. Financial statements of governmental funds focus primarily on the sources, uses, and balances of current financial resources and often have a budgetary orientation.

Infrastructure—Long-lived capital assets that normally are stationary in nature and normally can be preserved for a significantly greater number of years than most capital assets.

Interperiod equity—The extent to which the current-year revenues are sufficient to pay for the services provided that year and whether future taxpayers will be required to assume burdens for services previously provided.

Modified approach—A method of accounting for certain infrastructure assets that are part of a network or subsystem of a network in which depreciation expense is not reported and maintenance and preservation costs are expensed instead. A network or subsystem qualifies for this method of accounting when, among other conditions, management has committed to maintain the network or subsystem approximately at or above a specific condition level.

Modified accrual basis of accounting—The basis of accounting in which transactions are recognized when they occur with specifically identified modifications to reflect the current financial resource flows measurement focus. These modifications include the fact that expenditures are recognized in the period in which they are expected to require the use of current financial resources, revenue is not recognized until it is available to pay current obligations, and certain long-term liabilities are not recognized until due and payable.

Nonexchange transaction—A transaction in which a government gives (or receives) value without directly receiving (or giving) equal value in return. This also is referred to as a nonreciprocal transaction in some accounting literature.

Operational accountability—The responsibility of governments to report the extent to which they have met their operating objectives efficiently and effectively, using all resources available for that purpose, and whether they can continue to meet their objectives for the foreseeable future.

Short-term lease—A lease that, at the commencement of the lease term, has a maximum possible term under the lease contract of 12 months (or less), including any options to extend, regardless of their probability of being exercised.