



Calhoun: The NPS Institutional Archive
DSpace Repository

Theses and Dissertations

1. Thesis and Dissertation Collection, all items

1995-12

A comparative analysis of financial reporting models for private and public sector organizations

Areman, Bryan E.

Monterey, California. Naval Postgraduate School

<http://hdl.handle.net/10945/31271>

Downloaded from NPS Archive: Calhoun



Calhoun is a project of the Dudley Knox Library at NPS, furthering the precepts and goals of open government and government transparency. All information contained herein has been approved for release by the NPS Public Affairs Officer.

Dudley Knox Library / Naval Postgraduate School
411 Dyer Road / 1 University Circle
Monterey, California USA 93943

<http://www.nps.edu/library>

NAVAL POSTGRADUATE SCHOOL MONTEREY, CALIFORNIA



THESIS

**A COMPARATIVE ANALYSIS OF FINANCIAL
REPORTING MODELS FOR PRIVATE AND
PUBLIC SECTOR ORGANIZATIONS**

by

Bryan E. Areman

December, 1995

Principal Advisor:
Associate Advisor:

Douglas Moses
Michael Morris

Approved for public release; distribution is unlimited.

19960402 116

DTIC QUALITY INSPECTED 1

REPORT DOCUMENTATION PAGE

Form Approved OMB No. 0704-0188

Public reporting burden for this collection of information is estimated to average 1 hour per response, including the time for reviewing instruction, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden, to Washington Headquarters Services, Directorate for Information Operations and Reports, 1215 Jefferson Davis Highway, Suite 1204, Arlington, VA 22202-4302, and to the Office of Management and Budget, Paperwork Reduction Project (0704-0188) Washington DC 20503.

1. AGENCY USE ONLY <i>(Leave blank)</i>	2. REPORT DATE December 1995	3. REPORT TYPE AND DATES COVERED Master's Thesis	
4. TITLE AND SUBTITLE A Comparative Analysis of Financial Reporting Models for Private and Public Sector Organizations			5. FUNDING NUMBERS
6. AUTHOR(S) Areman, Bryan E.			
7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES) Naval Postgraduate School Monterey CA 93943-5000			8. PERFORMING ORGANIZATION REPORT NUMBER
9. SPONSORING/MONITORING AGENCY NAME(S) AND ADDRESS(ES)			10. SPONSORING/MONITORING AGENCY REPORT NUMBER
11. SUPPLEMENTARY NOTES The views expressed in this thesis are those of the author and do not reflect the official policy or position of the Department of Defense or the U.S. Government.			
12a. DISTRIBUTION/AVAILABILITY STATEMENT Approved for public release; distribution is unlimited.			12b. DISTRIBUTION CODE
13. ABSTRACT <i>(maximum 200 words)</i> <p>The objective of this thesis was to describe and compare different existing and evolving financial reporting models used in both the public and private sector. To accomplish the objective, this thesis identified the existing financial reporting models for private sector business organizations, private sector nonprofit organizations, and state and local governments, as well as the evolving financial reporting model for the federal government. Using archival research, the study characterized the alternative models in terms of reporting objectives, information users and their needs, accounting conventions, and the types and content of financial reports. Similarities and differences among the reporting models were identified. Broad findings include that the reporting models are generally similar in the reporting of financial condition and different in the reporting of operations. The different reporting practices follow logically from the varying objectives that financial reporting serves in the different sectors.</p>			
14. SUBJECT TERMS Financial Accounting, Financial Reporting, Financial Accounting Standards			15. NUMBER OF PAGES 138
			16. PRICE CODE
17. SECURITY CLASSIFICATION OF REPORT Unclassified	18. SECURITY CLASSIFICATION OF THIS PAGE Unclassified	19. SECURITY CLASSIFICATION OF ABSTRACT Unclassified	20. LIMITATION OF ABSTRACT UL

Approved for public release; distribution is unlimited.

**A COMPARATIVE ANALYSIS OF FINANCIAL REPORTING MODELS
FOR PRIVATE AND PUBLIC SECTOR ORGANIZATIONS**

Bryan E. Areman
Captain, United States Marine Corps
B.A., University of Missouri, Columbia 1987

Submitted in partial fulfillment
of the requirements for the degree of

MASTER OF SCIENCE IN MANAGEMENT

from the

**NAVAL POSTGRADUATE SCHOOL
December 1995**

Author:

[Redacted signature]

Bryan E. Areman

Approved by:

[Redacted signature]

Douglas Moses, Principal Advisor

[Redacted signature]

Michael Morris, Associate Reader

[Redacted signature]

Reuben T. Harris, Chairman
Department of Systems Management

ABSTRACT

The objective of this thesis was to describe and compare different existing and evolving financial reporting models used in both the public and private sector. To accomplish the objective, this thesis identified the existing financial reporting models for private sector business organizations, private sector nonprofit organizations, and state and local governments, as well as the evolving financial reporting model for the federal government. Using archival research, the study characterized the alternative models in terms of reporting objectives, information users and their needs, accounting conventions, and the types and content of financial reports. Similarities and differences among the reporting models were identified. Broad findings include that the reporting models are generally similar in the reporting of financial condition and different in the reporting of operations. The different reporting practices follow logically from the varying objectives that financial reporting serves in the different sectors.

TABLE OF CONTENTS

I. INTRODUCTION	1
A. BACKGROUND	2
B. OBJECTIVE	5
C. SCOPE AND LIMITATIONS	5
D. METHODOLOGY	6
II. PRIVATE SECTOR BUSINESS ORGANIZATIONS	9
A. BASIC OBJECTIVES OF FINANCIAL REPORTING	12
B. CHARACTERISTICS OF ACCOUNTING INFORMATION	13
C. ELEMENTS OF THE FINANCIAL ACCOUNTING MODEL	18
D. RECOGNITION AND MEASUREMENT	20
E. FINANCIAL REPORTS	25
III. PRIVATE SECTOR NONPROFIT ORGANIZATIONS	35
A. BASIC OBJECTIVES OF FINANCIAL REPORTING	38
B. ELEMENTS AND CHARACTERISTICS OF ACCOUNTING	40
C. RECOGNITION AND MEASUREMENT	41
D. FINANCIAL REPORTS	42
IV. STATE AND LOCAL GOVERNMENT	51
A. FUND ACCOUNTING	52
B. BASIC OBJECTIVES OF FINANCIAL REPORTING	55
C. ELEMENTS AND CHARACTERISTICS OF ACCOUNTING	58
D. RECOGNITION AND MEASUREMENT	60
E. FINANCIAL REPORTS	62
V. FEDERAL GOVERNMENT	73
A. BASIC OBJECTIVES OF FINANCIAL REPORTING	75
B. ELEMENTS AND CHARACTERISTICS OF ACCOUNTING	80
C. RECOGNITION AND MEASUREMENT	83
D. FINANCIAL REPORTS	89
VI. COMPARATIVE ANALYSIS	101
A. USERS OF FINANCIAL REPORTS	104
B. USER INFORMATION NEEDS	107
C. OBJECTIVES OF FINANCIAL REPORTING	109
D. RECOGNITION AND MEASUREMENT	112
E. FINANCIAL REPORTS	115
VII. SUMMARY & CONCLUSIONS	123
LIST OF REFERENCES	127

INITIAL DISTRIBUTION LIST 129

I. INTRODUCTION

Accounting for any organization is fundamentally a discipline based on recording the assets, liabilities and transactions undertaken by that organization. Financial reports are simply the presentation of an organization's financial story, based on those financial records. However, different kinds of financial reports are prepared by different kinds of organizations for different uses and users. Financial reporting needs of government differ from those of privately owned entities, because of the difference in users information needs.

The determination of whether an organization's financial reports are effective is driven by the needs of the users of those reports. The report users vary widely in the types of decisions they make, as well as the methods and information they use in their decision process. Consequently, the financial information in the reports must be presented in a manner that is understandable to a wide variety of users. In addition, it is useful if the information that has been measured and reported is done so in a similar manner by different organizations in the same industry or sector. Comparability allows decision makers to identify similarities and differences in information between organizations, which have not been obscured by differences in accounting practices. This leads to the need for a standard way of presenting the data in a framework for financial reporting.

A conceptual framework for financial reporting is a set of interrelated objectives and fundamentals that provide a foundation, from which accounting and reporting issues in a given sector can be addressed in a consistent manner. The objectives of financial reporting

represent the basis for the development of a conceptual framework for financial accounting, for both private and public sector organizations.

Financial reporting objectives are derived from the needs of the users of the reports, the goals and purposes they have for accounting. The objectives of financial reporting vary between the federal government, state and local government and private sector organizations. Consequently, there is some variation between the different sector's conceptual frameworks for financial reporting.

A. BACKGROUND

The Financial Accounting Standards Board (FASB), recognizing the need for a generally accepted financial reporting framework, issued in 1976, a three part discussion memorandum entitled "Conceptual Framework for Financial Accounting and Reporting: Elements of Financial Statements and Their Measurement." This document set forth the issues that needed to be addressed in establishing a conceptual framework that would be a basis for setting accounting standards and practices. Since the release of that document, the FASB has issued Statements of Financial Accounting Concepts that relate to the financial reporting for business entities. These statements lay the groundwork for the financial reporting framework in the private sector. Accounting standards set by FASB for general purpose, external financial reporting by privately owned business entities are concerned primarily with the needs of investors and creditors. A secondary concern is the internal consequences of information provided in the financial statements, such as, manager's behavior in response to the information. The original business entity model was used as a

a reference in the development of a later financial reporting framework for not-for-profit entities.

Accounting and financial reporting standards for state and local government, as well as colleges and universities in the United States, are set by the Governmental Accounting Standards Board (GASB), established in 1984. GASB has been conducting an ongoing review of financial reporting practices and standards, as they apply to state and local governments. The objective of this project is to determine the best way of displaying both the financial position of the entity and the results from its operations. In the development of this reporting framework, GASB has focused on identifying the users of external financial reports, as well as their information needs. In practice, GASB has also been concerned with the internal consequences to the entity of the financial statements. In addition, they have focused on consequences the reports may have on potential creditors and their determination of entities' credit-worthiness.

Accounting and financial reporting standards for the federal government are currently being developed by the Federal Accounting Standards Advisory Board (FASAB). The Secretary of the Treasury, the Director of the Office of Management and Budget (OMB), and the Comptroller General of the United States, principals of the Joint Financial Management Improvement Program (JFMIP), established FASAB in October 1990. FASAB recommends accounting standards, for the recognition and measurement of items in the financial reports required by the Chief Financial Officers Act of 1990, to the JFMIP principals for approval.

Upon approval, they become effective on the date specified in the standards published by OMB and GAO.

Accounting policy makers for the federal government are concerned with many of the same issues that are confronting the other standard setting bodies, although capital markets are of lesser concern at the federal level. Creditors usually do not use the governmental financial reports to evaluate the credit-worthiness of the United States. Congress and federal managers appear to be equally concerned with the consequences accounting standards may have on the behavior of federal employees. In addition, there is apprehension over the potential influence of financial reports on decisions by people involved in the political-governmental processes. Currently, there are multiple financial reporting models being used in the federal government. The ultimate objective of the FASAB is to provide a standard framework for federal reporting entities to use in the presentation of their financial information.

The accounting and financial reporting standards for the Department of Defense (DOD) are evolving along with those of the federal government as a whole. Currently, the DOD does not produce any kind of standard consolidated financial reports for external use. The reports that the DOD has historically produced are done so to allow them to monitor and control the obligation and expenditure of budgetary resources. The only reports that are produced for external reporting, are special reports used for presentation to various congressional committees. Beginning in fiscal year 1996 the DOD will be required to produce consolidated financial reports for external use, as directed by the CFO act of 1990.

B. OBJECTIVE

The objective of this thesis is to describe public and private sector financial reporting models and to identify and evaluate the similarities and differences among them. Initially, the current state of conceptual framework development for financial reporting models will be established and compared for each of the four sectors: private organizations; state and local government; federal government. In addition, the target users for the financial reports for each of the sectors will be identified and their information needs evaluated to allow comparison of the different frameworks based upon their reporting objectives. This will provide the Department of Defense with a framework which can serve as a foundation for understanding and evaluating alternative financial reporting systems.

C. SCOPE AND LIMITATIONS

This study focuses on the identification and evaluation of different existing and evolving financial reporting models and the organizations responsible for their development. Financial reporting models are driven by the objectives of accounting information as defined by users of the information. For the purposes of this study, users are defined to include both internal and external decision makers who rely upon the financial reporting information provided by the organization. In addition, the study focuses on the users of financial reporting models for each of the four sectors. The similarities and differences between users of the financial reports ultimately explain variations in the financial reporting models that exist.

Accounting and financial reporting standards for state and local governments, as well as colleges and universities, are set by the GASB. The colleges and universities reporting is built upon the fund accounting model used for state and local governments, with some modifications. Consequently, for ease of comparison, only the GASB financial reporting and practices for state and local governments will be addressed in this study.

Some of the conceptual framework models for financial reporting evaluated for this study include both financial and nonfinancial information. For purposes of this study, only the financial information was employed in evaluating and comparing the different financial reporting frameworks, due to the lack of uniformity in the utilization of nonfinancial information.

D. METHODOLOGY

This research used a two phase approach to explore current financial reporting frameworks in both private sector and government organizations. The basis for the research was established through an extensive review of the literature concerning financial reporting.

Based on the literature review, the first phase of research involved the identification of existing and evolving financial reporting models for private sector, state & local government and federal government organizations. Background information on the intent, execution and objectives of the financial reporting models developed by FASB for the private sector are provided in Chapter II. Chapter III addresses the current status of financial reporting for private sector nonprofit organizations, including the underlying objectives and basis of their financial reporting model. The conceptual framework for

financial reporting in state and local government, including background information and objectives of the model, are reported in Chapter IV. Chapter V provides background information on the current development by the FASAB of a conceptual framework for financial reporting in the federal government.

The second phase of the research consisted of assessing the similarities and differences among alternative financial reporting models existing in the private and public sectors. A framework was developed for use in comparing and contrasting the alternative reporting models. The models were compared in terms reporting objectives, users and user information needs, accounting conventions and types of financial reports. The results of the comparative analysis are presented and discussed in Chapter VI. A summary of research findings, as well as, conclusions reached are provided in Chapter VII.

II. PRIVATE SECTOR BUSINESS ORGANIZATIONS

In the private sector the Financial Accounting Standards Board (FASB) is responsible for the development of standards and principles for financial accounting and reporting. In this chapter the FASB's five Statements of Financial Accounting Concepts and how they provide a framework for financial reporting, will be presented. In addition, the underlying objectives, qualitative characteristics and elements that serve as a foundation for financial reporting in the private sector, will be discussed. Finally, the financial reports that are the culmination of the FASB's conceptual framework, will be presented.

The Financial Accounting Standards Board (FASB), in 1976 issued a three part memorandum entitled "Conceptual Framework for Financial Accounting and Reporting: Elements of Financial Statements and Their Measurement." This document marked the beginning of the development of a conceptual framework that has become the basis for setting accounting standards and practices, for the private sector. Since the release of that document, FASB has issued Statements of Financial Accounting Concepts that relate to financial reporting for business entities. These statements lay the ground work for the financial reporting framework.

FASB has issued five Statements of Financial Accounting Concepts (SFAC) that serve as a framework for financial reporting in the private sector. They are:

1. **SFAC NO. 1**, "Objectives of Financial Reporting by Business enterprises," presents the goals and objectives of accounting and are the building blocks for the conceptual framework.

2. **SFAC NO. 2**, "Qualitative characteristics of Accounting Information," examines the characteristics that make accounting information useful.

3. **SFAC NO. 3**, "Elements of Financial Statements of Business Enterprises," provides definitions of items that appear in the financial statements, such as assets, liabilities, revenues and expenses.

4. **SFAC NO. 5**, "Recognition and Measurement in Financial Statements of Business Enterprises," sets forth fundamental recognition criteria and guidance on what information should be formally incorporated into financial statements and when. In addition, this concepts statement addresses measurement issues that are closely related to recognition.

5. **SFAC NO. 6**, "Elements of Financial Statements," replaces SFAC NO. 3 and expands its scope to include not-for-profit organizations.

In understanding the conceptual framework presented by the FASB, it is helpful to see the relationship between the different concepts statements. Figure 2.1 provides an overview of the conceptual framework:

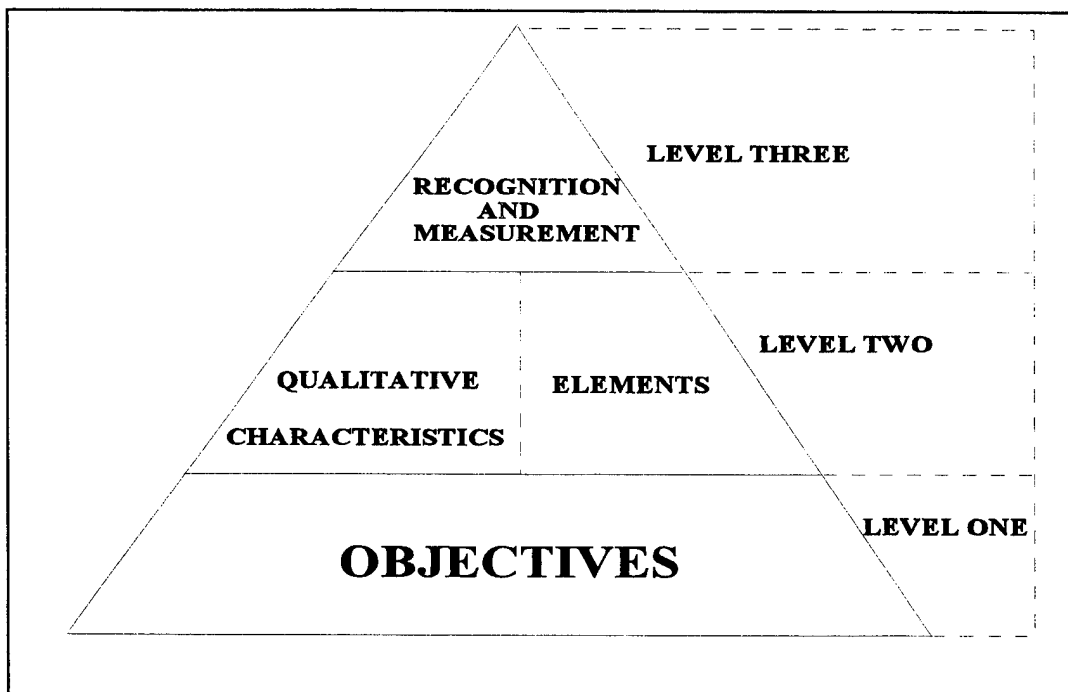


Figure 2.1. Conceptual Framework. After Ref. [1].

Level One: Basic objectives, which serve as building blocks of framework.

Level Two: Fundamental concepts of accounting information.

Level Three: Measurement and recognition concepts that accountants use in establishing and applying accounting standards.

A. BASIC OBJECTIVES OF FINANCIAL REPORTING

The objectives of financial reporting are developed by looking at the information needs of the users of the reports. The first step in developing objectives for financial reporting is to establish who the users of the reports are. The FASB has identified four primary users of their financial reports: 1) Current investors; 2) Future investors; 3) Current creditors; 4) Potential creditors. The FASB recognizes that the reporting entity's management also uses the financial reports. However, they are not considered a primary user, for the purpose of establishing user needs and objectives for financial reporting.

All financial reporting is concerned to varying degrees with decision making. The need for information on which to base financial decisions underlies the objectives of financial reporting. The objectives of financial reporting are the basis for judgements about the qualities of financial information, only when the objectives have been established can a start be made on defining the type of information needed to reach them. Objectives identify the goals and purposes of accounting and are the building blocks for the conceptual framework. The general objectives of financial reporting, are to provide information that is useful to present and potential investors and creditors and other secondary users in making investment, credit and other such decisions.

Based upon the needs of the four primary financial reports users, the FASB developed four objectives for their financial statements, all of which focus on providing information to aid decision makers in the decision process. The objectives of financial reporting in private sector for profit organizations are to provide information on:

1. **Cash Flows** - Financial reporting should provide information to help users in assessing the amounts, timing and certainty of future cash receipts from operations and other sources. The information should be understandable to those persons that have a working knowledge of business and economics and are willing to commit a reasonable amount of time to the study of the information. [Ref. 2]

2. **Financial Resources & Liabilities** - Financial reporting should provide information about the value and liquidity of the financial resources of an organization. In addition, all claims against those resources, by other entities, should be revealed. The effects of transactions and events on those resources must also be presented.

3. **Earnings** - Financial reporting should provide information about the entities financial performance during the period. Investors and creditors often utilize historical income data in evaluating the future earnings potential of an entity. The primary focus of financial reporting is information about the entities performance in terms of earnings.

B. CHARACTERISTICS OF ACCOUNTING INFORMATION

Financial reporting is done ultimately for the purpose of providing a basis for decision making by users and management. The amount and type of information to be provided and the format in which it should be presented involves determining which alternative provides the most useful information for decision makers. Consequently, the measure of information quality is reliant upon its usefulness in the decision making process.

The FASB in Concepts Statement No. 2 has identified the qualitative characteristics of accounting information that are useful to decision makers. In addition, FASB has

identified cost-benefit and materiality constraints as part of the conceptual framework. Decision makers vary widely in the types of decisions they make, the amount of information they have available to them from sources other than the financial report and in their ability to process information. In addition, decision makers analysis techniques differ. Consequently, the information required by decision makers' vary significantly. However, all users must have access to information that is presented in a logical and understandable format. Without understandability, all other information characteristics would be of little use. The requisite qualities for information provided in financial statements and the connection between them is illustrated in figure 2.2.

A HIERARCHY OF ACCOUNTING QUALITIES

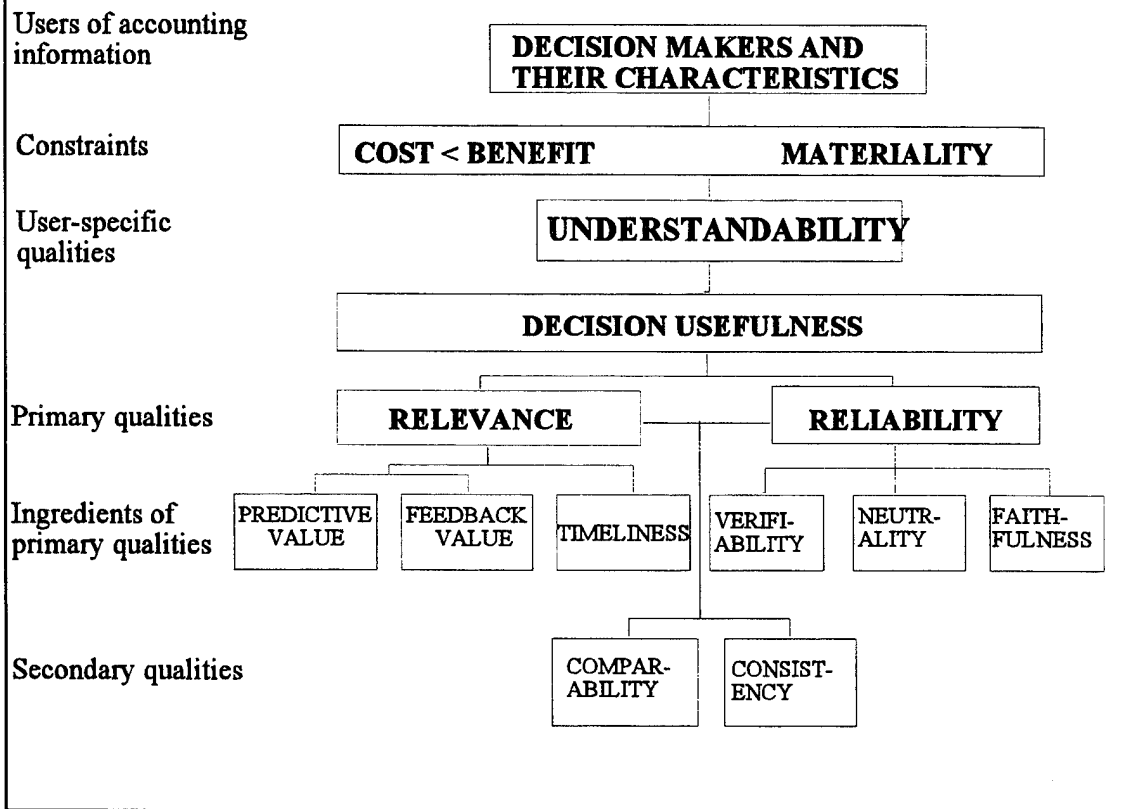


Figure 2.2. Hierarchy of Accounting Qualities. Ref. [1].

Relevance and reliability are the two primary information qualities that contribute to the decision usefulness of information. These qualities distinguish more useful information from less useful information in the decision process, subject to the constraints imposed by cost and materiality.

To be relevant, accounting information must help users to make predictions about the outcomes of past, present and future events. This information is considered relevant if it has predictive value and/or provides feedback on previous decisions. Information must also be timely. It must be available to decision makers before it loses its capacity to influence their decision. “Timeliness by itself cannot make information relevant, but the lack of it can make information irrelevant.” [Ref. 3]

Reliability is the quality of information that gives assurance that it is reasonably free of error and that it fairly represents what is intended. Reliability of information is a necessity for individuals that have neither the time nor the expertise to evaluate the accuracy of the information. To be useful information must be reliable and relevant. For accounting information to be reliable it must possess three characteristics: verifiability, neutrality and faithfulness.

Verifiability is demonstrated when a high degree of consensus exists among independent measurers using the same measurement methods. Representational faithfulness refers to agreement between the accounting numbers and the resources or events those numbers claim to represent. However, a high degree of representational faithfulness does not guarantee that the accounting information will be relevant to the users needs. In

addition, information must be neutral for it to be reliable. Neutrality means that, in formulating or implementing standards, the primary concern should be the relevance and reliability of the information that results, not the economic consequences of the standard.

[Ref. 1]

Consistency and comparability are the two secondary qualities of information that contribute to its decision usefulness. Information about a particular entity gains greatly in usefulness if it can be compared with similar information about another organization in the same industry or sector. Consistency allows users to identify real differences in information because the results have not been obscured by accounting differences between the entities. Comparability between organizations over time increases the usefulness of information. The significance of accounting information, depends largely on the user's ability to relate it to some standard.

Users tasked to make accounting decisions continually encounter the need to make decisions concerning materiality. Materiality decisions are primarily quantitative in nature. They deal with whether the item is of an amount that its inclusion in the financial statements would effect the users decision. The nature of the item is important because a relatively small item may be unimportant if it results from normal operations, but may be considered material if it is the result of exceptional operations.

Materiality is not an information quality that decision makers are concerned with in the decision process. However, materiality plays an important role in it's relationship with the primary and secondary information qualities, in determining whether an information

item should be provided. In the absence of absolute criteria for establishing a threshold for materiality, individual judgements are required to establish the need for inclusion. This judgement should be guided by the belief that the exclusion of an item of information would not have caused a reasonable person relying on the financial statements for a decision, to change that decision had the information in question been provided.

C. ELEMENTS OF THE FINANCIAL ACCOUNTING MODEL

An important part of creating a conceptual framework is the establishment of some standard elements or definitions. Accounting uses many terms that are specific to the business environment and require a definition for its intended use. All elements are defined in relation to a particular entity, which may be a business enterprise, an educational or charitable organization, a government unit, or a person. Concepts Statement No. 6 defines the ten interrelated elements that are related to measuring the performance and financial status of an organization: [Ref. 1]

1. **Assets.** Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.
2. **Liabilities.** Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.
3. **Equity.** Residual interest in the assets of an entity that remains after deducting its liabilities. In a business enterprise, the equity is the ownership interest.

4. **Investment by Owners.** Increases in net assets of a particular enterprise resulting from transfers to it from other entities of something of value to obtain or increase ownership interests (or equity) in it. Assets are most commonly received as investments by owners, but that which is received may also include services or satisfaction or conversion of liabilities of the enterprise.

5. **Distributions to Owners.** Decreases in net assets of a particular enterprise resulting from transferring assets, rendering services, or incurring liabilities by the enterprise to owners. Distributions to owners decrease ownership interest (or equity) in an enterprise.

6. **Comprehensive Income.** Change in equity (net assets) of an entity during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.

7. **Revenues.** Inflows or other enhancements of assets of an entity or settlement of its liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or carrying out other activities that constituted the entity's ongoing major or central operations.

8. **Expenses.** Outflows or other using up of assets or incurrences of liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.

9. **Gains.** Increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from revenues or investments by owners.

10. **Losses.** Decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from expenses or distributions to owners.

FASB classifies the aforementioned elements into two distinct groups. The first group is made up of three elements, assets, liabilities, and equity. They describe amounts of resources and claims to resources at a moment in time. The other seven elements describe events that affect an entity during a period in time. The first group is affected by elements of the second group and at any time is the cumulative results of all changes. This interrelationship is sometimes referred to as articulation. This results in financial statements that are fundamentally interrelated so that statements that show elements of the second class depend on statements that show elements of the first class and vice versa. [Ref. 4]

D. RECOGNITION AND MEASUREMENT

Recognition is the process of formally recording or incorporating an item in the financial statements of an organization. The recognition and measurement concepts serve as a justification in developing logical responses to financial reporting issues. They have been developed to attain a reasonable degree of uniformity in applying the accounting

standards. These guidelines can be divided into three distinct groups of recognition and measurement concepts: 1) assumptions; 2) principles; 3) constraints. [Ref. 5]

Assumptions

There are four basic assumptions that underlie the financial accounting structure: [Ref. 4]

1. **Economic Entity Assumption.** A major assumption in accounting is that specific economic activity can be identified with a particular entity. The activities of an entity can be separated from those of the owners and other business entities for accounting purposes.

2. **Going Concern Assumption.** Accounting methods are based on the assumption that the business entity will have a long economic life. Adopting this assumption of permanence allows the use of depreciation and amortization in the accounting process. The going concern assumption is acceptable in most business situations. Only when liquidation appears imminent is the assumption invalid.

3. **Monetary Unit Assumption.** Accounting is based upon the assumption that money is the means by which activities are conducted and that the monetary unit provides an appropriate basis for measurement and analysis. This assumption provides that the most effective means of expressing value is the monetary unit. This assumption is based upon the underlying assumption that the unit of measure remains relatively stable, thus ignoring inflation and deflation.

4. **Periodicity Assumption.** The time period assumption implies that the economic activities of an entity can be divided into artificial time periods. The most accurate time to

measure an entities activities would be to measure them at the time of their liquidation. However, various users have a need for financial information while the organization is still viable. In order to provide this type of information, accountants divide continuous operations into arbitrary time periods, for reporting purposes.

Principles

The basic assumptions of accounting are the basis for the principles or guidelines that the accountant follows in recording transactions. The guidelines relate basically to how assets, liabilities, and expenses are to be identified, measured, recorded and reported. There are four basic guidelines: [Ref. 4]

1. **Historical Cost Principle.** Traditionally, accountants and users of financial statements have found that cost is the most useful foundation for accounting measurement. Consequently, existing Generally Accepted Accounting Principles (GAAP) require that most assets and liabilities be recorded on the basis of acquisition cost. Utilization of the acquisition cost for reporting purposes has an important advantage over other valuation methods, it is reliable. Cost is definite and verifiable. In order for information to be considered reliable by both internal and external users, the information must be known to be accurate and based on fact. The accounting practice of conservatism dictates that items are recorded at lower of cost or market value. By using cost as the basis the for record keeping, accountants can provide objective and verifiable data in the financial reports.

2. **Revenue Recognition Principle.** Revenue is generally recognized when (1) realized or realizable and (2) earned. Revenues are realized when products are exchanged

for cash or claims to cash. Revenues are defined as realizable when assets received or held are readily convertible to cash or claims to cash. Revenues are not recognized until earned. They are considered earned when the organization has substantially accomplished what it must do in order to be entitled to the revenues. Recognition of revenue at the time of sale provides a consistent and measurable means of revenue recognition and serves as the general rule for revenue recognition. However, recognition of revenue is allowed in certain long-term construction contracts before the contract is completed. This is termed the percentage of completion method and its advantage is that revenue is recognized periodically on the basis of the percentage of work that has been accomplished on the job.

3. **Matching Principle.** Accountants attempt to match costs or expenses with the revenues that they create. Thus, expense recognition is tied to revenue recognition. In some cases it is difficult determining to which period revenues, an expense has contributed. Consequently, expenses are broken in to two groups: product or period expense. Expenses such as labor, material or overhead directly associated with the production of the product can be readily identified and carried forward to the period in which the revenue produced by those expenses is recognized. However, many expenses are not directly related to particular revenues but can be related to a period on the basis of transactions occurring in the period. Recognition of those expenses is largely independent of recognition of specific revenues but they are deducted from specific revenues by being recognized in the same period.

4. **Full Disclosure Principle.** In deciding what information to report, accountants follow the rule of providing any information that will influence the decision process of an informed user. Under this principle accountants are forced to make tradeoffs between providing adequate details on information pertinent to the user, without providing information that is too detailed, potentially hindering understandability. In determining the level of disclosure the accountant must also balance the costs of preparing and using the reports. Ultimately the accountant is faced with the problem of making sure that enough information is presented to ensure that a reasonably prudent investor will not be misled.

Constraints

In providing information that will be useful to users, there are four constraints that must be considered: [Ref. 4]

1. **Cost-Benefit Relationship.** The costs of providing information must be weighed against the benefits that will be derived from the information. In order to justify providing specific information, the perceived benefits must exceed the expected costs. The difficulty in doing a cost-benefit analysis is that the potential benefits are not always apparent in advance, if at all. In addition, benefits may accrue to a wide group of users, both known and unknown, further complicating the cost-benefit analysis. Because the costs are readily measurable but the benefits are not, the requirement for cost-benefit analysis as part of the accounting standards development process is becoming popular.

2. **Materiality.** An item is considered material if its inclusion or omission would influence the users decision. The relative size of an item is important in determining it's materiality.

3. **Industry Practices.** The unique nature of some industries and businesses, may require a departure from the basic conceptual framework and the underlying accounting guidelines. However, consistency within the industry in how similar items are treated, are critical to the reporting process.

4. **Conservatism.** When an accountant is in doubt about the treatment of an item, they should rely upon the convention of conservatism, which is that the solution that is least likely to overstate assets and/or income should be chosen. Simply put, if the issue is in doubt, it is better to understate than overstate.

E. FINANCIAL REPORTS

In providing information to users of financial statements, general purpose financial statements are relied upon. The intent of general purpose financial statements is to provide the most useful information possible to the various user groups at the least cost. Underlying the four objectives for financial reporting in the private sector is the belief that a reasonable level of financial accounting sophistication is possessed by users of the information contained in the financial reports. The assumption that users possess a reasonable level of competence, allows a more detailed presentation of information in the financial reports.

There are three standard general purpose financial statements that are included in private sector financial reports. The balance sheet, which reports the financial position of

the business at a particular point in time. The income statement reports the profit performance of the business entity. The statement of cash flows, reports the cash flows of the entity from various activities. [Ref. 6]

1. Balance Sheet. The purpose of the balance sheet is to report the financial position of the organization at a particular point in time. The balance sheet is referred to the statement of financial position, because it reflects the financial position of the entity, which is simply the amount of resources/ and liabilities the organization has. Assets are resources owned by the entity and liabilities are obligations of the entity and owner's equity is the owners financial interest in the organization. The basic accounting model for the balance sheet is: [Ref. 4]

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

The standard balance sheet format for private sector business organizations is as follows:

BALANCE SHEET

Assets

Current Assets:

Cash	xxx	
Accounts Receivable	xxx	
Inventories	xxx	
Other	<u>xxx</u>	
Total Current Assets		xxx

Non-Current Assets:

Long Term Investments	xxx	
Property, Plant and equipment	xxx	
Other	<u>xxx</u>	
Total Non-Current		<u>xxx</u>

TOTAL ASSETS xxx

Liabilities

Current Liabilities:

Accounts Payable	xxx	
Notes Payable	xxx	
Other	<u>xxx</u>	
Total Current Liabilities		xxx

Non-Current Liabilities:

Long Term Debt	xxx	
Other	<u>xxx</u>	
Total Non-Current Liabilities		<u>xxx</u>

TOTAL LIABILITIES xxx

Stockholder's Equity

Contributed Capital:

Common Stock	xxx	
Preferred Stock	xxx	
Additional Paid in Capital	xxx	

Retained Earnings xxx

TOTAL STOCKHOLDER'S EQUITY xxx

TOTAL LIAB. & STOCKHOLDER'S EQUITY xxx

2. **Income Statement.** The income statement reports the profit performance of the business entity. Profit is defined as the net income of the entity, which is simply the revenues less expenses. Revenues cause inflows of resources into an entity, and expenses cause outflows of resources. The income statement reports the revenue and expenses for a specified period of time. The accounting model for the income statement is: [Ref. 4]

$$\text{Revenues} - \text{Expenses} = \text{Net Income}$$

The standard income statement format for private sector business organizations is as follows:

INCOME STATEMENT

Revenues and Expenses

Revenues	xxx
Expenses	<u>(xxx)</u>

Operating Income	xxx
-------------------------	-----

Non-Operating Gains & Losses

Non-Operating Gains	xxx
Non-Operating Losses	<u>(xxx)</u>

Pretax Income	xxx
Income Tax	<u>(xxx)</u>

NET INCOME	xxx
-------------------	-----

3. Statement of Cash Flows. The statement of cash flows reports the entities cash flows from various activities. The primary categories of cash flows are: 1) Cash flows from operating activities; 2) Cash flows from investing activities; 3) Cash flows from financing activities. The accounting model for the statement of cash flows is:

$$\text{Cash (beginning of period) +/- Cash from Operations +/- Cash from Investing +/- Cash from Financing} = \text{Cash (end of period)}$$

The standard statement of cash flows format for private sector business organizations is as follows:

STATEMENT OF CASH FLOWS

Cash Flows from Operations:

Inflows from revenues	xxx
Outflows for expenses	<u>(xxx)</u>

Net Cash Flow from Operations xxx

Cash Flows from Investing:

Inflows from sale of non-current assets	xxx
Outflows for investments in non-current assets	<u>(xxx)</u>

Net Cash Flows from Investing xxx

Cash Flows from Financing:

Inflows from new debt or equity	xxx
Outflows to support debt or equity	<u>(xxx)</u>

Net Cash Flows from Financing xxx

Net Change in Cash xxx

Cash (Beginning of period) xxx

Cash (End of period) xxx

Changes in the financial position of a business, can be seen by comparing it's balance sheet at the beginning and the end of the period. The income statement and statement of cash flows are often referred to as change statements because they help users understand what caused the changes in the balance sheet. The income statement explains the change in the owner's equity section of the balance sheet, specifically retained earnings. The statement

of cash flows explains all of the changes on the balance sheet in terms of cash inflows and cash outflows.

The three financial statements are linked in important ways. This linking is called articulation, which means an amount in one statement is carried forward to another statement. Decision makers can better interpret the financial statements when they understand how changes in one affect the others.

The financial statements are the central focus of financial reporting for private sector organizations. They serve as the principal means for communicating accounting information to users outside of the organization. Although financial statements may also contain information from sources other than accounting records, accounting systems are generally organized on the basis of the elements of financial statements and provide the bulk of the information presented in the financial statements.

The relationship between the three standard financial statement that are commonly utilized in private sector financial reports is illustrated in figure 2.3.

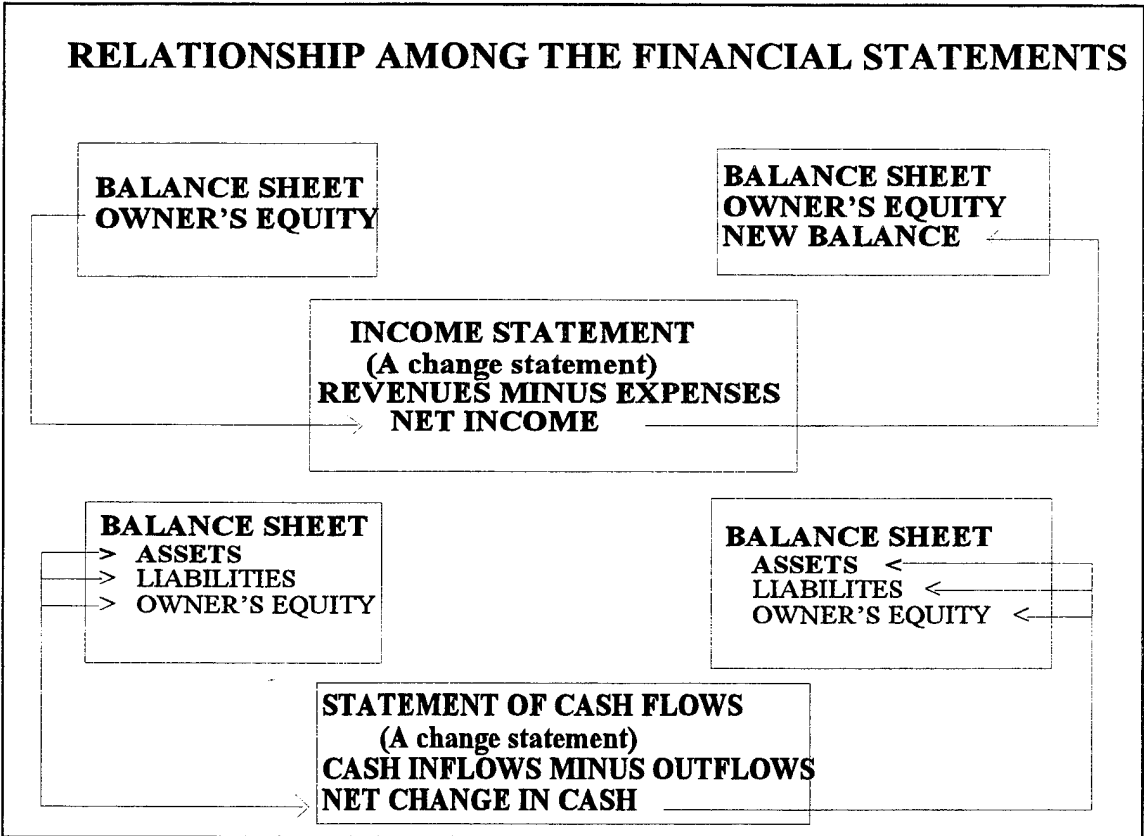


Figure 2.3. Financial Statements Relationships. From Ref. [4].

The assorted sections on each of the required financial statements have been designed to facilitate decision making. They are presented in a standard form, following the fundamental accounting and reporting principles established by FASB. The information provided on financial statements is of little value to decision makers if they are unable to find it, when they need it. In addition, they must be able to understand what is being presented.

The conceptual framework of accounting as developed by FASB, explains why accountants prepare the financial statements the way that they do. The primary objective of financial accounting is to provide information for decision makers to utilize in their decision making process. The conceptual framework for financial reporting in the private sector identifies the qualitative characteristics that information should possess, in order to make it useful for the various users of that information.

In this chapter the financial reporting conceptual framework for private sector business organizations and how it supports the presentation of the financial status of the organizations to the report users, were presented. In chapter III the FASB's conceptual framework for financial reporting in private sector nonprofit organizations, will be examined.

III. PRIVATE SECTOR NONPROFIT ORGANIZATIONS

The Financial Accounting Standards Board (FASB) has developed accounting standards for private sector nonprofit organizations, as well as, business organizations. In this chapter the FASB's conceptual framework for financial reporting in nonprofit organizations, will be presented. The objectives, qualitative characteristics and elements that serve as a foundation for financial reporting in private sector nonprofit organizations, will be identified. In addition, the financial statements that result from the conceptual framework for nonprofit financial reporting, will be defined.

By definition, the goal of a nonprofit organization is something other than earning profits. Rather than attempting to widen the difference between outputs and inputs, the goal is to render as much service as possible given an amount of resources. In most situations, the financial performance goal in a nonprofit organization is to break-even; that is, in general and over the long run, outputs should equal inputs.

The Financial Accounting Standards Board has devoted considerable resources to establishing a conceptual framework for accounting and financial reporting. The FASB's conceptual framework is intended to apply to all entities, nonprofit, as well as business. Elements of the conceptual framework are set forth in the series of Statements of Financial Accounting Concepts (SFAC). The SFAC's that were created for business enterprises also apply to those nonprofit organizations that are operated in a manner similar to business enterprises.

SFAC No. 4 “Objectives of Financial Reporting by Nonbusiness Organizations,” was developed specifically for nonprofit and government entities. According to SFAC No.4, the major distinguishing characteristics of nonbusiness organizations are: [Ref. 7]

1. Receipts of significant amounts of resources from resource providers who do not expect to receive either repayment or economic benefits proportionate to the resources provided.

2. Operating purposes that are other than to provide goods or services at a profit or profit equivalent.

3. Absence of defined ownership interests that can be sold, transferred, or redeemed, or that convey to a share of a residual distribution of resources in the event of liquidation of the organization.

The typical reason for the organization of a nonbusiness entity is to provide services to a group of constituents. In the usual case administrators of a nonbusiness organization attempt to determine in advance the outflows of resources needed to provide services during a given time period, then attempt to secure an inflow of resources approximately equal to the desired outflow.

In the nonprofit sector, organizations operate in a variety of fashion, from very restricted to nearly restriction free. Some entities in the nonbusiness category may operate under very detailed and specific legal restrictions as to the sources of financial resources they may utilize, the amounts they may raise from each source, and the uses they may make of the proceeds from each source, this is particularly true of local governmental units. Other

entities in the nonbusiness sector are about as free as business enterprises from legal restriction as to the sources and uses of financial resources, but all entities are subject to some degree of regulation. [Ref. 7]

Nonbusiness organizations include governmental and other nonprofit organizations. For the purpose of applying conceptual accounting standards, nonprofit organizations are classified as either client-supported or public supported organizations.

An essential characteristic of any organization is that it uses resources to produce goods and services. In a business organization, the resources used during a period are labor, material, and services. For accounting purposes, these are called expenses. Amounts realized from selling goods or rendering services to outside entities are revenues. These revenues provide the resources needed for continued operations. [Ref. 8]

Nonprofit organizations also use resources. The amount of resources used during a period, their expenses, can be measured about as well as those in a business organization. Some nonprofit organizations also obtain their financial resources entirely, or almost entirely, from revenues realized from selling goods or rendering services. Such organizations are defined as "Client-supported organizations." Examples of client-supported nonprofit organizations are schools and colleges whose financial resources are derived from tuition and other fees for services rendered, hospitals that are financed by patient charges, credit unions and other similar organizations that are financed by user charges.

In other nonprofit organizations, however, a significant part of financial resources are obtained from sources other than revenues. Revenues being defined as an exchange

transaction, where the organization furnishes goods or services in exchange for financial resources. Among these sources other than revenues are appropriations from entities, taxes, contributions and grants. In these organizations, the amount of goods and services produced during a period cannot be measured by revenues. In many such organizations there are restrictions on the use of the resources obtained from these nonrevenue sources. These type organizations are called "Public-supported organizations." Examples of public-supported organizations are governmental units supported from tax levies. [Ref. 8]

A. BASIC OBJECTIVES OF FINANCIAL REPORTING

In developing a conceptual framework for financial reporting for nonprofit organizations, the FASB first focused on identifying financial reporting objectives. These objectives were developed by identifying the users of the financial reports and then evaluating their needs. The FASB identified four primary users of nonprofit financial reports: [Ref. 8]

1. **Governing bodies** - Boards of trustees, boards of directors, etc.
2. **Creditors** - Commercial bankers, vendors and others who have extended credit or are considering an extension of credit.
3. **Resource providers/Constituents** - Donors and prospective donors, federated fund raising organizations and dues paying members.
4. **Oversight bodies** - National headquarters of organizations and accrediting agencies.

The SFAC No. 4 sets forth the objectives of general purpose external financial reporting by nonbusiness organizations. The objectives stated by FASB do not consider the needs of administrators, or any other parties deemed to have the ability to enforce their demands for information.

As with financial reporting in private sector business organizations, information forms the basis for decision making. The need for information on which to base financial decisions is fundamental to the development of objectives for financial reporting in nonprofit organizations. Nonprofit reporting objectives identify the goals and purposes of accounting and are the building blocks for the conceptual framework.

Based upon the needs of the four primary financial reports users, the FASB developed four objectives for nonprofit financial statements, all of which focus on providing information to aid decision makers in the decision process. The FASB believes that general purpose external financial reporting for nonbusiness organizations should provide: [Ref. 7]

1. **Resource Allocation** - Information useful in making resource allocation decisions.
2. **Service Assessment** - Information useful in assessing services and ability of organization to provide services.
3. **Management Performance** - Information useful in assessing management stewardship and performance.
4. **Financial Position** - Information about assets, liabilities, and equity as of a point in time, and changes in those elements over a period of time.

Although the brief statements of objectives for nonbusiness organizations are worded in a manner similar to the brief statements of objectives of financial reporting by business enterprises, the discussion of the objectives in SFAC No. 4 is based on recognition of the fact that external users of financial reports of nonbusiness organization are not owners, and that performance of a nonbusiness organization is measured by “changes in the amount and nature of the net resources” together with information about its “service efforts and accomplishments,” rather than by net income. [Ref. 9]

B. ELEMENTS AND CHARACTERISTICS OF ACCOUNTING

The FASB in Concepts Statement No. 2, “Qualitative Characteristics of Accounting Information”, provides the characteristics that make accounting information useful. In Concepts statement No. 3, “Elements of Financial Statements of Business Enterprises”, the FASB provides definitions of items that appear in the financial statements, such as assets, liabilities, revenues and expenses.

Concepts Statements numbers 2 and 3 provide the foundation for the conceptual framework of accounting and financial reporting for business organizations. In order to distinguish between business organizations and all other entities, FASB adopted the term nonbusiness organizations to refer to nonprofit and government organizations. The FASB provided amendments to SFAC NO. 2 and SFAC No. 3, applying them to nonbusiness organizations, as well. [Ref. 7] The FASB’s accounting characteristics and elements for business organization which were presented in the previous chapter are also applicable to nonbusiness organizations.

Additionally, the FASB provided elements created specifically to address the treatment of net assets (equity) in nonprofit organizations. The FASB requires reporting for the organization as a whole. Organizations in reporting for the entity as a whole are required to display separately, various types of equity. The FASB requires reporting by three classes of net assets: unrestricted, temporarily, and permanently restricted. [Ref. 10]

Unrestricted net assets are those that are neither permanently restricted nor temporarily restricted by donor-imposed stipulations. Temporarily restricted net assets result from contributions and other inflows of assets whose use by the organization is limited by donor imposed stipulations that either expire by passage of time or can be fulfilled and removed by actions of the organization pursuant to those stipulations. Permanently restricted net assets are those resulting from contributions and other inflows of assets whose use by the organization is limited by donor-imposed stipulations that neither expire by passage of time nor can be fulfilled or otherwise removed by actions of the organization.

C. RECOGNITION AND MEASUREMENT

Nonprofit organizations are required to use accrual basis accounting for external financial reporting purposes. Many small nonprofit organizations operate on a cash basis for their daily operations, but they are required to adjust their records for financial statement purposes.

Nonprofit organizations have no ownership interests corresponding to owners' equity in a business. The difference between assets and liabilities is referred to as net assets or equity. A nonprofit's net assets increase in two ways: (1) **Public support** - through receipts

from providers who do not expect to receive either repayment or economic benefits in proportion to their contributions; and (2) **Revenues** - from the sale of goods and services.

[Ref. 10]

The accrual basis of accounting is used for financial reporting purposes in nonprofit organizations, as it is in business. Under accrual basis accounting, revenues are recognized when earned and public support is recognized when received. Ordinarily, contributed tangible assets are capitalized and recognized as revenue at their fair value at the date of the gift. However, conditional public support is not recognized until it becomes unconditional. Expenses are recognized when the related liabilities are incurred for the unrestricted assets class.

The FASB requires that nonprofit organizations capitalize and depreciate their operating assets, including buildings and equipment, and improvements. In addition, they must disclose: (1) depreciation expense for the period; (2) book value balances by major classes of depreciable assets; (3) accumulated depreciation by major asset class; (4) a general description of the depreciation methods used for major asset classes. [Ref. 10]

D. FINANCIAL REPORTS

Generally Accepted Accounting Principles (GAAP) applicable to separately issued, general purpose financial statements of entities or activities in the public sector are guided by standards of the FASB except in circumstances where the GASB has issued a pronouncement applicable to such entities or activities. (GASB standards generally apply

to those entities or activities when included in combined general purpose financial statements issued by state and local government units or colleges and universities.)

Nonprofit organizations currently provide financial statements that differ in their form and content. However, there are three standard financial statements that are included in nonprofit sector financial reports. The balance sheet/statement of financial position, which reports the readily spendable resources of the organization and the claims against those resources. The statement of activity, reports the results of economic activities for the nonprofit organization and the resulting changes in net asset classifications. The cash flow statement, reports the entities cash flows from various activities.

1. Balance Sheet or Statement of Financial Position. The purpose of the balance sheet is to report the organization's readily spendable resources and the claims against those sources. Since these entities have no capital stock or other equity claims capable of being sold or traded, the equity section of the balance sheet is called "Net Assets", which is equal to the difference between the assets and liabilities. The accounting model for the balance sheet is:

$$\text{Assets} = \text{Liabilities} + \text{Net Assets}$$

The standard balance sheet format for a nonprofit organization is as follows:

STATEMENT OF FINANCIAL POSITION

Assets:

Cash and Cash Equivalents	xxx
Accounts Receivable	xxx
Prepaid Items	xxx
Inventories	xxx
Short-Term Investments	xxx
Long-Term Investments	xxx
Physical Assets	<u>xxx</u>

TOTAL ASSETS xxx

Liabilities and Net Assets:

Liabilities:

Accounts Payable	xxx
Notes Payable	xxx
Annuity Obligations	xxx
Refundable advance	<u>xxx</u>

TOTAL LIABILITIES xxx

Net Assets:

Unrestricted	xxx
Temporarily restricted	xxx
Permanently Restricted	<u>xxx</u>

TOTAL NET ASSETS xxx

TOTAL LIABILITIES & NET ASSETS xxx

2. Statement of Activity. The purpose of the statement of activity is to report the results of economic activities for the organization and the resulting changes in net asset classifications. The typical statement of activity bears a close resemblance to the income statement for business enterprises, except that the revenues and expenses for the different asset classifications are reported separately. The accounting model utilized in each asset classification for the statement of activity:

$$\text{Support and Revenues (Net Inflows) - Expenses and losses (Net Outflows) = Change in Net Assets}$$

The standard statement of activity format for a nonprofit organization is as follows:

STATEMENT OF ACTIVITY

Changes in Unrestricted Net Assets:

Support, Revenue and Gains:

Support - Contributions	xxx	
Support - Other	xxx	
Investment Income	<u>xxx</u>	
Total Unrestricted Revenues and Gains		xxx

Net Assets Released from Restrictions:

Satisfaction of Program Restrictions	xxx	
Satisfaction of Equipment Restrictions	xxx	
Expiration of Time Restrictions	<u>xxx</u>	
Total Assets Released from Restrictions		xxx

Expenses and Losses:

Education and Research	xxx	
Fund-Raising	xxx	
Administrative and General Expense	<u>xxx</u>	
Total Expenses and Losses		<u>xxx</u>

Total Change in unrestricted Net Assets xxx

Changes in Temporarily Restricted Assets:

Contributions	xxx	
Income on Investments	xxx	
Revenues	xxx	
Net Realized and Unrealized Gains	xxx	
Net Assets Released from Restrictions	<u>xxx</u>	

Total Change in Temporarily Restricted Assets xxx

Changes in Permanently Restricted Net Assets:

Same as for temporarily restricted assets		<u>xxx</u>
---	--	------------

Total Change in Permanently Restricted Net Assets xxx

Total Increases in Net Assets xxx

Net Assets, Beginning of the year xxx

NET ASSETS, END OF THE YEAR xxx

3. Cash Flow Statement. The cash flow statement reports the organization's cash flows from operating, investing and financing activities. The cash flow statement for nonprofit organizations is almost identical to those of a business organizations. The accounting model for the cash flow statement is:

$$\text{Cash (Beginning of period) +/- Cash from Operations +/- Cash from Investing +/- Cash from Financing} = \text{Cash (End of period)}$$

The standard cash flow statement format for nonprofit organization is as follows:

CASH FLOW STATEMENT

Cash Flows from Operating Activities:

Change in Net Assets xxx

Adjustments to Reconcile Change in Net Assets to Net Cash

Provided By Operating Activities:

Depreciation xxx

Change in Receivables xxx

Change in Inventories xxx

Change in Prepaid Expenses xxx

Change in Payables xxx

Total Cash Flow from Operating Activities xxx

Cash Flows from Investing Activities:

Change in Physical Assets xxx

Sale/Purchase of Investments xxx

Total Cash Flow from Investing Activities xxx

Cash Flows from Financing Activities:

Proceeds from Contributions Restricted for:

Investment Endowment xxx

Investment in Plant xxx

Investment Subject to Annuity Agreements xxx

Total Proceeds from Restricted Contributions xxx

Other Financing Activities:

Int. & Div. Restricted for Reinvestment xxx

Changes in Notes Payable xxx

Proceeds from Mortgage xxx

Total Cash Flow from Other Financing xxx

Total Cash Flow from Financing Activities xxx

Net Change in Cash and Cash Equivalents xxx

Cash and Cash Equivalents at Beginning of the Year xxx

CASH AND CASH EQUIVALENTS (END OF YEAR) xxx

Nonprofit organizations, concerned with achieving their service objectives within the constraints of resources available to them, require inflow-outflow statements that disclose the extent to which those objectives have been met. The FASB's financial reporting system for nonprofit organizations is designed to disclose the asset-obligation position and the extent to which enterprise objectives had been achieved over a specified period of time. The financial statements of nonprofit organizations allow interested parties to evaluate the fiscal and operational accountability of management, as well as the potential debt paying ability of the enterprise.

In this chapter, the conceptual framework for financial reporting in private sector nonprofit organizations, was presented. In chapter IV the Governmental Accounting Standards Board's conceptual framework for financial reporting in state and local governments, will be examined.

IV. STATE AND LOCAL GOVERNMENT

Accounting and financial reporting standards for state and local government in the United States are set by the Governmental Accounting Standards Board (GASB), established in 1984. In this chapter fund accounting, which is the way state and local governments monitor the receipt and disbursement of resources, will be defined. In addition, the objectives, characteristic and elements that underlie the GASB's conceptual framework for financial reporting for state and local governments, will be presented.

The GASB has been conducting an ongoing review of government financial reporting practices and standards. The focus of their review has been to determine the best way of displaying both the financial position of state and local government entities and the results from their operations.

In the development of a reporting framework, GASB has focused on identifying the users of external governmental reports, as well as their information needs. GASB has also been concerned with the internal consequences on the entity, of the financial reports. In addition, they have looked at the consequences the reports may have on potential creditors and their determination, or the entities credit-worthiness.

To ensure that the financial report users need for quality information was met, in 1987 GASB established the fundamental qualitative requirements for the presentation of governmental financial information. These characteristics and conditions serve as the structure for government financial reporting framework.

A. FUND ACCOUNTING

Governmental accounting and financial reporting have been adapted to ensure and demonstrate compliance with legal requirements. State and local governments use a variety of separate accounting entities known as “funds” to control and monitor the receipt and disbursement of resources for specific activities. These individual funds are accounted for separately on the financial books of state and local governments. This process is referred to as fund accounting.

The accounts of municipal government entities are organized on the basis of funds, each of which is considered a separate accounting entity. The operations of each fund are accounted for in a separate set of self-balancing accounts that comprise its assets, liabilities, fund equity, revenues, and expenditures, as appropriate. Governmental resources are allocated to and accounted for in individual funds based upon the purpose for which they are to be spent and the means by which spending activities are controlled.

The various funds of the entity are grouped into two categories, business-type and nonbusiness-type activities. The funds used to account for the resources of activities that are considered business-type, are called proprietary funds. The funds used to account for those activities that are not considered business-type, are called governmental funds. Additionally, governments often serve as an agent or in a fiduciary capacity for individuals and other governments. A special type of fund, called fiduciary funds, was created to account for these limited types of activities. [Ref. 11] The following is a list of the fund types used by state and local governments:

Governmental Fund Types

1. **General Fund** - Used to account for all financial resources except those required to be accounted for in another fund.

2. **Special Revenue Funds** - Used to account for the proceeds of specific revenue sources that are legally restricted to expenditures for specified purposes.

3. **Debt Service Fund** - Used for the accumulation and disbursement of financial resources that will be used to make payments on long-term debt.

4. **Capital Project Fund** - Used to account for the acquisition or construction for major capital facilities.

Proprietary Funds

5. **Enterprise Fund** - Used to account for operations that are financed and operated in a manner similar to private business.

6. **Internal Service Fund** - Used to account for the financing of goods or services provided by one department to other departments, on a cost reimbursement basis.

Fiduciary Funds

7. **Agency Fund** - Custodial in nature and does not involve measurement of the results from operations.

Account Groups

1. **General Fixed Assets Account Group** - Accounts for all fixed assets of the city other than those accounted for in proprietary funds.

2. **General Long-Term Debt Account Group** - Accounts for all long-term obligations of the city other than those accounted for in proprietary funds.

Governmental funds are those through which most governmental functions of the organization are financed, they are funding oriented. They are concerned with the short term budgetary needs of the government, and how those needs will be financed. Governmental funds do not report a government's general long term obligations. They do not report the entity's fixed assets, because they are not available to meet the government's short term budgetary needs. [Ref. 12]

Activities that are accounted for in the governmental funds are financed through taxes and intergovernmental revenues. The acquisition, use and balances of the government's financial resources, except those accounted for in the proprietary funds, are accounted for through governmental funds. The measurement focus is based upon the determination of changes in financial position rather than upon determination of net income.

Proprietary funds are used to account for the government's ongoing operations. These funds are employed to account for those operations that are financed and operated in a manner similar to private business, where the intent of the governing body is that the costs of providing goods or services to the general public, on a continuing basis be financed primarily through user fees. The measurement focus is based upon determination of net income.

Fiduciary funds are those funds through which activities where the organization acts as an agent or in a fiduciary capacity, for individuals or other governments, are recorded.

reporting governmental organization may collect taxes on behalf of another governmental entity. In that case the collecting organization is acting as an agent for the other entity, on whose behalf the monies are being collected. In addition, the reporting entity may act as a trustee for gifts or endowments, which places the reporting entity in the position of fiduciary responsibility. The high degree of accountability demanded of public officials requires that the holding or management of resources in a fiduciary capacity be reflected in the government's own financial statements. The entities fiduciary activities are reported separately from both their business-type and governmental type activities.

Information on the government's long term obligations and fixed assets are reported in a separate set of accounts called account groups. Account groups are not funds and do not report operational information. They provide a list of a government's general fixed assets or general long term obligations. Changes in the entity's general fixed assets or general long term debt are disclosed in the notes of the annual reports, rather than in an operating statement.

B. BASIC OBJECTIVES OF FINANCIAL REPORTING

In developing a conceptual framework for financial reporting for state and local government, GASB first focused on identifying external financial reporting objectives. These objectives were developed by identifying the users of the financial reports and then evaluating their needs. The GASB Concepts Statement No. 1, Objectives of Financial Reporting, identified three groups of primary users of external financial reports: [Ref. 13]

1. Citizens - taxpayers, voters, public interest groups and the media.

2. **Legislative and Oversight Bodies** - state legislatures, county boards, city councils, school boards and boards of trustees.

3. **Investors and Creditors** - individual and institutional investors, securities underwriters, bond rating agencies and bond insurers.

GASB did not identify government managers as a primary user group of external financial reports because of their ability to gather information from other sources. However, this does not mean that governmental managers were not an expected user of the information, but simply that GASB did not consider them a primary user, for the development of the objectives, based upon user needs.

The public utilizes government financial statements to evaluate the level and quality of services provided and whether those services are being paid for currently or will require future tax increases or other sources of funding. In addition, the public is interested in the rate at which existing resources are being consumed.

The legislative and oversight bodies are concerned with fiscal compliance and the data presented in financial reports, provide the information needed to assure users that spending mandates are complied with and that resources are being used as they were intended. In addition, they utilize the financial reports to evaluate the performance of management, in terms of how well they managed their resources. This is accomplished by comparing the organization's operating results with their budget.

Investors and creditors use the financial reports to determine the financial viability of the organization. The organization's viability can be tested in a number of ways, to

include testing for solvency and liquidity, a review of the nature of cash inflows, as well as the degree of transferability of assets. Further, viability can be measured similar to the way private sector organizations are evaluated, such as the relationship between resource inflows and outflows during a specific period and the assets of an organization relative to their liabilities.

Financial reporting objectives effectively are a road map that accounting and financial reporting standards follow. GASB Concept Statement No. 1, titled "Objectives of Financial Reporting", defines the nine basic objectives of financial reporting for state and local governments: [Ref. 11]

1. **Interperiod Equity** - Financial reporting should provide information to determine whether interperiod equity exists. Interperiod equity is defined as current-year revenues being sufficient to pay for current year services.

2. **Compliance** - Financial reporting should demonstrate whether resources were obtained and used in accordance with the entity's legally adopted budget; it should also show compliance with other finance related legal requirements.

3. **Service Level** - Financial reporting should provide information to assist users in assessing the service efforts, costs, and accomplishments of the government entity.

4. **Sources and Uses of Resources** - Financial reporting should provide information about sources and uses of financial resources.

5. **Financing** - Financial reporting should provide information about how the governmental entity financed its activities and met cash requirements.

6. **Operational Performance** - Financial reporting should provide information necessary to determine whether the entity's financial position improved or deteriorated as a result of the year's operations.

7. **Financial Position** - Financial reporting should provide information about the financial position and condition of a governmental entity.

8. **Capital Assets** - Financial reporting should provide information about a government entity's physical and other nonfinancial resources having useful lives that extend beyond the current year, including information that can be used to assess service potential of those resources.

9. **Resource Restrictions** - Financial reporting should disclose legal or contractual restrictions on resources and risks of potential loss of resources.

These objectives serve as a foundation for the conceptual framework that the GASB has developed. The fundamental concepts of government accounting information and the financial statements that have been established, were done so in response to the various users needs and objectives.

C. ELEMENTS AND CHARACTERISTICS OF ACCOUNTING

Accounting data must possess certain characteristics if they are to be of value to users of financial reports. These characteristics are described in GASB's Concepts Statement No. 1. They can be briefly summarized as follows: [Ref. 11]

1. Understandability - Requires that data contained in financial reports be presented in such a way as to be accessible to those users without a detailed knowledge of accounting principles.

2. Reliability - Data must faithfully represent the substance of the underlying events or transactions.

3. Relevance - Only data that is useful to report users should be included in the financial statements.

4. Timeliness - Financial reports must be provided in time, for the information they provide to affect the decision.

5. Consistency - Accounting principles should be used consistently over time, so that financial reports of one period may be compared to those of another without having the data skewed by changes in accounting practices. Any changes any accounting practices should be disclosed in the notes of the financial statements.

6. Comparability - Similar transactions and events should be reported similarly by different organizations. Differences in the treatment of an event should be substantive rather than the result of differences in accounting.

There are several limitations of financial reporting in the municipal government arena. Financial reports cannot be prepared that meet all the needs of every user, because the reports would quickly become to cumbersome for general use. Another limitation is the cost of accumulating information, compared to the benefits the users derive from the

information. The GASB states that “the cost-benefit relationship should be carefully considered, in the establishment of standards.”

D. RECOGNITION AND MEASUREMENT

The accounting principles employed by state and local governments are driven by the unique accounting environment created by the use of fund accounting. Many of the recognition and measurement principles utilized in municipal government accounting are the same as those found in the private sector or are slight modifications to those principles, to allow the principles to be tailored to the special needs of fund accounting. [Ref. 14]

The first such principle is the accounting basis used by state and local governments. Basis of accounting refers to when revenues and expenses are recognized in the accounts and reports in the financial statements. The modified accrual basis of accounting is followed in the governmental funds. Under this basis, revenues are recognized when they become susceptible to accrual, that is when they become both measurable and available to finance expenditures of the current period. Available is defined as when the revenue is collectible within the current period or “soon enough thereafter” to be used to pay liabilities of the current period. Measurable means that the dollar value of the transaction can be determined. [Ref. 11]

For the governmental funds, expenditures are recognized in the accounting period in which the fund liability is incurred except for; (1) inventories that may be considered expenditures either when purchased or used, and (2) prepaid insurance and similar items that may be considered expenses either when paid for or when consumed.

Proprietary fund revenues and expenses are recognized on the accrual basis. Revenues are recognized in the accounting period in which they are earned and become measurable. Expenses generally are recognized when the economic benefits from those expenses are used in providing goods or services.

Fiduciary fund revenues and expenses or expenditures (as appropriate) are recognized on the basis consistent with the fund's accounting measurement purpose. Nonexpendable trust and pension trust funds are accounted for on the accrual basis; expendable trust funds are accounted for on the modified accrual basis.

The treatment of long-term debt is similar to private sector organizations in the proprietary and trust funds, but is different in the governmental funds. Debt and other long term liabilities directly related to and expected to be paid from proprietary and trust funds are reported in those funds as liabilities. Other unmatured long term debt of the government is normally displayed in the general long term debt account group. General long term debt is defined as only those debt instruments and other forms of noncurrent general obligations, that were not specific liabilities of any proprietary or trust fund and were not current liabilities properly recorded in the governmental funds.

Fixed asset valuation and depreciation for municipal governments is similar to that of private sector organizations, except for the governmental funds, due to their measurement focus. Fixed assets are accounted for at cost or, if the cost is not readily determinable, at estimated cost. Donated fixed assets are recorded at their estimated fair value at the time of the donation.

Depreciation is defined as an allocation of the net costs of the fixed asset, over its estimated useful life. Fixed assets accounted for in proprietary funds are depreciated and the value of that asset, less accumulated depreciation, is carried on the accounts of the proprietary fund. The fixed assets that are used in the performance of the activities that are accounted for in the governmental funds are called general fixed assets and are accounted for in the general fixed assets account group. General fixed assets are usually not depreciated.

The contrast between the measurement focus of the governmental funds and that of the proprietary funds, is the reason for the differences in the various funds application of the valuation and depreciation principle. Depreciation expense is a measure of the exhaustion of economic resources. It has no effect on the flow of current financial resources measurement focus used for the governmental funds because it neither provides nor requires the use of financial resources. This distinction is one of the fundamental difference between the proprietary and governmental funds.

E. FINANCIAL REPORTS

Municipal government financial statements are segregated into separate subsections employing a pyramid approach to financial reporting. The beginning statements presented in the financial reports (top of the pyramid) contain a relatively broad focus and less detailed information, they are referred to as general purpose statements. For the purpose of this study, only the general purpose statements were utilized. The following sections of the

financial reports (figure 4.1, moving down the reporting pyramid) include gradually increasing levels of reporting detail.

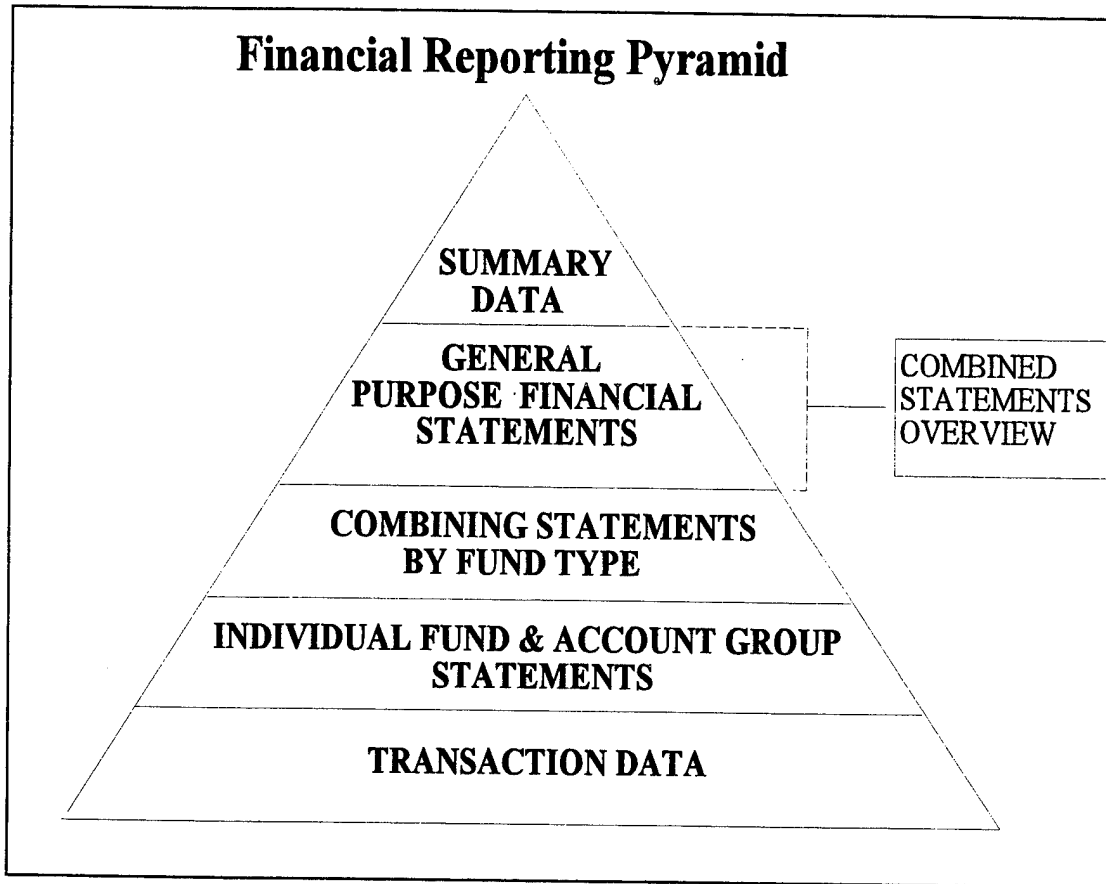


Figure 4.1. Financial Reporting Pyramid. From Ref. [11].

The financial statements are divided into four specific levels: [Ref. 15]

1. **Summary Data** - Provides specific information on a given subject, requested by an individual or group of users.

2. **General Purpose Financial Statements (GPFS)** - Provides report users with an overview and broad perspective of the financial position and results of operations of the government entity as a whole. The GPFS does not provide individual fund information. It does provide aggregated data by each fund type and for both account groups in separate, adjacent columns.

3. **Combining Statements - by Fund Type** - Combining statements are presented in the second level, after the GPFS for each fund type for which the entity maintains more than one individual fund. These statements include separate, adjacent columns for each individual fund of a given fund type, which effectively serve as separate financial statements for each of the individual funds. They also include a total for all such funds, which carries forward to the presentation of that fund type in the GPFS.

4. **Individual Fund or Account Group Statements** - These statements present information on the individual funds and account groups where such data could not be readily presented in the combining or combined statements.

5. **Transaction Data** - Are the underlying accounting transactions that the financial statements are built on. They are not presented in the entities financial statements, other than in summary form on the various statements.

The financial reports of state and local governments, provide the statements users with an overview of the governmental entity, from the individual fund or account group level to the combined statements overview level. The individual statements provided at each level of reporting, are prepared in accordance with GAAP.

There are a total of five different general purpose consolidated financial statements prepared by state and local governments. These statements consist of a balance sheet, three operating statements and a cash flows statement. These statements join the individual fund statements into combined statements for reporting purposes. A list of the different combined statements and the fund types that they are required for, follows: [Ref. 15]

1. **Combined Balance Sheet** - All fund types and account groups.

Accounting model: $\text{Assets} = \text{Liabilities} + \text{Fund Balances}$

The standard balance sheet format for state and local government organizations is as follows :

BALANCE SHEET

Assets:

Cash and Cash Equivalents	xxx
Investments	xxx
Receivables	xxx
Advances to other funds	xxx
Inventory	xxx
Prepaid Expenses	xxx
Property, Plant and Equipment	xxx
(Less) Accumulated Depreciation	<u>xxx</u>

TOTAL ASSETS xxx

Liabilities:

Accounts Payable	xxx
Due to other Funds	xxx
Advances from other Funds	xxx
Bonds	xxx
Deferred Revenue	<u>xxx</u>

TOTAL LIABILITIES xxx

Equity and other Credits:

Contributed Capital	xxx
Investment in General Fixed Assets	xxx
Retained Earnings:	
Reserved	xxx
Unreserved	xxx
Fund Balances:	
Reserved	xxx
Unreserved	<u>xxx</u>

TOTAL EQUITY AND OTHER CREDITS xxx

TOTAL LIAB., EQUITY & OTHER CREDITS xxx

2. **Combined Statement of Revenues, Expenditures and Changes in Fund Balances** - This is the first of the three operating statements, it is prepared for all governmental fund types and similar trust funds.

Accounting model: Revenues - Expenditures = Change in fund balance

The standard combined statement of revenues, expenditures, and changes in fund balance is as follows:

COMBINED STATEMENT OF REVENUES, EXPENDITURES AND CHANGES IN FUND BALANCES

Revenues and Expenses:

Revenues	xxx	
Expenditures	(xxx)	
Excess (Deficiency) or Revenues Over (Under) Expenditures		xxx

Other Financing Sources (Uses):

Proceeds from Bond Issuance	xxx	
Operating Transfers In	xxx	
Operating Transfer Out	(xxx)	
Excess (Deficiency) of Revenues over (Under) Expenditures and other Sources (Uses)		xxx

Fund Balances at Beginning of Year		<u>xxx</u>
---	--	------------

FUND BALANCES AT END OF YEAR		xxx
-------------------------------------	--	-----

3. Combined Statement of Revenues, Expenditures and Changes in Fund Balances (Budget and Actual) - The second operating statement is prepared for all governmental fund types for which annual budgets have been legally adopted.

The standard format for combined statement of revenues, expenditures, and changes in fund balances (budget to actual), is the same as statement of revenues, expenditures and changes in fund balances except two columns are added reflecting budgeted and actual amounts for each line item.

4. Combined Statement of Revenues, Expenses and Changes in Retained Earnings - The third operating statement is prepared for all proprietary fund types and similar trust funds.

Accounting model: $\text{Revenues} - \text{Expenses} = \text{Changes in retained earnings}$

The standard combined statement of revenues, expenses and changes in retained earnings format for state and local governments is as follows:

**COMBINED STATEMENT OF REVENUES, EXPENSES AND
CHANGES IN RETAINED EARNINGS**

Operating Revenues and Expenses

Operating Revenues	xxx
Operating Expenses	<u>(xxx)</u>

Income (Loss) from Operations	xxx
--------------------------------------	-----

Non-Operating Revenues and (Expenses):

Interest Income	xxx
Interest Expense	xxx
Bond Issuance Fees	<u>xxx</u>

Non-Operating Revenues (Expenses)	<u>xxx</u>
--	------------

Income (Loss) before Operating Transfers	xxx
---	-----

Operating Transfers:

Operating Transfers In	xxx
Operating Transfers Out	<u>(xxx)</u>

Net Income (Loss)	xxx
--------------------------	-----

Retained Earnings at Beginning of Year	<u>xxx</u>
---	------------

RETAINED EARNINGS AT END OF YEAR	xxx
---	-----

5. **Combined Statement of Cash Flows** - All proprietary fund types and similar trust funds.

Accounting model: Cash (Beginning of Year) +/- Cash from Operations +/-
Cash from Financing +/- Cash from investing = Cash (End of Year)

The standard combined statement of cash flows format for state and local government is as follows:

COMBINED STATEMENT OF CASH FLOWS

Cash Flows from Operations:

Inflows from Revenues	xxx
Outflows from expenses	<u>(xxx)</u>

Net Cash Provided (Used) By Operating Activities xxx

Cash Flows from Financing:

+/- Non-Capital Financing Activities	xxx
+/- Capital Financing Activities	<u>xxx</u>

Net Cash Provided (Used) by Capital and Related Financing Activities xxx

Cash Flows from Investing:

Interest and Dividends	xxx
Purchase of Investments	(xxx)
Proceeds from sale or maturation of investments	<u>xxx</u>

Net Cash Provided (Used) by Investing xxx

Net Increase (Decrease) in Cash xxx
Cash at Beginning of Year xxx

CASH AT END OF YEAR xxx

The operating statements are the focal point in state and local government financial reporting. These statements provide information on the inflows and outflows of current financial resources (for governmental activities) and economic resources (for business type activities). The results of operations are used to compare prior years results and also to compare those of governments that provide similar services.

When an activity receives a significant portion of its funding through user charges, it is referred to as a "business-type activity." When an activity is largely funded through taxes, it is called a "governmental-type activity." The needs of users of governmental-type activity financial information have historically, not been the same as those of users of financial information about the business-type activities.

Financial information on government's business-type activities centers on the cost of providing services, and the degree to which this cost is being recovered through user charges. This is much different from the focus that is found in the governmental-type activities, where the focus is on available spendable resources and short term demands upon them, rather than on long term cost recovery. Accordingly, municipal governments report their governmental-type and business-type activities in separate operating statements.

Municipal government financial reporting in the past has not emphasized the balance sheet effects of operations because of the view that current year costs can be paid by future years revenues, if need be. However, there is growing demand for governments to live within their means and balance sheets are viewed as a way of measuring that ability.

The conceptual framework of financial accounting for state and local governments as developed by GASB, explains why the government accountants prepare the reports the way they do. The assorted statements provided by state and local governments in their financial reports have been designed to facilitate decision making and provide accountability.

The GASB is analyzing the feasibility of providing more of an entity wide perspective in their financial reporting, rather than the current fund reporting perspective. They are considering the development of an operating statement for state and local governments which would give the organizations overall operating results on one statement, rather than separate operating statements for different fund types. However, the differences between the various fund types, in terms of accounting basis used, has made it difficult conceptually to combine the three operating statements into one.

In this chapter the conceptual framework for financial reporting in state and local governments and how it supports the presentation of the financial status of the organizations to their report users, was presented. In chapter V the FASAB's conceptual framework for financial reporting in the federal government, will be examined.

V. FEDERAL GOVERNMENT

In this chapter the current level of development on the conceptual framework for financial reporting in the federal government, will be discussed. The objectives, characteristics and elements that will make up the foundation of the conceptual framework for financial reporting will be introduced. In addition, the expected standard report statements that will result from the conceptual framework will be presented and defined.

Accounting and financial reporting standards for the federal government are currently being developed by the Federal Accounting Standards Advisory Board (FASAB). The Secretary of the Treasury, the Director of the Office of Management and Budget (OMB), and the Comptroller General of the United States, principals of the Joint Financial Management Improvement Program (JFMIP), established FASAB in October 1990. FASAB recommends accounting standards for recognition and measurement of items in the financial reports required by the Chief Financial Officers (CFO) Act of 1990, to the JFMIP principals for approval. Upon approval, they become effective on the date specified in the standards published by OMB and GAO. [Ref. 16]

Federal agencies have traditionally prepared financial reports to permit themselves and others to monitor and control the obligation and expenditure of budgetary resources. However, with the enactment of the CFO's act, Congress called for the production of financial statements that fully disclose a Federal entity's financial position and results from operations, and provide information not just for the effective allocation of resources, but also

information with which Congress, the public and others can assess management performance and stewardship.

The FASAB is expected to complete the federal government's first set of "generally accepted accounting standards" during the fall of 1995. This will mark the first time, the federal government will have the following: (1) Objectives of Federal Financial Reporting; (2) A reporting Model; (3) Cost Accounting Standards; and (4) Federal Government Generally Accepted Accounting Standards. This will complete the basic set of accounting standards contemplated by the FASAB and Vice President Gore's National Performance Review. [Ref. 17]

The accounting and reporting standards used by the private sector and state and local governments contain accounting concepts appropriate to those sectors, but neither is completely adequate for an organization as large and diverse as the federal government. Unique standardized accounting and financial reporting concepts are necessary for the federal government, to allow for users' needs to be met by governmental financial reporting. [Ref. 18]

Accounting policy makers for the federal government are concerned with many of the same issues that confront other standard setting bodies, although capital markets are of lesser concern at the federal level. Creditors usually do not use the governmental financial reports to evaluate the credit-worthiness of the United States. Various congressional committees and federal managers appear to be equally concerned with the consequences accounting standards may have on the behavior of federal employees. In addition, there is

apprehension over the potential influence of financial reports by people involved in the political-governmental processes.

The accounting framework being developed by FASAB reflects the diversity that exists in the federal government reporting environment. It also reflects the needs expressed by the current and potential users of federal financial information. During the development of the framework, the FASAB was cognizant of the fact that many information sources other than the financial statements are available to meet the information needs of the various users. Consequently, the conceptual framework was not developed with the intent of meeting all of the information needs of the different users.

A. BASIC OBJECTIVES OF FINANCIAL REPORTING

The objectives of financial reporting for the federal government are not unlike those objectives from the other sectors, in how they are developed. The need for information on which to base financial decisions underlies the objectives of all financial reporting. The objectives of federal financial reporting are the basis for judgements about the qualities of financial information. Only when the objectives have been established can a start be made on defining the type of information necessary to reach them. These objectives identify the goals and purposes of accounting and are the building blocks for the federal government's conceptual framework for financial reporting.

The objectives developed by the FASAB are designed to guide the board in developing accounting standards which will strengthen the financial information reported by the federal government. They help focus the development of new accounting standards

on providing enhanced accountability and decision-making, while improving cost effectiveness. [Ref. 19]

The federal government derives its powers from the consent of the governed. It therefore has a responsibility to report on its actions and the results of those actions. These reports must accurately reflect the distinctive nature of the federal government and must provide information useful to the citizens, their elected representatives, federal executives, program users and various other users. Providing this information to the public is an essential part of accountability in government. [Ref. 20] Financial reporting is not the only source of information to support decision making and accountability. However, financial reporting can make a very big contribution towards fulfilling those goals.

The FASAB has developed the financial reporting objectives based upon the needs of those who use the reports. FASAB identified four primary groups of users of the federal financial reports:

1. **Citizens** - This group includes individuals and interest groups that are concerned with the costs and results of federal government programs.
2. **Congressional Committees** - Congressional committees need information upon which to base policy and resource allocation decisions.
3. **Federal Executives** - Federal executives also need information upon which to base policy and resource allocation decisions.
4. **Federal Program Managers** - Primary users of financial information. They need information that will allow them to carry out program objectives.

Government managers are the primary users of the financial information. They are responsible for carrying out program objectives with resources entrusted to them. Reliable and timely cost information helps them ensure that resources are spent to achieve expected results and outputs, and alerts them to waste and inefficiency.

Congressional committees and federal executives, including the President, make policy decisions on program priorities and allocate resources among programs. These officials need cost information to compare alternative courses of action and to make program authorization decisions by assessing costs and benefits. They also need financial information to evaluate program performance.

Citizens, including the news media and interest groups, are concerned with the costs and results of federal programs that affect their interests. They need program financial information to judge whether resources are allocated to programs rationally and if the programs operate efficiently and effectively. [Ref. 21]

Based upon the needs of these users, the board developed four fundamental objectives of federal financial reporting:

1. **Budgetary Integrity** - Federal financial reporting should assist in fulfilling the government's duty to be publicly accountable for monies raised through taxes and other means. In addition, reporting should reveal whether expenditures were accomplished in accordance with the appropriation laws that establish the government's budget.

2. **Operating Performance** - Federal financial reporting should assist in evaluating the service efforts, costs and accomplishments of the reporting entity. In addition, they should assist in evaluating the manner in which the services and accomplishments were financed and how the entity's assets and liabilities were managed.

3. **Stewardship** - Federal financial reporting should assist report users in assessing the impact on the country of the government's operations and investments for the period and how, as a result, the government's and the nation's financial conditions have changed.

4. **Systems and Controls** - Federal financial reporting should assist report users in understanding whether financial management systems and internal accounting and administrative controls are adequate to ensure that activities are accomplished within federal laws and standards.

The FASAB and its sponsors believe that any description of federal financial reporting objectives should consider the needs of both internal and external report users and the decisions they make. This dual focus is necessary because federal officials should have ready access to information, often find in practice that it is not available. The reasons for this problem, are the size and complexity of the government, the rapid turnover among senior political executives, and the division of authority in the federal government.

The FASAB's focus on internal users is a departure from what the other standard setting bodies have done, relative to report users. There is a perceived lack of information on cost of operations at the manager level. Federal program managers lack the means to understand and control the full cost of programs they administer. This is because existing

financial and budgetary systems do not deliver enough useful information for daily management and for improving program operations. Most of the information, historically available to managers, is more appropriate for external reporting, such as budget presentation or limited financial reporting to the Department of Treasury or the Office of Management and Budget.

Federal managers have been in the practice of controlling inputs without considering the full costs and value of program outcomes. Budgeting, the primary process in the federal government, focuses on managing inputs such as money and other resources, even though managers also need information on the effectiveness, quality, and productivity of their programs. In addition, the budgetary process, operating with generally inadequate financial systems, provides little information to external users beyond budget justifications. [Ref. 21]

Financial reporting is often defined as the process of recording, reporting and interpreting, in terms of dollars, an organization's financial transactions and events with economic consequences for that organization. However, financial reporting in the federal government also deals with nonfinancial information about service efforts and accomplishments of the government. Federal reporting, measures the inputs of resources used by the government, the outputs of goods and services provided by the government, the outcomes and impacts of government programs, and the relationship among these elements. [Ref. 19]

The processes of preparing and auditing financial reports is expected to enhance the government's overall accountability by providing greater assurance that transactions are

recorded and reported accurately, that consistent definitions are used to describe the transactions. [Ref. 22] Consequently, the goal of federal financial reporting is to fulfill the government's duty to manage programs economically, efficiently, and effectively and be publicly accountable.

B. ELEMENTS AND CHARACTERISTICS OF ACCOUNTING

The federal government gets its powers from the consent of the people. It therefore has a responsibility to report on its actions and the results of those actions. These reports must reflect the unique nature of the federal government and must provide information useful to the various users of that information. Providing this information to the public is an important part of the accountability inherent in government. This information is essential in planning and conducting government functions efficiently and effectively. [Ref. 19]

The federal government lacks the external restraints that exist in the private sector, where the value of output can be directly measured. The federal government is not subject to the discipline of competitive markets for private goods, services and capital. Transactions between citizens and the government are not free market exchanges between willing participants. Taxpayers are required by law to provide resources based upon their financial circumstances rather than their desire for particular government services. Even when fees are charged for government services, they are not intended to be a market clearing price, one which in the private sector would allow supply and demand to balance.

The lack of external restraints in the federal government, creates a need for special control mechanisms. Some of which already exist in the form of political restraints, such as

separation of power and regular elections. However, accounting and financial reporting also have an important role to play in providing controls. Audited financial reports can provide users with assurance that the accounting systems are providing consistent and reliable data. Thus providing the accountability necessary in the government environment. [Ref. 19]

The federal government is an extremely complex organization composed of many different components. For accounting and reporting purposes, it may be viewed from at least three perspectives. However, the nature of each type of component and the relationships among the components and perspectives are not always consistent.

The first type of perspective, is the organization perspective. The federal government is composed of organizations that manage resources and are responsible for operations. These include the major departments and independent agencies, which are generally divided into suborganizations. [Ref. 18]

The second type of perspective is the budget perspective. The federal government is composed of accounts presented in the budget, called budget accounts. These accounts vary from very small accounts, which are useful for constraining management, to very large accounts, which can be used to finance many activities. A budget account may coincide with an organization or one or more of its suborganizations. Other times, several budget accounts need to be aggregated to constitute an organization or sub-organization. Budget accounts are also categorized, as mandated by law and defined by OMB, into functions and subfunctions that represent national needs of continuing national importance and substantial expenditures of resources.

The third perspective is that the government is composed of programs and activities. Each program and activity is responsible for producing certain outputs in order to achieve desired outcomes.

In a few instances, there is a one-to-one relationship among the three perspectives. A single budget account finances a single program and organization. Thus, the program is carried out only by the single organization and the organization performs only one program. However, most programs are financed by more than one budget account, some of which might not be under the control of the organizational unit administering the program. Some programs are even administered by more than one organization. In addition, a single organization or budget account could be responsible for several programs.

This complex structure is the result of the evolution of federal organizations over many years. As federal missions and programs have expanded and changed, new departments have been created and new duties have been assigned to existing organizations. Similarly, the budget structure has evolved in response to the needs of the Congress; its committees and subcommittees; and various initiatives by the President, program managers and interest groups.

The occasional overlap of programs and budget accounts among more than one organizational unit complicates financial reporting for the federal government. The association of financial data with the responsibility centers, which managers typically use for organizing and operating, permit the practice of aggregating information for not only the organization and suborganization, but also for one or more programs performed by the

organization, and one or more of the budget accounts for which the organizations responsible. This approach supports the establishment of accountability in the organizations while still enabling them to provide information pertaining to their individual programs. [Ref. 18]

A reporting organization may not control all the budget accounts used to finance one or more of the programs it administers. However, any revenues attributable to or costs incurred on behalf of the programs it administers, are associated with that reporting organization. The departments and independent agencies are considered organizational units and therefore are the primary reporting entities.

C. RECOGNITION AND MEASUREMENT

The federal government maintains its accounts using the full accrual basis of accounting. Under the full accrual basis, revenues are recognized when earned. Expenditures are recognized when they are incurred.

Accounting systems used by the federal government provide information for two distinct purposes: (1) to ensure agency managers avoid over expending or over obligating appropriations; (2) to account for assets entrusted to the care of agencies and for the equities in those assets, liabilities and capital. As a result, federal agencies use a two-track accounting system. One track is a self-balancing set of budgetary accounts, which demonstrates budgetary compliance. The other track is a self-balancing set of proprietary accounts, which are used for financial management. [Ref. 23]

When most people think about the federal accounting model, they think of the budgetary accounting system. This is the system that is used to keep track of spending authority and the various stages of budget execution. The FASAB does not recommend principles or standards for the budget, but they do recommend accounting principles that will help provide relevant reliable financial information to support the budgetary process.

The FASAB is primarily concerned with the “proprietary “ accounts and the reports prepared from the information in them. These are the accounts used to record the assets and liabilities that are not accounted for in the budgetary accounts. These proprietary accounts and their reports are concerned with the recording and presentation of financial position and results from operations.

Since the FASAB identified the federal managers themselves as a primary user of the financial reports, there has been an emphasis on managerial cost accounting in the development of accounting standards. It was felt that if federal managers did not know the full cost of their programs, they could not be expected to make competent judgements on the value and effectiveness of their operations. Without full cost information, neither managers nor oversight organizations and stakeholders would be able to adequately define accountability for program delivery.

Summary of new standards: [Ref. 21]

Costing Standards

1. Costing Systems - This standard requires the reporting entities to establish a managerial cost accounting system that will regularly accumulate the full cost of the organizations operations.

2. Responsibility Segments - This standard requires the reporting entity to divide into useful segments that can define outputs and measure the costs of outputs.

3. Full Costs - This standard focuses the reporting entity's attention on determining it's full costs of operations, processes, and outputs.

4. Inter-Entity Costs - This standard requires that each entity's full cost incorporate all costs of goods and services it receives from other entities.

5. Unused Capacity Costs - This standard requires reporting entities top determine the capacity costs of responsibility segments, and identify and report the cost of unused capacity as a separate expense.

6. Costing Methodology - This standard requires the accumulation of resource costs by type of resource, accumulate outputs by production unit, and assign costs to outputs.

7. Relationship among Cost Accounting, Financial Reporting, and Budgeting - This standard requires that managerial cost information be integrated and reconcilable with existing financial systems.

The FASAB expects the cost standards to evolve and become the link between federal agencies' managerial cost accounting and their financial reporting. This new

information is expected to be used as the basis for displays on the financial statements of Federal entities. Currently, financial statements generally reflect information that is not based on full cost and does not have the broader dimensions that managerial cost accounting information will provide. These standards are expected to set the framework for a fundamental improvement in the kinds of information used internally and reported externally.

These new costing standards are being presented as flexible standards. The FASAB recognized that the diverse environment and structure of the federal government, prevents the adoption of a specific managerial cost accounting system for the federal government as a whole. The standards are meant to outline preferred methods for developing such systems. The preferred methods are intended to ensure that the systems will generate a broad, integrated array of timely information, useful for planning, controlling, and improving operations.

The full assignment of all costs of a period, including general and administrative expenses and all other indirect costs, is an important basis for measuring costs of providing a service. However, this may not be the relevant cost for making all decisions. For example, incremental cost is more appropriate for many kinds of decisions, while opportunity cost is more appropriate for others. Accordingly, the accounting system should permit the calculation of the relevant costs needed for a range of decisions, as determined by the specific situations, and financial reports should reflect costs suitable to the purpose intended.

[Ref. 19]

Among those who need managerial cost information of federal agencies are the Congress and federal executives. However, the use of financial information begins at the program level, the primary beneficiary of these new standards is the federal program manager. If cost information is not useful to the program manager, its value is in serious question, both for improving basic program operations and for accountability purposes. Consequently, managerial cost accounting systems will be developed in partnership with program managers.

Revenue Standards

1. Accounting for Inflows of Resources from Revenues - Ensures standard treatment of recognition and measurement of revenue inflows.

2. Accounting for Inflows of Resources from Other Financing Sources - Ensures standard treatment of recognition and measurement of financing sources other than revenues.

The accounting standard applicable to revenues, will make the U. S. Government's proprietary accounting more supportive of the budget and more comprehensible to those who work primarily with the budget.

For the federal government, revenue is defined as the inflow of resources that the government demands, earns, or receives by donation. Revenue comes from two sources: exchange transactions and nonexchange transactions. Exchange revenues arise when a government entity provides goods and services to the public or to another government entity for a price, this is also called earned revenue. Nonexchange revenues arise primarily from

exercise of the government's power to demand payments from the public, but also includes donations.

The term revenue does not encompass all financing sources of government reporting entities, such as most of the appropriations they receive. These other sources of financing do, however, provide resource inflows to government reporting entities.

The essential differences among exchange revenues, nonexchange revenues, and other financing sources affect the way they are recognized and measured under the accrual method of accounting. Properly classifying these inflows according to their nature, provides the basis for applying different accrual accounting principles. In addition, proper classification is essential to constructing financial statements that meet the FASAB's financial reporting objectives. [Ref. 24]

The federal government external financial reporting is primarily concerned with proprietary type accounts. These accounts and their reports are focused on the recording and presentation of financial position and results from operations. Revenue is the deciding factor for the determination of the accounting basis to be used. The essential differences among exchange revenues, nonexchange revenues, and other financing sources affect the way they are recognized and measured under the accrual method of accounting. Classifying these inflows according to their nature, provides the basis for applying different accrual accounting principles. In addition, proper classification is essential to constructing financial statements that meet the FASAB's financial reporting objectives.

D. FINANCIAL REPORTS

Historically, U. S. Government financial statements have not been used for planning and control as well as they might have been. In part, this is because accounting standards have not been fully attuned to the government's needs and circumstances. Another important reason is the continuing primacy of the budget as a financial planning and control tool. In the past, financial reports have not presented budget execution information with the financial statements in a way that helped users relate these two types of financial information. [Ref. 24]

The FASAB has no authority to recommend budgetary accounting standards and principles. However, it can consider the budgetary information needs of executive agencies and others and recommend certain reporting on the budget, as it is carried out in accordance with budgetary concepts and requirements. It also can recommend a reconciliation of the budgetary information with the accrual-basis financial information. This can help bridge the gap between the budget and the financial statements.

The federal government's proposed financial reporting framework for reporting entities, consists of six individual statements. The following is a list of the proposed statements:

1. **Statement of Net Cost** - Reflects net operating costs for the reporting entity. Under the accounting standards currently proposed, exchange revenues would be deducted from gross operating costs on the statement of net costs to show the net cost of the entity's operating activities. This is the amount for which the entity is responsible and that must

ultimately be paid by the taxpayer through taxes and other demand type revenues or financed by government borrowing or donations. All operating costs and applicable exchange revenues should be shown in the statement of net costs.

Accounting model: Gross operating costs - Exchange revenue =

Net cost of operating activities

The standard format for the statement of net cost for the federal government is as follows:

STATEMENT OF NET COSTS

Cost to Produce Exchange Revenue:

Interest Expense	xxx	
Depreciation Expense	xxx	
Annual Leave Expense	xxx	
Subsidy Expense	xxx	
Other Expense	<u>xxx</u>	
Total Cost to Produce Exchange Revenue		xxx

(Less) Exchange Revenue:

Intra governmental	xxx	
Interest Income	<u>xxx</u>	
Total Exchange Revenue		(xxx)

Net Cost of Exchange Transaction	xxx	
Other Costs	<u>xxx</u>	
NET COST OF OPERATIONS		xxx

2. **Statement of Custodial Activity** - Reflects custodial activity, amounts collected and accrued for other reporting activities, of the reporting activity. For reporting entities that collect taxes for other entities, cash collections and the adjustment to calculate the accrual-basis revenue would be reported in statements separate from those used to report on the collecting entity's own operations. The statement of custodial activity would reflect the collections by type of nonexchange transaction, the adjustments to calculate the accrual-basis revenue, and the disposition of the amounts to the entities entitled to receive them. The collecting entities would not recognize inflows from these collecting activities as their own revenues.

Accounting model: Collections - Dispositions = Net Custodial Activity

The standard format for the statement of net cost for the federal government is as follows:

STATEMENT OF CUSTODIAL ACTIVITY

Tax Revenues for Others:

Taxes Received	xxx	
Increase in Net Receivables	<u>xxx</u>	
Total Revenues		xxx

Disposition of Revenues:

Transferred to Others	xxx	
Increase in Amounts to be Transferred	<u>xxx</u>	
Total Disposition of Revenues		<u>xxx</u>

NET CUSTODIAL ACTIVITY		xxx
-------------------------------	--	-----

3. Statement of Changes in Net Position - Reflects net results of operations and change in net position, similar to income statement in private sector. In the statement of changes in net position, the net result of the entity's operations would be presented by deducting from the net cost of operations the financing for that net cost, i.e., 1) nonexchange revenues, 2) the amount of appropriations used, and 3) other financing sources. To arrive at the change in net position during the period, adjustments would then have to be made for any prior period adjustments and any changes in unused but available appropriations.

[Ref. 24]

Accounting Model: Results from operations +/- Prior period adjustments
+/- Change in unexpended appropriations = Change in net position

The standard statement of changes in net position format for the federal government is as follows:

STATEMENT OF CHANGES IN NET POSITION

Results from Operations

Net Cost of Operations	xxx
Appropriations Used	xxx
Nonexchange Revenues	xxx
Transfers (In and Out)	<u>xxx</u>
Net result of Operations	xxx
Prior Period adjustments	<u>xxx</u>
Net Change in Cumulative Results	xxx
Change in Unexpended Appropriations	<u>xxx</u>
CHANGE IN NET POSITION	xxx

4. **Statement of Budgetary Resources** - Reflects budgetary data from initial authorization by Congress, to obligation of funds, to outlays. The statement of changes in net position does not provide complete information about the flow of budgetary sources; nor does it provide information on the budgetary basis of accounting. Information on that basis is used to control the obligation and expenditure of budgetary resources. Accordingly, a statement of budgetary resources should show this information. This statement tracks the execution of the budget from current and prior year appropriations, to obligations of those budgetary resources, and finally to cash outlays to satisfy obligations.

Accounting model: Provides status of budgeted funds

The standard statement of budgetary resources format for the federal government is as follows:

STATEMENT OF BUDGETARY RESOURCES

Budgetary Resources Made Available:

Current Appropriations	xxx	
Borrowing Authority	xxx	
Collections	xxx	
Reimbursements for Services	<u>xxx</u>	
Total Budgetary Resources Made Available		xxx

Status of Budgetary Resources:

Obligations Incurred (Gross)	xxx	
Expired Authority	xxx	
Other	<u>xxx</u>	
Total, Status of Budgetary Resources		xxx

Outlays:

Obligations Incurred	xxx	
Add Obligated Fund Balance, Oct. 1	xxx	
Deduct Obligated Fund Balance, Sept . 30	<u>xxx</u>	
Total Outlays		xxx

5. **Statement of Financing** - Reflects budget obligations and other financing sources and the adjustments necessary to determine net cost of operations. The statement of financing will explain the relationship between obligations incurred and the net cost of

operations. It also reports any nonbudgetary financing sources and provides a reconciliation or translation from the budget to the financial statements. Those who work with the budget need such a translation. The statement will help those people and others who use financial statements to understand the net cost of operating the entity.

Accounting model: Net obligations & nonbudgetary resources + Change in items ordered but not received + Other resources + Costs that do not require resources + financing sources yet to be provided = Net cost of operations

The standard statement of financing format for the federal government is as follows:

STATEMENT OF FINANCING

Obligations and Nonbudgetary Resources:	
Obligations Incurred (Gross)	xxx
Adjustments	<u>xxx</u>
Net Obligations and Nonbudgetary Resources	xxx
 Change in Goods, Services, and Benefits Ordered but not yet Received or Provided:	 xxx
 Other Resources that do not Fund Net Cost of Operations:	 xxx
 Costs that do not Require Resources:	 xxx
 Financing Sources Yet to be Provided:	 <u>xxx</u>
 NET COSTS OF OPERATIONS	 xxx

6. Balance Sheet - The balance sheet reflects capital balances. The current balance sheet used by federal entities would be simplified. The flow effects of current capital transactions would be shown in the statement of changes in net position, and certain capital balances would be consolidated using the new balance sheet format. Currently, donations and transfers-in of assets without reimbursement are reflected directly in the balance sheet as additions to capital. In addition, appropriations used to acquire capital assets are also reflected in the current balance sheet as additions to capital. They are not reflected in operations until the assets are depreciated. As a result, the current effects of these transactions and events are obscured, only accumulated balances at the end of the accounting period are shown. [Ref. 24]

New accounting standards are proposed for unreimbursed asset transfers between government entities, for donations, and for appropriations used. These standards would require that flows from the related transactions and events be separately recognized in the statement of changes in net position. Thus, the results of these flows would be combined with the results of other operating flows in one capital account, "cumulative results from operations". The only other capital account on the current balance sheet, "unexpended Appropriations," would remain unchanged. Eliminating separate balances showing the accumulated amounts of invested capital, donations, and transfers from other government entities would omit some information from the balance sheet. However, that information is not ordinarily used. Entities with reason to do so could continue to report this information separately. [Ref. 21]

Accounting model: Assets = Liabilities + Fund balances

The standard balance sheet format for the federal government is as follows:

BALANCE SHEET

Assets:

Fund Balance with the Treasury	xxx	
Loans Receivable	xxx	
Equipment	xxx	
(Less) Depreciation	<u>xxx</u>	xxx
Other	<u>xxx</u>	
TOTAL ASSETS		xxx

Liabilities:

Accounts Payable	xxx	
Annual Leave Liability	<u>xxx</u>	
TOTAL LIABILITIES		xxx

Net Position:

Unexpended Appropriations	xxx	
Transferred in Capital	xxx	
Donated Capital	xxx	
Invested Capital	xxx	
Cumulative Results from Operations	<u>xxx</u>	
TOTAL NET POSITION		<u>xxx</u>

TOTAL LIABILITIES AND NET POSITION		xxx
---	--	------------

The main source of financing for the government as a whole are exchange and nonexchange revenues and borrowing from the public. However, for component reporting entities, the sources of financing are provided through the budget and are largely financing sources other than revenue. Appropriations and other budget authority provide an agency with the authority to incur obligations, to acquire goods and services or to provide benefits. These other financing sources are not earned by an entity's operations. Therefore, as with nonexchange revenue, financial statements should report them in a way that does not obscure the entity's net cost to taxpayers.

Budgetary resources have a different character than both exchange revenue and nonexchange revenue. Budgetary inflows should be reported in a manner that reflects two different perspectives, the proprietary effect and the budgetary effect. The proposed proprietary accounting reports the availability of these resources in the balance sheet or in the notes. Appropriations are reported as capital when enacted into law, while borrowing authority is disclosed in the notes. Because government entities are expected to expend capital from appropriations rather than maintain it, the proposed accounting for the use of appropriations differs from the private sector's accounting for capital.

The budget provides the principal basis for planning and controlling obligations and expenditures made by government entities. For the most part, obligations and cash, rather than accrual accounting, are the bases for budgeting and reporting on budget execution.

However, the FASAB has recognized that accrual accounting and the budget are complimentary. Accrual accounting provides a more timely and complete understanding of

the reporting entity's financial position and results of operations. Often, accrual-basis accounting provides better information than cash-basis accounting for evaluating performance. In certain instances, it may provide more information for planning and better control of operations.

The FASAB's proposed financial statements, would show how the results of operations affect the entity's net financial position. In addition, they will provide a means of reconciling the budget-basis statement with the accrual-basis statements. This will allow users to identify the net cost of operating the entity and ultimately the net cost to taxpayers for which each reporting entity is responsible..

The conceptual frameworks for the private sector, state & local governments and the federal government have been presented. In chapter VI, a comparative analysis of the different conceptual frameworks will be provided.

VI. COMPARATIVE ANALYSIS

In the preceding chapters the conceptual frameworks for financial reporting in the private sector, state & local governments and federal government were presented. In this chapter a comparative analysis of the reporting frameworks for the different sectors will be presented.

The conceptual framework for financial reporting for the three sectors can be compared on a number of different levels. For the purpose of this analysis the three sectors were compared in the following areas: 1) Users and their information needs; 2) Objectives of financial reporting; 3) Recognition and measurement; 4) Types of financial reports published. These comparisons allowed identification of similarities and differences among the three sectors in their conceptual frameworks for financial reporting, as well as an opportunity to see the reasons for any differences.

There are three separate organizations responsible for the development of the conceptual frameworks for financial accounting and reporting for private and public sector organizations. Each of the standard setting bodies has various advisory groups and interest groups which are involved in the process of developing standards and concepts. However, ultimately it is the responsibility of those independent standard setting bodies to establish and/or change the accounting practices of their respective sectors. The independence of the standard setting bodies, as well as the inherent differences between the various sectors, has

led to some differences in the conceptual frameworks for financial reporting, developed for each of the different sectors.

The Financial Accounting Foundation (FAF) oversees the operations of both the FASB and the GASB. The GASB is aided in its work by the Governmental Accounting Standards Advisory Council (GASAC), which is a consultative body made up of representatives of major groups interested in governmental accounting and financial reporting. The Financial Accounting Standards Advisory Council (FASAC), acts in an advisory capacity to the FASB on private sector financial accounting and reporting issues.

The FASAB has less power than the standard setting bodies for the other sectors, in that they serve in more of an advisory role for the establishment of federal accounting and reporting. The FASAB simply proposes standards for final approval to the Joint Financial Management Improvement Program (JFMIP), which consists of representatives from the OMB, GAO and Treasury.

The relationship between the organizations and standard setting bodies involved in the standard setting process are illustrated in figure 6.1.

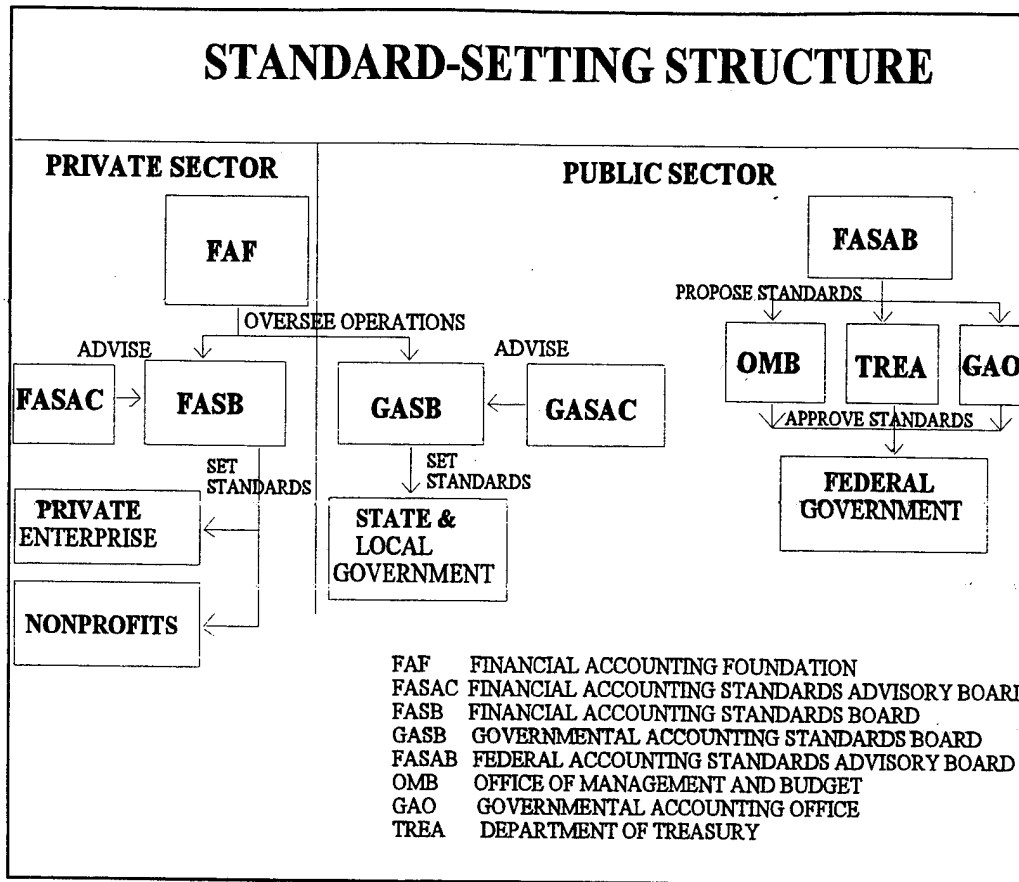


Figure 6.1. Standard setting bodies. After Ref. [11]

A. USERS OF FINANCIAL REPORTS

The first area of comparison is the users of financial reports and their information needs. For the purpose of this comparison users are defined as those groups or individuals identified by the cognizant standard setting bodies as the primary users of financial reports. These users were identified for the expressed purpose of evaluating their information needs, so as to provide a means of establishing a set of financial reporting objectives for that sector based upon those needs.

USERS OF FINANCIAL REPORTS

USERS	FASB PROFIT	FASB NONPROFIT	GASB STATE & LOCAL GOVERNMENT	FASAB FEDERAL GOVERNMENT
Investor	X			
Creditors	X	X	X	
Oversight bodies		X	X	X
Legislative bodies			X	X
Governing bodies		X		X
Managers/ executives				X
Citizens/ constituents		X	X	X

In the development of a conceptual framework for financial reporting each of the standard setting bodies started by identifying the users of those financial reports. The list of users of financial information varied between the different sectors. What becomes evident in comparing the different user lists, is that the longer the list of users, the longer the list of user needs and, in an attempt to meet all the different users corresponding needs, the more cumbersome the resulting objectives for financial reporting become.

For private sector profit oriented organizations, the FASB focused on investors and creditors as the primary users of their financial reports. They separated investors and creditors into two groups: 1) current investors and creditors; 2) potential investors and creditors. The board also recognized that the reporting entity's management also uses the financial reports. However, they were not considered a primary user for the purpose of establishing user needs and objectives for financial reporting. This allowed the FASB to focus on the needs of investors and creditors in the development of a conceptual framework for the private sector.

The FASB identified four primary users of financial reports for nonprofit organizations. The FASB did not consider administrators as a primary group of users, because it was felt that they have the ability to gather any information they may need from other sources.

The GASB identified four primary users of state and local government external financial reports. The board did not identify government managers as a primary user group of external financial reports because of their ability to gather information from other sources.

However, this does not mean that governmental managers were not an expected user of the information, but simply that the GASB did not consider them a primary user for the development of the objectives based upon user needs.

The FASAB identified five primary groups of users of federal government financial reports. Government managers were seen as the most important user of the financial reports for the purpose of developing the conceptual framework for financial reporting. The government managers need reliable and timely financial information to help ensure that resources are used as intended. This is an important difference. The primary users of federal government reports are seen to be internal users, government managers. While the primary users of financial reports in the other sectors are seen to be individuals external to the reporting entity and managers are seen as secondary users..

The primary users that the FASB identified for private sector profit oriented organizations are all user that have an ownership interest in the organization or a claim against the organization. That is they are primarily concerned with the amount of earnings generated by the organization. However, the other three types of organizations evaluated for this study had as primary users individuals or groups that have an auditor type perspective on the organization and it's operations. That is they are primarily concerned with how the organization is operated, in terms of efficiency, effectiveness and compliance. They are concerned to a lesser degree with the results from operations.

low number of identified users for this sector, the information needs are few and specific.

For private sector nonprofit organizations the report users' information needs are a little more diverse. Similar to the for profit organizations, users need information to aid them in evaluating the credit worthiness of the organization. In addition, users need information to evaluate management performance, as well as efficiency and effectiveness of the organization's operations. Also, users of nonprofit financial reports need information on the rate at which resources are being consumed, so the entity's ability to continue to provide services can be determined.

For state and local government organizations report user needs are similar to those of users of nonprofit organizations reports. A primary need of users of state and local government reports is information on the organization's compliance with spending mandates, as well as information on accountability for the organization's resources. In addition, users are concerned with government managers performance and the efficiency and effectiveness of the organization. Also, users of the reports need information on the credit worthiness of the organization.

Users of federal government financial reports need information on costs, to ensure that resources are spent in pursuit of expected results and outputs and to alert them to waste and inefficiencies. Information is also needed on which to base program performance evaluations and to measure resource consumption rates. In addition, users need information to determine the level of compliance with spending mandates.

The users of private sector business financial reports are ultimately concerned with the organization's current earnings and the organization's ability to produce future earnings. So these users want information that will help them to evaluate the organization's operating performance.

The primary users of financial reports of the other three types of organizations evaluated for this study, nonprofit, state and local government and federal government, are all principally concerned with accountability issues and the continuing financial viability of the organization. Consequently, the users' needs are quite different from those of private sector business organizations, where the focus is on organizational earnings.

C. OBJECTIVES OF FINANCIAL REPORTING

The objectives of financial reporting were developed by looking at the report users information needs. All financial reporting is concerned to varying degrees with decision making. The need for information on which to base decisions underlies the objectives of financial reporting. Objectives identify the goals and purposes of accounting and are the building blocks of the different sectors' conceptual frameworks for financial reporting. Due to the variation between users and uses of financial reports in the separate sectors, there are differences between the reporting objectives of the sectors. The following is a list of objectives by sector:

OBJECTIVES OF FINANCIAL REPORTING

	FASB	GASB	FASAB
	<u>PROFIT</u>	<u>NONPROFIT</u>	<u>STATE & LOCAL GOVERNMENT</u>
			<u>FEDERAL GOVERNMENT</u>
To Provide Info:			
On future cash flows		Useful in making resource allocation decisions	About compliance w/ legal restrictions on use of resources
			For assessing management performance & stewardship
About financial resources of entity		For assessing management performance & stewardship	On whether the org's financial position improved during period due to ops
			To assure resources are used as intended
About liabilities of entity		For assessing org. ability to continue providing services	About sources and uses of resources
			For assessing services provided
On entities operating performance (Earnings)		About financial resources of entity	On financial viability of org.
			For assessing how entity's assets and liabilities were managed
		About changes in financial resources	For assessing management performance & stewardship
			To evaluate how services were financed
		On rate at which current resources are being consumed	For assessing org. ability to continue providing services
			On how nations financial position has changed due to years operations
			On rate at which current resources are being consumed
			To ensure activities are accomplished within legal requirements

The different standard setting bodies agree that all financial reporting is concerned with decision making. In private sector for profit organizations, financial reporting provides information to help users in assessing the amounts, timing and certainty of future cash receipts from operations and other sources. Another objective of financial reporting in the private sector is to provide information about the financial resources of an entity and any claims against those resources. The primary objective of financial reporting in private sector profit oriented organizations, the one which all of the other objectives support, is to provide information about the entities financial performance.

The objectives for private sector nonprofit organizations are to support the two fundamental requirements for their financial reporting. First, to provide a means of evaluating management, both in terms of stewardship and performance. Second, to provide a way of evaluating the resource allocation decisions and the probability of continued availability of resources.

In state and local government organizations, the need for information about sources and uses of resources underlies the objectives of financial reporting. There are legal restrictions on the use of some of the resources available to state and local government organizations. The continued availability of resources in amounts large enough for the organization to continue operations is a central part of the objectives developed by the GASB. Similar to nonprofit organizations, providing information for evaluating management in terms of stewardship and performance is also a key objective for their financial reporting.

The objectives developed by the FASAB for the federal government are very similar to those of both nonprofit and state and local government organizations. The need for information on sources and uses of resources is a central issue in the objectives for federal government organizations. Ensuring legal compliance in the use of resources is also an objective. In addition, information which facilitates an evaluation of management, based on performance and stewardship, is a primary goal of federal financial reporting.

The differences in the objectives of financial reporting for the separate sectors are a function of the differences between the users of the reports and their needs in each sector. In private sector business organizations the objectives of financial reporting provide the framework for evaluating current and future earnings of the organization. The objectives for the other three sectors are quite different, in that they focus on management performance and stewardship, as well as, compliance with legal requirements on the use of resources. The three nonbusiness type sectors have little concern with earnings or results from operations, other than as a means of evaluating the entities ability to continue to provide services. Consequently, they focus on providing information which will be useful in evaluating the continuing availability of resources in amounts which would provide for the organizations continuation in its current form (i.e. the ability to continue to provide the services currently offered).

D. RECOGNITION AND MEASUREMENT

Recognition and measurement is the process of formally recording or incorporating an item in the financial statements of an organization. The primary recognition and

measurement principle for each of the sectors deals with the basis of accounting for financial reporting. The basis of accounting refers to when revenues and expenses are measured and then recognized in the accounts and reports of the financial statements. Accrual basis accounting is used by the different sectors for their proprietary or business type accounts. Modified accrual basis accounting is used in the nonbusiness type accounts.

BASIS OF ACCOUNTING

	PROFIT	NONPROFIT	STATE/LOCAL	FEDERAL
BASIS			GOVERNMENT	GOVERNMENT
ACCRUAL	X	X	X	X
MODIFIED ACCRUAL			X	

The three sectors use either accrual basis accounting or modified accrual basis accounting. Accrual basis provides that revenues are recognized when earned and expenses are recognized when the related liabilities are incurred. Under modified accrual basis accounting, revenues are recognized when they become susceptible to accrual, that is when they become both measurable and available to finance expenditures of the current period. Measurable means that the amount of the transaction can be determined.

Private sector business type organizations utilize accrual basis accounting for the recognition of revenues and expenses. Revenues are not recognized until earned. They are

considered earned when the organization has substantially accomplished what it must do in order to be entitled to the revenues. Recognition of revenues at the time of sale provides a consistent and measurable means of revenue recognition and serves as the general rule for revenue recognition. Accountants in the private sector attempt to match costs or expenses with the revenues that they create. Thus, expense recognition is tied to revenue recognition.

Nonprofit organizations typically use accrual basis accounting for financial reporting purposes. Under the accrual basis, revenues are recognized when earned and public support/contributions are recognized when received. Expenses are recognized when the related liabilities are incurred.

State and local government's accounting practices for financial reporting are driven by the unique accounting environment created by the use of fund accounting. This leads to the use of a different basis of accounting dependent upon the fund type. Governmental funds utilize modified accrual basis accounting. Proprietary fund revenues and expenses are recognized on the accrual basis. Fiduciary fund revenues and expenses or expenditures (as appropriate) are recognized on the basis consistent with the fund's accounting measurement purpose. Nonexpendable trust and pension funds are accounted for on the accrual basis; expendable trust funds are accounted for on the modified accrual basis.

The federal government external financial reporting is primarily concerned with proprietary type accounts. These accounts and their reports are focused on the recording and presentation of financial position and results from operations. Revenue is the deciding factor for the determination of the accounting basis to be used. For the federal government,

revenue is defined as the inflow of resources that the government demands, earns, or receives by donation. Revenue comes from two sources: exchange transactions and nonexchange transactions. Exchange revenues arise when a government entity provides goods and services to the public or to another government entity for a price; this is called earned revenue. Nonexchange revenues arise primarily from exercise of the government's power to demand payments from the public, but also includes donations.

The essential differences among exchange revenues, nonexchange revenues, and other financing sources affect the way they are recognized and measured under the accrual method of accounting. Classifying these inflows according to their nature, provides the basis for applying different accrual accounting principles. In addition, proper classification is essential to constructing financial statements that meet the FASAB's financial reporting objectives.

E. FINANCIAL REPORTS

In providing information to users of financial reports, general purpose financial statements are relied upon by each of the different sectors. The intent of general purpose financial statements is to provide the most useful information possible to the primary user groups identified for each of the sectors, at the least cost. Due to the differences in the needs of the primary users, there is some variation in the type and format of financial statements provided by the different sectors. The following is a summary of statements by sector.

FINANCIAL STATEMENTS

	FASB	GASB	FASAB
		STATE & LOCAL	FEDERAL
	<u>PROFIT</u>	<u>NONPROFIT</u>	<u>GOVERNMENT</u>
Balance sheet		Balance sheet/ statement of financial position	Combined balance sheet
Income Statement		Statement of activity	Combined statement of revenues, expenditures and changes in fund balances
			Statement of net changes in net position
			Statement of net costs
			Combined statement of revenues, expenditures and changes in fund balances (Budget to Actual)
			Combined statement of revenues, expenses and changes in retained earnings
Statement of cash flows	Cash flow statement	Combined statement of cash flows	Statement of custodial activity
			Statement of financing
			Statement of budgetary resources

Each of the four types of organizations evaluated in this study include in their financial reports a balance sheet or similar statement. In addition, each of the organizational sectors include an operating statement or statements in their financial reports, which reflect the financial results of operations for the period. The private sector profit and nonprofit organizations, as well as the state and local governments, include in their financial reports a statement of cash flows. The federal government does not have a cash flow statement in their financial reports, but they do provide budgetary reports that are not presented in the financial reports of the other sectors.

The balance sheets provided by the different sectors are all very similar in format and content. All four organizational balance sheets presented the entities' assets and liabilities. The sub-accounts of assets were very comparable among the private sector organizations and state and local governments. They each included asset sub-accounts, such as, cash, receivables, inventory, investments and physical assets. In addition, the different sectors had a small number of special asset accounts for items peculiar to their sector. The federal government had only two asset sub-accounts: (1) fund balance with the Treasury; and (2) other.

The liabilities section of the balance sheet for the private sector profit organizations, nonprofit organization, and state and local governments are quite similar. They all break out the liabilities into sub-accounts. There were two liability accounts that appeared in each of their balance sheets: (1) notes payable; (2) accounts payable. In addition, these three

sector have unique liability accounts that fit their specific reporting objectives. The federal government does not have the same liability sub-accounts, other than accounts payable.

Each of the different organizational types treat their balance sheet's equity section differently. This is largely attributable to the differences in how the various sectors receive resources. Private sector profit oriented organizations break their equity section into two sub-accounts, contributed capital and retained earnings. Nonprofit organizations title their equity section "Net assets" and break it down into three sub-accounts: (1) unrestricted assets; (2) temporarily restricted assets; (3) permanently restricted assets. State and local governments title their equity section "Equity and other credits" and break it down into four sub-accounts: (1) contributed capital; (2) investment in general fixed assets; (3) retained earnings; (4) fund balances. The federal government entities title their equity section "Net position", with sub-accounts that consist of types of capital accounts.

Each of the four sector provide at least one operating statement in their financial reports. The private sector profit oriented organizations provide an "Income statement", which presents the net income for the organization. Nonprofit organizations provide an operating statement called "Statement of activity", which bears a close resemblance to the income statement for the profit oriented organizations. The only difference is that the different asset restriction classifications are reported separately in the nonprofit's statement of activity.

State and local governments have three operating statements: (1) combined statement of revenues, expenditures and changes in fund balances; (2) combined statement of revenues,

expenditures and changes in fund balances (budget to actual); (3) combined statement of revenues, expenses and changes in retained earnings. The format and content for the three operating statements are almost identical to the income statement of the profit oriented organization. The reason for the three operating statements is to provide a means of reporting the different fund types operating results separately, as well as providing a means of comparison between budgeted and actual results.

The federal government has two operating statements: (1) statement of changes in net position; (2) statement of net costs. The statement of net costs reflect the net operating costs for the reporting entity during the accounting period. This statement serves as the foundation for reporting the results from operations. In addition, it supports the objective of providing federal managers with a means of establishing the cost of operations for the period. The statement of changes in net position reflects the net results of operations and change in net position, similar to the income statement for private sector organizations.

The private sector profit and nonprofit organizations, as well as state and local governments, provide a statement of cash flows in their financial reports. The federal government does not provide a cash flow statement.

Each of the three sectors that provide cash flow statements, do so in almost an identical manner. The cash flow statements for the three sectors provide the reporting entities' cash flows from various activities. Each of the sectors break their cash flows down into three categories: (1) cash flows from operating activities; (2) cash flows from investing activities; (3) cash flows from financing activities.

The federal government does not provide a cash flow statement. However, it does prepare three additional statements that the other sectors do not provide: (1) statement of custodial activity; (2) statement of financing; (3) statement of budgetary resources. The statement of custodial activity reflects amounts collected and accrued for other entities by the reporting entity. The statement of financing provides budget obligations and other financing sources and the adjustments necessary to determine the net cost of operations. The statement of budgetary resources provides budgetary data from initial authorization by Congress, to obligation of funds, to outlays.

The difference in the objectives of financial reporting for the separate sectors leads to the differences in their financial statements. In private sector business organizations the objectives of financial reporting provide the framework for evaluating current and future earnings of the organization. Consequently, financial reporting for this sector focuses on providing the specific information required to evaluate earnings.

The objectives for the other three sectors are quite different, in that they focus on management performance and stewardship, as well as compliance with legal requirements on the use of resources. The three nonbusiness type sectors have little concern with earnings or results from operations, other than as a means of evaluating the entities ability to continue to provide services. Consequently, they focus on providing information which will be useful in evaluating the continuing availability of resources in amounts which would provide for the organizations continuation in its current form (i.e. the ability to continue to provide the services currently offered).

VII. SUMMARY & CONCLUSIONS

This thesis has identified the different existing and evolving financial reporting models for private sector profit and nonprofit organizations, state and local governments and the federal government. The organizations responsible for the development of the financial reporting models were discussed.

In addition, the users of the financial reports for each of the sectors and their needs were identified and compared. The financial reports generated by each sector based upon their users needs were presented. Lastly, the similarities and differences among the financial reporting frameworks for each of the sectors were evaluated. Now some broader observations about the different sectors and their financial reporting will be presented.

Financial reporting for state and local governments, federal government and nonprofit organizations are substantially different from that of profit oriented organizations. In most government and nonprofit organizations, the goal is to provide the highest level of service with the resources available. However, profit oriented organizations have a goal of improving owner welfare, which is usually measured in terms of earnings.

This fundamental difference in operating objectives leads to differences between the user needs for the various sectors. Profit oriented entities focus on evaluating the organization as a whole. In governmental and nonprofit organizations, certain activities are accounted for and reported separately. The intent in the latter is to provide accountability at the lowest level possible. For governmental and nonprofit organizations, the focus is not

on a single element reflecting the operations of the organization, such as earnings, but rather on providing detailed information on the organization's various activities.

In governmental and nonprofit entities, operating activities are separated from long term financing and activities related to the purchase of non-current assets. This separation helps decision makers to focus on specific activities and funding sources, allowing the evaluation of individual parts of the organization. However, the governmental and nonprofit organization's reporting focus on individual activities makes discerning the financial performance of the organization as a whole more difficult.

The difference in objectives for the different sector leads to the variations in how the sectors prepare and present their financial statements. In private sector profit oriented organizations the objectives of financial reporting provide the framework for evaluating current and future earnings of the organization. Consequently, financial reporting for this sector focuses on providing the specific information required to evaluate earnings.

The objectives for the other three sectors are quite different, in that they focus on management performance and accountability. The governmental and nonprofit sectors have little concern with earnings or results from operations, other than as a means of evaluating the entities ability to continue to provide services. Consequently, their financial statements focus on providing information which will be useful to users in evaluating the continuing availability of resources in amounts which would provide for the organizations continued ability to provide services at their current levels.

The accounting and financial reporting standards for the DOD are evolving along with those of the federal government as a whole. Currently, the DOD does not produce any kind standard consolidated financial reports for external use. The reports that the DOD has historically produced are done so to allow them to monitor and control the obligation and expenditure of budgetary resources. The only reports that are produced for external reporting are special reports used for presentation to various congressional committees. Beginning in fiscal year 1996, the DOD will be required to produce consolidated financial reports for external use, as directed by the CFO act of 1990. The Department of Defense will have a very difficult time meeting this requirement due to their current lack of external financial reports. This suggests some topics for future research:

1. An analysis of the current state of financial reporting within the Department of Defense, with recommendations for improvement.
2. An evaluation of the Department of Defenses' ability to comply with the FASAB's requirements, and recommendations on what steps the DOD needs to take in order to achieve compliance.

LIST OF REFERENCES

1. Kieso and Weygandt, *Intermediate Accounting, Revised Edition*, Prentice Hall, 1989.
2. Paul A. Griffin, *Usefulness to Investors and Creditors of Information Provided by Financial Reporting, Second Edition*, Financial Accounting Standards Board, 1989.
3. Financial Accounting Standards Board, *Statement of Financial Accounting Concept, Statement Number 2*, 1980.
4. Daniel G. Short, *Fundamentals of Financial Accounting, Seventh Edition*, Irwin, 1993.
5. Financial Accounting Standards Board, *Statement of Financial Accounting Concept, Statement Number 5*, 1984.
6. Financial Accounting Standards Board, *Statement of Financial Accounting Concept, Statement Number 6*, 1985.
7. L. E. Hay, PH.D., CPA, *Accounting for Governmental and Nonprofit Entities, Seventh Edition*, Irwin, 1985.
8. Financial Accounting Standards Board, *Financial Accounting in Nonbusiness Organizations*, 1980.
9. Financial Accounting Standards Board, *Reporting of Service Efforts and Accomplishments*, 1987.
10. Patricia P. Douglas, *Governmental and Nonprofit Accounting, Second Edition*, Harcourt Beale & Company, 1995.
11. Government Finance Officers Association, *Governmental Accounting, Auditing and Financial Reporting*, 1993.
12. J.M. Williams, CPA, "Financial Reporting Model: Fund Perspective," Association of Government Accountants Professional Development Conference, 1995.
13. Governmental Accounting Standards Board, *The Needs of Users of Governmental Financial Reports, Research Report*, 1994.
14. Martin Ives, "The Governmental Financial Reporting Entity," *The Government Accountants Journal*, Winter 1995.

15. Governmental Accounting Standards Board, Governmental Financial Reporting Model: Core Financial Statements, 1995.
16. U.S. Department of Treasury, Consolidated Financial Statements of the United States Government, 1993.
17. Federal Accounting Standards Advisory Board, Federal Accounting Standards Advisory Board Soon to be Complete Basic Work, 1995.
18. Federal Accounting Standards Advisory Board, Entity and Display Concept Statement, 1995.
19. U.S. Office of Management and Budget, Statement of Federal Financial Accounting Concepts, Statement Number 1, 1993.
20. U.S. Office of Management and Budget, Statement of Federal Financial Accounting Standards, Statement Number 1, Accounting for Selected Assets and Liabilities, 1993.
21. Federal Accounting Standards Advisory Board, Statement of Recommended Accounting Standards, Exposure Draft, 1994.
22. U. S. Office of Management and Budget, Federal Financial Reporting and the Role of the Federal Accounting Standards Advisory Board, 1993.
23. J.R. Razek & G.A. Hosch, Introduction to Governmental and Not-For-Profit Accounting, Third Edition, Prentice Hall, 1995.
24. Federal Accounting Standards Advisory Board, Accounting for Revenue and Other Financing Sources, 1995.

INITIAL DISTRIBUTION LIST

	No. Copies
1. Defense Technical Information Center Cameron Station Alexandria, Virginia 22304-6145	2
2. Library, Code 52 Naval Postgraduate School Monterey, California 93943-5101	2
3. Capt. Bryan E. Areman Marine Forces Atlantic Comptroller Camp Lejeune, North Carolina 28542	2
4. Professor Douglas Moses Naval Postgraduate School Code AS/MO Monterey, California 93943-5000	2
5. LCDR Michael Morris Naval Postgraduate School Code 36 Monterey, California 93943-5000	1