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THE NATURE AND DIVERSITY OF GOVERNMENTAL ACTIVITIES

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Abstract

In this article, I discuss the Governmental Accounting Standards Board (GASB), which establishes accounting standards for state and local governmental units and which is a sister organization of the Financial Accounting Standards Board (FASB). I also discuss the nature and diversity of governmental activities, the objectives of governmental financial reporting, the two different kinds of flow statements that are used to present operating statements for governmental activities, and other reporting.

1. Governmental Accounting Standards Board

Its Purpose, Structure, and Location

In 1984, the Governmental Accounting Standards Board was created as an arm of the Financial Accounting Foundation (FAF) to establish state and local governmental accounting standards. Thus the FAF now oversees both the FASB and the GASB. The GASB has a seven-member board (appointed for five-year terms), with a full-time chairperson. A simple majority (four votes) is needed to issue a pronouncement (compared with a super-majority of five votes for the FASB). The GASB is located in the same Norwalk, Connecticut, headquarters as the FASB.

No Authority to Establish Standards for the Federal Government

The GASB does not have authority to establish financial reporting standards for the federal government. The Federal Accounting Standards Advisory Board (FASAB), which functions independently of the FAF, the FASB, and the GASB, however, proposes reporting standards to (1) the Office of Management and Budgets (OMB), (2) the General Accounting Office (GAO), and (3) the Treasury department, all of which issue their own standards.

Status of Pre-GASB Standards

Prior to GASB's creation, state and local governmental accounting standards were established by various bodies (the last one being the National Council on

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Governmental Accounting—NCGA— which made some major reporting improvements during its existence from 1978 to 1984) These various bodies were sponsored by the Government Finance Officers Association (GFOA), which is for the governmental sector what the American Institute of Certified Public Accountants (AICPA) is for the private sector. The GFOA's web site is <http://www.gfoa.org>.

State and local governmental accounting standards in force at the time of GASB's creation continue in force until their status is changed by a subsequent GASB pronouncement (as mandated by GASB Statement No. 1, "Authoritative Status of NCGA Pronouncements and AICPA Industry Audit Guide").

The Jurisdictional Arrangement for the GASB and the FASB

The current jurisdictional arrangement (effective since November 30, 1989) for the GASB and the FASB is that each board has primary responsibility for setting standards for the reporting entities within its jurisdiction. Under this arrangement, an entity subject to the jurisdiction of one board

1. Is not required to change its reporting methods as a result of a standard issued by the other board.
2. Must follow a pronouncement of the other board if required to do so by the primary board.
3. May elect to follow the pronouncements of the other board (or look to other sources for guidance) when the primary board has not addressed a specific issue. Furthermore, a governmental unit that elects to use such FASB standards must use them on an all-or-nothing basis; thus a governmental unit cannot pick and choose among those FASB standards (the ones that do not conflict with or contradict GASB pronouncements).

Governments have the option of consistently following compatible FASB guidance issued after November 30, 1989, for activities reported as (1) business-type activities in government-wide statements and (2) Enterprise Funds (discussed later).

2. The Nature and Diversity of Governmental Activities

Governmental operations are unique for several reasons: (1) their absence of a profit motive, (2) their extensive legal requirements, (3) their diverse activities, and (4) their use of fund accounting.

The Absence of a Profit Motive: What to Measure?

The fundamental difference between the private sector and the governmental sector is that the former is organized and operated to make a profit for its owners while the latter exists to provide services to its citizens on a substantially nonprofit basis. In the private sector, profit measurement is possible because a causal relationship exists between expenses and revenues: costs and expenses are incurred to generate revenues. As a result, it is appropriate to compare these categories and determine profitability. The services of governmental units, however, are not intended to generate revenues. Thus revenues are not earned; they stand alone. This circumstance raises two key questions:

- > Should revenues be compared with the costs of providing services?
- > Is some other comparison of inflows and outflows more appropriate?

Extensive Legal Requirements

Constitutions, charters, and statutes regulate governmental units. Many legal provisions pertain to financial accounting areas. For example, certain activities or specified revenues must frequently be accounted for separately from all other operations. The uses of certain revenues may be limited. In some instances, a certain method of accounting—such as the cash basis—may be stipulated. We discuss the accounting ramifications of these requirements later in the chapter.

Many governmental units are required by law to follow GAAP and be audited annually by outside CPA firms or governmental audit agencies.

Diversity of Activities

Governmental activities are tremendously diverse and are classified into three broad categories:

1. **Governmental Activities.** Activities that do not resemble commercial activities are classified in this category. These operations provide primary services, and they are normally financed from tax revenues. Examples are education, public safety, the judicial system, social services, and administration.

2. **Business-Type Activities.** These activities resemble commercial activities. Usually financed wholly or partially from user charges, these operations may be considered secondary services. Examples are utilities, public transportation, parking facilities, and recreational facilities. Business-type operations usually have the objective to earn a profit or recover a certain level of operating costs from fees charged the public for their use.

3. **Fiduciary Activities.** These activities pertain to accounting for assets held by a governmental unit as trustee or agent. The most common example is a pension fund for current and former public employees. **Key Point:** These assets and their earnings benefit parties other than the governmental unit or its citizens.

The Use of Fund Accounting

Because of the legal requirements pertaining to financial accounting areas and the diversity of governmental activities, the use of a single set of accounts to record and summarize all the financial transactions of a governmental unit is neither legally possible nor practical. Accordingly, the GASB Codification requires that governmental accounting systems be organized and operated on a fund basis. Under a fund-based accounting system, certain activities are accounted separately from all other operations. Thus each governmental unit uses multiple general ledgers (if 10 funds are used, 10 different general ledgers are used). The GASB Codification defines a fund as follows:

A fund is ... a fiscal and accounting entity with a self-balancing set of accounts recording cash and other financial resources, together with all related liabilities and residual equities or balances, and changes therein, which are segregated for the purpose of carrying on activities or attaining certain objectives in accordance with special regulations, restrictions, or limitations.

Fund Balance versus Net Assets Terminology

The difference between a fund's assets and liabilities might be loosely thought of as the fund's "equity." This term, however, is deemed inappropriate except for business-type activities. The following table shows the terminology used:

Governmental Activities

Fund Statements:

Fund balance—

Reserved

Unreserved

Government-Wide Statements:

(Same net assets categories as used for business-type activities)

Business-Type Activities

Fund Statements and

Government-Wide Statements:

Net Assets (or Fund Equity)—

Invested in capital assets,
net of related debt

Restricted

Unrestricted

3. The Objectives of Governmental Financial Reporting

GASB Concepts Statement No. 1, "Objectives of Financial Reporting," sets forth three overall objectives of governmental financial reporting and nine additional objectives that flow from the three overall objectives.

4. Measurement Focus: What Flows to Measure for Operations

The concept of measurement focus pertains to presenting in an operating statement information concerning flows for a period of time (examples are (a) cash flows, (b) cash and receivable flows combined, (c) cash, receivables, and accounts payable flows combined, or (d) all assets and liabilities flows. Thus measurement focus is exclusively an operating statement concept of "which assets and liabilities should be included in the flow presented in the measure for operations."

Because of the diversity of governmental activities, the reporting issue is raised as to whether (1) the same flows should be measured for all three types of activities or (2) different flows should be measured.

As a point of reference, recall that business enterprises (proprietary in nature) present an operating statement called an income statement. An income statement measures the inflows and outflows that impact an entity's net asset's (total assets—total liabilities) for a period of time. Thus an income statement uses the economic resources measurement focus. In addition, business enterprises present a statement of cash flows, which has a much more limited measurement focus than that of an income statement. Thus business enterprises present two flow statements.

Business-Type Activities of Government

Some governmental activities are managed in a manner similar to those of business enterprises because the objective is to recover either all or a majority of the cost of providing services through user charges. For such activities, it is sensible to use the economic resources measurement focus and thus present an operating statement that shows revenues, gains, expenses (including depreciation expense), and losses. Rather than calling this operating statement an income statement, however, the title "Statement of Revenues and Expenses and Changes in Net Assets" is deemed more appropriate in view of the fact that the intent is not to generate income or maximize profits as in the private sector. Thus a statement of revenues and expenses for business-type activities answers the following questions:

1. What revenues were generated during the year?

2. What expenses were incurred during the year?
3. What was the improvement or deterioration in the governmental unit's overall economic condition as a result of events and transactions that occurred during the year? (Stated differently what was the change in net assets that resulted from operations?)

A Secondary Statement as Well

It is also sensible to present a statement of cash flows for business-type activities, as the private sector does. This comprehensive manner of reporting (two flow statements, one of which is the economic resources measurement flow), is required in both fund statements and government-wide statements for business-type activities. Consequently, negligible reporting issues exist for business-type activities. In contrast, reporting governmental activities has historically been quite controversial.

Governmental Activities of Governments

For governmental activities, the reporting issues are (1) whether to use the same measurement focus (economic resources measurement locus) as for business-type activities or a different measurement focus and (2) whether one or two flow statements are needed. The various proposed alternative flows that are possible—for the operating statement—are as follows:

1. Flows of economic resources and claims against those resources that impact net assets (the economic resources measurement focus discussed earlier).
2. Flows of cash (A very narrow measurement focus).
3. Flows of current financial resources (essentially cash and receivables) and claims against those **items that will** be paid **in the** current period or shortly thereafter (the current financial resources measurement focus). Thus it measures the impact on certain net assets (certain current assets - certain current liabilities).
4. Flows of total financial resources (essentially cash, receivables, prepaids, and inventories) and claims against those items that will be paid in the current period or shortly thereafter (the total financial resources measurement focus).
5. Flows of current financial resources (essentially cash and receivables) and claims against those items that were incurred in the current period—regardless of when paid.
6. Flows of total financial resources (essentially cash, receivables, prepaids, and inventories) and claims against those items that were incurred in the current period—regardless of when paid.

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