

Chapter 1

The Government and Not-For-Profit Environment

TRUE/FALSE (CHAPTER 1)

1. The main objective of a typical governmental entity is to earn a profit.
2. A government's budget may be backed by the force of law.
3. Governmental entities have no need for an accounting system.
4. Governments and not-for-profits employ a system of accounting known as fund accounting.
5. Governments and not-for-profits may never engage in business-type activities.
6. Lenders use the financial statements of governments and not-for profits just as they would those of businesses, that is, to help assess the borrower's credit-worthiness.
7. Financial statements, no matter how prepared, do not directly impact the economic worth of an entity.
8. Cash flow statements are governments' paramount financial documents.
9. Most governments budget on an accrual basis.
10. The Governmental Accounting Standards Board established generally accepted accounting principles for all state and local government entities, as well as all nongovernment entities.

MULTIPLE CHOICE (CHAPTER 1)

1. A primary characteristic that distinguishes governmental entities from business entities is
 - a) the need to generate revenues equal to or in excess of expenditures/expenses.
 - b) the importance of the budget in the governing process.
 - c) the need to provide goods or services.
 - d) the correlation between revenues generated and demand for goods or services.
2. Which of the following characteristics is NOT a characteristic that may distinguish a governmental or not-for-profit entity from a business entity?
 - a) There is often no direct link between revenues generated and expenditures/expenses incurred.
 - b) Capital assets may neither produce revenues nor save costs.
 - c) Revenues may not be indicative of demand for goods and services.
 - d) The mission of the entity will determine the goods or services provided.
3. The most significant financial document provided by a governmental entity may be
 - a) the balance sheet.
 - b) the operating statement.
 - c) the operating budget.
 - d) the cash flow statement.
4. Which of the following statements is NOT true?
 - a) All governmental entities engage in similar activities.
 - b) There are many different types of governments.
 - c) Governments may engage in activities similar to activities engaged in by for-profit entities.
 - d) Managers may have a short-term focus and thereby sacrifice the long-term viability of the entity.
5. Which of the following activities is NOT an activity in which a governmental entity might engage?
 - a) Selling electric power.
 - b) Operating a golf course.
 - c) Operating a book store.
 - d) All of the above are activities that might be carried out by a government.
6. In which of the following activities is a not-for-profit entity least likely to engage?
 - a) Providing educational services.
 - b) Providing health-care services.
 - c) Providing for the national defense.
 - d) Retail sales of cookies.
7. To obtain a comprehensive understanding of a government's fiscal health, a financial analyst should obtain an understanding of which of the following?
 - a) All of the resources owned by the governmental entity.
 - b) All of the resources which may be summoned by a governmental entity.
 - c) Demographic data about the residents served by the governmental entity.
 - d) All of the above.

8. Which of the following is common to both governments and not-for-profit entities but distinguishes these entities from for-profit entities?
- a) The budget is generally the most significant financial document.
 - b) Revenues are not necessarily indicative of demand for goods or services.
 - c) There is frequently no direct link between revenues and expenses.
 - d) All of the above are common to both governments and not-for-profit entities but distinguish them from for-profit entities.
9. Which of the following is NOT a purpose of external financial reporting by governments?
External financial reports should allow users to
- a) Assess financial condition.
 - b) Compare actual results with the budget.
 - c) Assess the ability of elected officials to effectively manage people.
 - d) Evaluate efficiency and effectiveness.
10. Which of the following is NOT a reason that users of government and not-for-profit external financial statements need to have information to enable them to assess the financial condition of a government?
- a) To determine the ability of the entity to meet its obligations.
 - b) To determine the ability of the entity to continue to provide services.
 - c) To predict future fiscal developments.
 - d) To evaluate the overall profitability of the entity.
11. Users of financial statements should be interested in information about compliance with laws and regulations for which of the following reasons?
- a) To determine if the entity has complied with bond covenants.
 - b) To determine if the entity has complied with taxing limitations.
 - c) To determine if the entity has complied with donor restrictions on the use of funds.
 - d) To determine all of the above.
12. Which of the following is NOT generally considered a main user of government and not-for-profit entity external financial statements?
- a) Investors and creditors.
 - b) Taxpayers.
 - c) Donors.
 - d) Management.
13. Which of the following is NOT a probable use a donor would make of the external financial statements of a not-for-profit entity?
- a) To determine the creditworthiness of the entity for investment purposes.
 - b) To determine the proportion of entity resources directed to programs as opposed to fund-raising.
 - c) To determine the salaries paid to the top officials of the entity.
 - d) To determine the allocation of resources within the entity.

14. A regulatory agency would use the external financial statements of a local government for which of the following purposes?
- a) To assure that the entity is spending and receiving resources in accordance with laws, regulations or policies.
 - b) To help assess management's performance.
 - c) To exercise general oversight responsibility.
 - d) To do all of the above.
15. Which of the following objectives is considered to be the cornerstone of financial reporting by a governmental entity?
- a) Accountability.
 - b) Budgetary compliance.
 - c) Interperiod equity.
 - d) Service efforts and accomplishments.
16. Which of the following is NOT an objective of financial reporting by governmental entities as established by GASB?
- a) Financial reporting should assist users in determining if current period revenues were sufficient to pay for current-period services.
 - b) Financial reporting should assist users in assessing the management skills of top management.
 - c) Financial reporting should assist users in evaluating the operating results of the governmental entity for the year.
 - d) Financial reporting should assist users in assessing the level of services that can be provided by the governmental entity and its ability to meet its obligations as they come due.
17. Which of the following is NOT an objective of financial reporting for not-for-profit entities as established by FASB? Financial reporting should provide information that is useful to present and potential resource providers and other users in:
- a) Making rational decisions about the allocation of resources to those organizations.
 - b) Assessing the services provided and the entity's ability to continue to provide those services.
 - c) Assessing the types of services provided and the need for those services.
 - d) Assessing how managers have discharged their stewardship responsibilities.
18. As used by GASB, interperiod equity refers to which of the following? Financial reporting should:
- a) Demonstrate compliance with finance-related contractual requirements.
 - b) Provide information to determine whether current-year revenues were sufficient to pay for current-year services.
 - c) Demonstrate whether resources were obtained and used in accordance with the entity's legally adopted budget.
 - d) Provide information to assist users in assessing the government's economy, efficiency, and effectiveness.

19. Given a specific set of data, the basis of accounting selected by or imposed on a governmental entity will least affect which of the following?
- a) Determining whether or not the governmental entity has a balanced budget.
 - b) Determining whether or not the governmental entity has the ability to issue debt.
 - c) Determining whether or not certain events occurred.
 - d) Determining the annual payments to a government-sponsored pension plan.
20. The Governmental Accounting Standards Board is the primary standard-setting body for:
- a) All governments.
 - b) All state and local governmental entities.
 - c) All governments and all not-for-profit entities.
 - d) All state and local governments and all not-for-profit entities.
21. Under certain circumstances a governmental entity might use standards established by which of the following standard-setting bodies?
- a) GASB.
 - b) FASB.
 - c) AICPA.
 - d) All of the above.
22. The primary standard-setting body for accounting and financial reporting by a state-supported college or university is:
- a) GASB.
 - b) FASB.
 - c) AICPA.
 - d) All of the above.
23. In descending order, the hierarchy of GAAP applicable to a church-owned college may be:
- a) FASB Statements, AICPA Industry Audit Guides, FASB Implementation Guides, GASB Standards.
 - b) FASB Statements, FASB Technical Bulletins, FASB Implementation Guides, AICPA Practice Bulletins (if cleared by FASB).
 - c) GASB Statements, AICPA Industry Audit Guides, GASB Implementation Guides, FASB Standards.
 - d) GASB Statements, GASB Technical Bulletins, GASB Implementation Guides, AICPA Practice Bulletins (if cleared by GASB).
24. Governments and not-for-profits employ a system of accounting known as
- a) budget accounting.
 - b) financial accounting.
 - c) fund accounting
 - d) tax accounting.
25. Which of the following rule-making authorities would establish accounting standards for all nongovernment not-for-profits?
- a) AICPA.
 - b) FASB.
 - c) GASB.
 - d) APB.

PROBLEMS (CHAPTER 1)

1. Thorn County adopted a cash budget for FY2000 as follows. The City budget laws prohibit budgeting or operating at a deficit. During the year the County collected or spent the following amounts. Was the County in compliance with the budget? Did the County accomplish the goal of interperiod equity? Explain your answers in detail.

	<u>Budgeted</u>	<u>Collected/Spent</u>
Receipts from Property tax collections		
From the 1999 levy	\$ 100,000	\$ -0-
From the 2000 levy	\$1,000,000	\$ 900,000
In advance for 2001	\$ 50,000	\$ -0-
Receipts from Bonds Issued	\$ 500,000	\$ 500,000
Borrowed from Bank (due in 5 years)	\$ -0-	\$ 75,000
Disbursements		
Salaries and Wages	\$ 500,000	\$ 500,000
Operating Expenses	\$ 200,000	\$ 275,000
City Hall Annex purchased	\$ 500,000	\$ 500,000
Payments on Debt-Principal	\$ 150,000	\$ 150,000
Payments on Interest	\$ 50,000	\$ 50,000
Pension Contribution	\$ 80,000	\$ -0-

Explanations provided by the City for the differences between budget and actual are as follows. Property tax collections are down because the major industry in the community closed and many citizens are currently unemployed. Operating expenses are up because the only bridge over a river bisecting the City sustained damages by an uninsured motorist and had to be repaired immediately. The repair was not budgeted.

2. Save-the-Birds (STB), a not-for-profit entity dedicated to acquiring and preserving habitat for upland birds, prepares financial statements in accordance with generally accepted accounting principles. Currently, standards require that a not-for-profit entity report as revenue in the year received virtually all contributions. During the current year STB received a donation of several hundred acres of prime habitat for upland birds. STB will require several hundred thousand dollars in additional donations in order to make the land completely suitable for the birds. Before embarking on its fund-raising campaign STB prepares financial statements which are summarized as follows.

Statement of Financial Position (Balance Sheet)

Cash	\$ 8,000
Supplies	\$ 2,000
Equipment (net of depreciation)	\$ 5,000
Land	<u>\$1,000,000</u>
Total Assets	<u>\$1,015,000</u>

Liabilities	\$ 1,000
Net Assets—Unrestricted	\$ 14,000
Net Assets—Restricted	<u>\$1,000,000</u>
Total Liabilities and Net Assets	<u>\$1,015,000</u>

Statement of Activities (Income Statement)

Revenues	\$1,030,000
Expenses:	
Salaries	<u>\$ 30,000</u>
Change in Net Assets	<u>\$1,000,000</u>

What difficulties, if any, will Save-the-Birds encounter in their new fund-raising drive? Knowing that the donation of the land accounted for \$1,000,000 of the revenue reported by Save-the-Birds, do you think the financial statements present fairly the financial position and results of operations of this not-for-profit entity?

3. Johnson City prepares its budget on the cash basis and prepares its external financial statements on the accrual basis. From the following data prepare statements of activity (income statements) on both the cash basis and the accrual basis. Which statement best represents the results of operation of the City? Which statement best demonstrates compliance with laws and regulations? Which statement would you rather see? Which conveys the best information to the citizens of Johnson City?

The City levies taxes in the current year of \$1 million. Of this amount \$.9 million is collected during the current year, \$.05 will be collected next year, and \$.04 will be collected in the future. \$.01 will never be collected. During the current year the City pays bills from prior periods \$.06 million, bills of the current period \$.8 million, and defers payment until future periods bills that were received for services consumed during the current period \$.1 million.

ESSAY (CHAPTER 1)

1. In the United States, educational services can be provided by federal governmental entities, by non-federal governmental entities, by not-for-profit entities, and by for-profit entities. Are the accounting and financial reporting standards the same for each of these entities? Should they be the same?
2. The Governmental Accounting Standards Board (GASB) stated that an objective of financial reporting should be to measure interperiod equity. “Financial reporting should provide information to determine whether current-year revenues were sufficient to pay for current-year services.” What is your understanding of ‘interperiod equity.’? What costs incurred in the current year should be paid for by the taxpayers of the current period? What costs incurred in the current year should be paid for by future taxpayers?
3. A not-for-profit entity raises funds to support specific programs, services, and activities. The recipients of the programs, services, and activities are frequently not the providers of the resources to deliver the programs, services, and activities. What information would donors to these not-for-profit entities be interested in seeing? What information would program beneficiaries be interested in seeing? Identify other users of the financial statements of a not-for-profit and the types of information in which they would be interested.

ANSWERS TO TRUE/FALSE (CHAPTER 1)

1. False
2. True
3. False
4. True
5. False
6. True
7. True
8. False
9. False
10. False

ANSWERS TO MULTIPLE CHOICE (CHAPTER 1)

1. B
2. D
3. C
4. A
5. D
6. C
7. D
8. D
9. C
10. D
11. D
12. D
13. A
14. D
15. A
16. B
17. C
18. B
19. C
20. B
21. D
22. A
23. A
24. C
25. B

ANSWERS TO PROBLEMS (CHAPTER 1)

1. The City has 'balanced' its current period operations. Total inflows are \$1,475,000 and total outflows are \$1,475,000. The City was seriously impacted by the closure of the major employer in town. Costs associated with operating the City are generally fixed over the short-run and could not be cut. The City compensated for the shortfall in property tax revenues by failing to make the pension contribution in the current period and by borrowing on a long-term note at the bank. Although one expenditure category exceeded the budgeted amount (operating expenses was \$75,000 more than budgeted), another was short by \$80,000 (pension contributions). The City has probably complied with the budget laws that prohibit operations at a deficit (if deficit is defined as a cash deficit). It has probably not complied with the budget laws if the laws state that current revenues (not including borrowing) must be equal to or exceed current period costs.

Interperiod equity is another issue. By failing to make the required contribution the City has passed on to future taxpayers costs that were associated with operations of the current period. By borrowing at the bank the City has incurred obligations that must be borne by future taxpayers.

2. Save-the-Birds will be launching a major fund-raising drive with a financial statement that shows \$1,030,000 in donations and only \$30,000 in expenses. It may be difficult to explain to potential donors why the entity is conducting a fund-raising drive at the present time. The balance sheet should help Save-the-Birds explain why they need the additional monies. However, many people familiar with financial statements of for-profit entities may have difficulty understanding how an entity can generate a \$1,000,000 'profit' and still need to be soliciting funds. The equity section shows Net Assets of \$1,000,000. It may be difficult for readers to understand that this is not similar to Retained Earnings in for-profit entities. The distinction between unrestricted and restricted may be meaningless to the average reader. [Students may react as readers—why do they need another fund-raising drive now? If so, they have failed to grasp an important issue for many not-for-profit entities.]

The financial statements of Save-the-Birds present fairly the financial position and results of operations of the entity. The financial statements do not tell the whole story. It will be necessary for Save-the-Birds to explain why they need the funds.

3. Johnson City financial statements would be as follows:

<u>Cash Basis</u>		<u>Accrual Basis</u>
\$.9 million	Property Tax Receipts	
	Property Tax Revenues	\$.99 million
- .06 million	Prior Period Expenses	
	Accrued Expenses	- .1 million
<u>- .8 million</u>	Current Expenses	<u>- .8 million</u>
\$.04 million	"Net Income"	\$.09 million

The cash basis financial statement would best demonstrate compliance with the budget but the non-cash basis financial statement would best convey results of operations. As a citizen, I would like to see both because legal compliance is important to me but so are results of operations. It may take both statements to fully inform the public about operations. [NOTE: At this point students have not been exposed to 'modified accrual' accounting so they will not struggle with the NCGA Interpretation 3 issues imbedded in this problem.]

ANSWERS TO ESSAY QUESTIONS (CHAPTER 1)

1. Accounting standards for educational institutions differ by the nature of the ownership. Public schools (K-12) are accounted for in the same way as state and local governments. Private schools, colleges, and universities are accounted for using standards established by FASB. For-profit educational institutions would use the FASB rules for other for-profit entities.

Since these entities are all involved in delivering the same basic service—education—it would appear that they should have the same standards. However, public schools are subject to the same openness as other government activities. The citizens should have a voice in determining what services are offered through the schools and how those services are delivered. The budget process is the opportunity for the public to be heard and the adopted budget is a plan of action to which citizens can, and should, hold officials accountable. For-profit schools are organized to generate profits and should measure net income using full accrual accounting. Not-for-profit entities generate revenues from tuition and solicit contributions from the public, or a select group of the public. Donors to not-for-profit entities may be interested in different information than taxpayers are interested in.

Students will have differing opinions about the appropriateness of different accounting standards for educational institutions determined by ownership rather than by activity. The question is designed to solicit their thoughts.

2. Interperiod equity means that the citizens of one time period should pay the costs of the goods and services consumed during that time period. Interperiod equity as an accounting concept means that the financial statements should measure the success of a governmental entity in accomplishing the goal of raising sufficient revenues to pay for the cost of services consumed during a period. Interperiod equity is a policy decision, not an accounting decision. Accounting should reflect what has happened, not drive what will happen. Governments should strive to accomplish interperiod equity, but in some cases interperiod equity is difficult to measure. What portion of the cost of World War II should have been borne by the citizens of that period? Are there intangible benefits enjoyed by citizens of the 1990's that exist because of the costs incurred to participate in that War? How do we measure the benefits of a well-educated citizenry? Should the citizens of today pay for the costs of educating the future businessmen, political leaders, scientists, musicians or should the citizens who enjoy the benefits of these talents pay the costs of educating these individuals.

Certainly governments should strive to raise sufficient revenues to pay the 'current operating costs' of the government activities. Can governments raise more revenues in one period than they consume in one period to leave lasting benefits to future generations—roads, bridges, monuments, etc.? As a public we are less apt to criticize the benefits we receive that were paid for by previous taxpayers than we are to criticize the debts we currently pay that paid for services consumed in the past.

3. Donors to not-for-profit (NFP) entities are probably interested in information about the costs incurred by the NFP. Donors would be interested in comparing the cost of delivering services incurred by one entity compared to the cost incurred by another entity for delivering the same type of service. The amount spent on programs compared to the amount spent on fund-raising and general and administrative costs would be of interest to donors. Major donors should be very interested in the amounts spent on salaries to top NFP officials because major donors are in effect paying those salaries. Beneficiaries would be interested in the costs of delivering the goods and services and the success of the NFP in securing the funds necessary to continue to deliver those goods and services.

Regulatory agencies, such as the IRS, would be very interested in the financial information of NFP entities. Governments would be interested in the financial information of NFP entities. Many governments are considering outsourcing or privatizing the delivery of goods and services. If other entities can, indeed, perform those services more efficiently than government, perhaps the services should be privatized or outsourced.