EXPOSURE DRAFT

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Federal Government Financial Accounting and Reporting Entities.

United States General Accounting Office

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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

ACCOUNTING AND FINANCIAL
MANAGEMENT DIVISION

Under the Accounting and Auditing Act of 1950, the General Accounting Office (GAO) is responsible for establishing accounting standards for Federal agencies. To carry out this responsibility, GAO first established standards in 1952 and has revised them periodically. Since recent years have seen many advances in accounting theory and practice, we have decided to reexamine these Federal Government standards first in concept and then in practice to see if changes are needed or desirable.

Our first goal is to develop a conceptual framework within which consistent Federal accounting requirements can be maintained. Once this framework is completed, we will reevaluate the accounting, reporting, and operational requirements to determine the needed changes. We expect the long-range benefit of this effort to be more useful information in financial reports.

To date, several exposure drafts have been issued for comment covering the objectives, the elements, and the measurement concepts of accounting and financial reporting. This document defines the accounting and financial reporting entities of the Federal Government.

Similar efforts are underway by the Council of State Governments to develop a definition of the State reporting entity which will be recommended for consideration by the National Council on Governmental Accounting (NCGA), the recognized standard-setting body for State and local governments. In developing the entity concept for the Federal Government, we drew upon the work of the NCGA and the Council of State Governments' State Government Accounting Project to the extent it could be applied to the Federal sector.

This document is issued as an exposure draft to Federal departments and agencies, to members of the accounting profession and the academic community, and to interested persons in the financial community. We encourage your review of this document and solicit your comments on how it can be improved and on whether the entity concepts it identifies and defines seem to be appropriate for the Federal Government both conceptually and realistically. Please send comments by January 31, 1982, to:

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Sincerely yours,

W D Campbell

W. D. Campbell
Acting Director

PROPOSED STATEMENT ON ACCOUNTING AND FINANCIAL REPORTING OF THE FEDERAL GOVERNMENT

ISSUED FOR COMMENT

FEDERAL GOVERNMENT FINANCIAL ACCOUNTING AND REPORTING ENTITIES

CONTENTS

ACCOUNTING AND FINANCIAL REPORTING ENTITIES IN THE FEDERAL GOVERNMENT

INTRODUCTION

1. The overall accounting and financial reporting structure in the Federal Government has two major components: the conceptual framework and the practice requirements. The conceptual framework consists of two levels: the objectives, which were tentatively established in the February 29, 1980, Exposure Draft entitled "Objectives of Accounting and Financial Reporting in the Federal Government," and the fundamental concepts, which include the entity concepts that will be defined tentatively by this statement. The practice requirements also consist of two levels: the standards and the operational criteria. Each level of the structure builds upon the base provided by the preceding level.

2. This statement focuses on identifying and defining entities so that appropriate information will be furnished that will help achieve the objectives of accounting and financial reporting in the Federal Government. This concept is only one of many to be included in the fundamental level of the conceptual framework. The first concept of the fundamental level covers the elements of financial reports. These were tentatively established in the August 12, 1980, Exposure Draft entitled "Elements of Accounting and Financial Reporting in the Federal Government." The second concept covers the measurement concepts. These were tentatively established in the November 11, 1980, Exposure Draft entitled "Measurement

Concepts of Accounting and Financial Reporting in the Federal Government." Concepts to be covered by other statements include recognition and reporting. Attached figures 1 and 2 describe plans for the fundamental concept level.

3. This statement does not specify accounting standards, procedural requirements, or reporting standards as does GAO's "Policy and Procedures Manual for Guidance of Federal Agencies." Rather, it is intended to provide the basis for interpreting, establishing, and maintaining standards.

REPORTING ENTITY DEFINED AND SUMMARIZED

4. The manner in which the entity is defined and the boundaries imposed dictate the type of economic activity that will be reported. The entity must be defined so that accounting will furnish data both quantifiable and nonquantifiable that can be used to help explain, plan, predict, and control the entity's activities. Over the years, various ownership theories (also referred to as entity concepts) have evolved, influencing the manner in which the accounting entity is defined. However, little consideration was given to which of these concepts should generally guide in the selection of the elements of economic activities to be reported within and for the Federal Government. Instead, statutory laws and the budget system have guided financial accounting and reporting within the Federal Government by traditionally focusing on the activities of individual agencies and other governmental organizations such as independent commissions.

5. Most ownership concepts describe profit-oriented organizations whose goal is to furnish financial information to investors and creditors on earnings and profits. In contrast, the goal of the Federal Government is not to earn profits, but rather to provide information useful for assessing management's performance and stewardship. Such assessment basically involves determining what has been achieved and what can be achieved. In this respect, users are mainly interested in how many services of various types were performed as represented by program spending. This is the fundamental difference in information needs between governmental and profit-oriented organizations. However, aside from the nature of user interest, both profit-oriented and governmental organizations are involved in activities whose accounting aspects do not differ substantially.

6. Based on the objective of providing information useful for assessing management's performance and stewardship, this statement identifies the "commander" concept as the entity concept that provides most of the guidance in the identification of reporting entities and the determination of their boundaries. The commander concept is relevant for Federal Government activity because it focuses on the effective economic control of resources by the officials or commanders of a unit. The following criteria were used to develop a definition that would guide in the determination of which economic units qualify as separate entities.

1. An official or board of directors is authorized by an act of Congress as having the highest degree of autonomy and accountability over resources in performing a mission.

2. The activities, functions, and programs under the accountability of an official or board of directors, as established by law, are to be combined to form a governmental unit within the executive, legislative, or judicial branches of the Federal Government.

3. The Congress or an oversight body requires the preparation of financial reports for its use and the public's.

7. By applying these criteria to the commander concept, one can define the reporting entity(ies) for Federal Government financial reports as, "any governmental unit in which the officials are either elected by the public or appointed by the President with advice and consent of the Congress or otherwise represent the highest level of accountability within a governmental unit." Therefore, financial information should be presented for each department, agency, or other governmental organization, including any independent establishment, that is controlled by or dependent on the executive, legislative, or judicial branches of the Federal Government. In this respect, specific departments and agencies are accountable for the resources that have been entrusted to them and thus are referred to as "Department/Agency Entities."

8. In addition to information about resources managed by specific organizational entities within the Federal Government, users need information that shows the accountability of each branch of the Federal Government. In this respect, users will view the executive, legislative, and judicial branches of the Federal Government as separate entities responsible for controlling

and reporting on the resources under their control. Therefore, the department/agency entities within each of the three branches should be integrated in separate financial summary reports, enabling reference to the "Executive, Legislative and Judicial Branch Entities."

9. Also, users need information that provides a simple overview of the Government as a whole, including the results of its financial operations for specified periods of time and a summary of what it owns and owes. With this perspective users can view the Federal Government as a single entity. To this end, the information reported by the department/agency entities should be integrated in a financial summary report enabling reference to the "Federal Government Entity."

10. This statement identifies and discusses six conventional entity theories: proprietary, corporate entity, residual equity, enterprise, fund, and commander. It also relates the characteristics of the commander entity concept to the overall objectives of Federal Government financial accounting and reporting, and sets forth criteria for determining whether an economic unit qualifies as a reporting entity.

LIMITATIONS OF THE ENTITY CONCEPT

11. The purpose of this statement is to identify and define an appropriate unit, commonly referred to as the entity, upon which financial accounting and reporting standards for the Federal Government can be established, interpreted, and applied. However, inherent limitations of the entity concept should be taken into account. These limitations are discussed in the following paragraphs.

12. First, the approach for identifying the entity concepts relevant in the Federal sector, unlike that in the profit-oriented private sector, is very complex and controversial. The entity might include one or more of the following:

a. The Federal Government as a whole.

b. Each branch of government as a separate entity.

   1. executive branch.

   2. legislative branch.

   3. judicial branch.

c. Each department, agency, or organizational unit conducting relatively autonomous operations under any one of the above three branches.

d. Each other organizational unit not included above but considered an instrumentality of the Federal Government (such as some Government corporations).

e. Each program, activity, or function within a department, agency or instrumentality of the Federal Government.

13. Another possible limitation in establishing the boundaries separating entities for financial accounting and reporting purposes arises from the legal considerations and restrictions imposed by the Congress. For example, the judicial and legislative branches of the Federal Government are not required to report on their financial operations in accordance with the Comptroller General's accounting principles and standards or to adhere to the Department of the Treasury's system of central accounting.

CONVENTIONAL ENTITY CONCEPTS

14. Over the years, evolving ownership concepts have influenced the manner in which the entity has been defined and explained

for accounting and reporting purposes. Six conventional ownership or entity concepts are customarily acknowledged for exemplifying the entity concept: proprietary, corporate entity, residual equity, enterprise, fund, and commander. The following paragraphs define these concepts. The goal of subsequent discussions on the relationship of entity concepts to the objectives of financial accounting and reporting is to focus on which concept is most relevant for selecting an appropriate reporting entity in the Federal Government.

15. Proprietary concept. The proprietary concept, best adapted to the single proprietorship and partnership forms of organization, evolved from and revolves around the personal relationship between the management of an organization and its ownership. The proprietorship, or wealth, of an organizational entity is considered to be the net value of the organization to its owners. Thus, the net income of each period is added to the personal capital accounts of the owners, including additional investment, and the owner withdrawals are deducted to determine proprietorship.

16. Corporate entity concept. The corporate entity concept recognizes the existence of an organization separate from the personal affairs of its owners and identified as a distinct legal body.

17. Residual equity concept. In the residual equity concept, all investors in a firm except common stockholders are thought of as outsiders. The objective of this approach is to provide better information to common stockholders for making investment

decisions. The residual equity concept falls between the proprietary and corporate entity concepts. Under the corporate entity viewpoint all investors are considered outsiders, whereas under the proprietary concept all investors are considered insiders.

18. The enterprise theory. The enterprise theory views the organization as a separate economic unit, as does the corporate entity theory. However, although the corporate entity theory considers the unit to be operated for the benefit of its owners, the enterprise theory considers the unit to be a social institution operated for the benefit of many interest groups, including the general public. The enterprise theory supports the value-added form of income determination which equates revenues with receipts and expenses with payments. Hence, it is intended to represent all of the value an entity has added to the economy. It may be thought of as a social theory of accounting.

19. The fund concept. The fund concept adopts a financing source and control oriented unit as the basis for accounting. Each fund is viewed as a separate entity. The fund concept differs from other ownership theories in that it assumes neither the personal relationship of the proprietary theory nor the personalization of the organizational unit as an economic and legal unit of the entity theory. Fund assets represent existing and prospective goods and services to be provided (by the unit), whereas fund liabilities and invested capital, or fund balance, represent restrictions imposed by legal and

contractual provisions and commitments. Unappropriated or uncommitted fund balance represents net assets to be used for carrying out the mission or objectives of the entity.

20. The commander concept. The commander concept focuses on the effective and economic control over resources by the officials or commanders of a unit, whereas the other entity concepts define the entity in terms of the area of economic interest of particular groups, or in terms of funds. Thus, the commander theory shifts the focus and emphasis of financial reports from the special interests of owners and other groups to the collective interests of all user groups. It recognizes that control over the activities of an organization comes from within the unit, as well as from external influences such as public opinion, and emphasizes what the managers have accomplished. Financial reports prepared under the commander theory thus attempt to provide information useful in assessing management's performance and stewardship given the purposes, objectives, resources, and constraints of the environment in which the managers function.

THE RELATIONSHIP OF ENTITY CONCEPTS TO THE OBJECTIVES

21. The preceding paragraphs briefly defined ownership concepts that have had a significant influence on the manner in which the entity has been defined and explained for financial accounting and reporting purposes. The choice of which ownership concept is relevant for defining the entity(ies) of the Federal Government emerges from the study of the objectives or goals toward which financial accounting and reporting

is directed. The exposure draft entitled "Objectives of Accounting and Financial Reporting in the Federal Government" tentatively establishes the objectives of the Federal sector. The objectives were established in three stages: (1) identifying users, (2) determining their information needs, and (3) ascertaining the content of information that satisfies these needs. Financial reports are the basic means of communicating information to meet user needs, and how the entity is defined and the limitations imposed dictate the detail of elements used to construct financial reports, including narrative disclosure and explanations.

22. The primary objective of accounting and financial reporting for the Federal Government is to provide useful information for assessing management's performance and stewardship. Such information must focus on the entity's financial viability, program activity, fiscal compliance, and resource allocation decisions, and it must be presented in terms of the entity's economic resources--including its assets, liabilities, obligations, and residual balances--and the creation of, use of, and rights to those economic resources. The following paragraphs define the objectives of financial accounting and reporting and then discuss them in relation to the entity concepts previously presented. The commander concept is identified as the most appropriate primary basis for defining the entity(ies) of the Federal Government.

a. <u>Financial viability</u>. An objective of financial accounting and reporting is to provide information useful in assessing financial viability, which is defined as the ability to provide the same level of resources that have been provided in the past or are expected to be provided in the future. To help indicate financial viability, financial reports must show resources entrusted to management, obligations in terms of resources, changes in resources and obligations, and resource flows and liquidity.

b. Program activity. An objective of accounting and financial reporting is to provide information useful in assessing program activity. Program activity information must focus on the use of resources, which are the inputs and outputs under various programs and projects.

c. Fiscal compliance. An objective of accounting and financial reporting by the Federal Government is to provide information useful in assessing compliance with legal and regulatory limitations. Information on fiscal compliance provides objective evidence of accountability. In the private sector, the profit factor generally provides a built-in control which limits wasteful spending. Because the profit factor does not exist in the Federal Government, legal and regulatory limitations on economic resources and on program activities usually are imposed on departments and agencies.

d. Resource allocation. Another objective of accounting and reporting is resource allocation. This is the process of distributing budget authority; deciding on the use of resources in carrying out operations; and choosing Government securities from a creditor's standpoint.

23. As previously mentioned, the primary objective of accounting and financial reporting is to provide information that is helpful for assessing management's performance and stewardship. To be helpful, information must indicate whether resources entrusted to management have been used efficiently and economically. In the private sector this is often not difficult to determine because the profit factor both guides and reveals management's performance. The proprietary, corporate entity, enterprise, and residual equity concepts concentrate on information--such as net income and earnings per share--presumably needed by owners of profit-seeking organizations. The Federal Government, however, manages economic resources which are not used to convert goods and services into profits. Since profit cannot be used to indicate performance, the proprietary, enterprise, corporate entity, and residual entity concepts are not relevant concepts for identifying the reporting entity(ies) of the Federal Government.

24. To be useful in evidencing accountability and performance in the Federal Government, information must focus on financial viability, program activity, fiscal compliance, and resource allocation decisions. With this type of information, users can assess whether officials have effectively controlled resources entrusted to them in providing services under various programs and activities. Of the two remaining entity concepts, fund and commander, only the latter focuses on the effective economic control over resources by the officials who have been given spending authority.

25. The fund concept supports accountability for the sources and uses of resources within a program or fund. This is a very detailed level of accountability resembling the method used by agencies and departments to report budget information to the Office of Management and Budget. Each program or fund is treated for accounting and reporting purposes as a separate entity with a distinct accounting system.

26. On the other hand, the commander concept supports the accountability and managerial effectiveness of all programs administered by the officials of an agency or department entrusted with resources. All programs and activities under an official's control are combined for reporting purposes. This shows the Federal Government's viability more clearly than under the fund concept because it bears directly on the total resources. It also is compatible with the budget system because it provides flexibility for reporting useful data on program activities or on any program components, whether past, present, or future. Additionally, the commander concept provides a sound foundation for providing information useful in assessing fiscal compliance. It does so by emphasizing managerial control over such matters as spending and debt ceilings, restrictions on the use of economic resources, and future project and program obligations of the Federal Government and its major components.

ENTITIES INCLUDED IN ACCOUNTING
AND FINANCIAL REPORTING

27. The Federal Government performs a wide variety of functions and activities, making it difficult to compare its diverse

operations for purposes of defining internal and external reporting entities. In the past, no guiding principle has existed for identifying entities to achieve the objectives of accounting and financial reporting. Instead, statutory laws and the budget system have played a key role in the way financial accountability is maintained and reported. In the absence of definitive criteria, any department, agency, organizational unit, or instrumentality of the Federal Government, the Federal Government as a whole, or any program, activity, or function can be considered as separate and distinct entities.

28. Since the entity has been loosely interpreted, the commander concept was chosen to guide in defining and identifying the reporting entities of the Federal Government. The commander concept is broad enough to serve the primary aggregate information needs of all financial report users because it can be related to the most fundamental objective common to all activities in the Federal Government: the effective control of resources entrusted to the officials of a unit.

29. Under the commander concept, reporting entities are defined as any governmental unit whose officials have accountability over resources and power under law to manage obligations on behalf of the Government. In this document, officials are defined as only those who are elected by the public or who are appointed by the President and confirmed by Congress or who otherwise represent the highest level of accountability.

Figure 3 presents an overview of the accountability of and within the Federal Government, which is discussed in the following paragraphs.

30. Each department, agency, organizational unit, or instrumentality of the Federal Government that is headed by an official or a board of directors who is either elected by the public or appointed by the President and confirmed by the Congress or who otherwise represents the highest level of accountability is a separate entity within the Federal Government and is henceforth known as "Department/Agency Entity." This definition is consistent with the intent of the Congress to establish accountability for governmental resources. For example, under Title 31, U.S.C., Money and Finance, each executive agency must maintain an accounting system and produce financial reports disclosing its operations in accordance with principles and standards prescribed by the Comptroller General of the United States. Title 31 defines departments and establishments to mean any executive department, independent commission, board, bureau, office, agency, or other establishment of the Government. The legislative branch and the Supreme Court are expressly excluded. Also, each department, agency, or instrumentality of the executive, legislative, and judicial branches of the Federal Government is considered a separate entity having responsibility and accountability for its budget authority, obligations, and outlays, and is subject to audit of the manner in which it has discharged and reported upon its responsibilities and accountabilities.

31. All programs and activities that are the responsibility of an official head of a department/agency entity are part of the entity's total accountability. They should not be considered separate entities. Nevertheless, this will not preclude reporting both quantitative and nonquantitative information on the results of a program or an activity within financial reports. This type of information is essential for planning resource needs of Federal agencies, and can be displayed by major functional area to meet national needs, as is done in the Federal budget. This aspect will be discussed in a subsequent statement on the Federal accounting and reporting structure.

32. Since the Constitution separates the major responsibility for managing the affairs of the United States Government between the executive, legislative, and judicial branches and requires each one to develop and submit estimated expenditures and proposed appropriations for budget decisions, each branch should be perceived as a separate and distinct entity. Therefore, each department/agency entity under the administrative control of one of the three branches would be integrated to form either the "Executive Branch Entity," "Legislative Branch Entity," or "Judicial Branch Entity."

33. Because each branch of the Federal Government is an entity (or Federal Government subentity) and because elected or appointed officials are accountable for resources entrusted to them, the activities of the Federal Government when viewed collectively should be perceived as one entity. The Federal Government

as a whole is henceforth known as "Federal Government Entity." The following reasons support this:

a. Congress clearly intended that the Federal Government be held accountable, as a whole, to the public for the collective financial operations and status of the individual agencies. This is expressed in Title 31, U.S.C., Section 66.B, where it is stated that the Department of the Treasury is responsible for reporting to the President, the Congress, and the public, on the results of the financial operations of the Government.

b. The network of interconnected activities throughout the Federal Government makes it evident that the operations of all agencies must be integrated for Federal Government accountability and for making decisions about national needs and priorities. For this reason, in 1975 the Department of the Treasury, in cooperation with GAO and other agencies, initiated a project to develop a financial report that would provide a simple overview of what the Government owns and owes. It is not intended to be an official report on the Government's financial position and operation. Rather, its purpose is to contribute to the improvement of governmental accounting by studying various accounting and reporting issues.

Figure 1

EFFORTS IN THE FUNDAMENTAL LEVEL

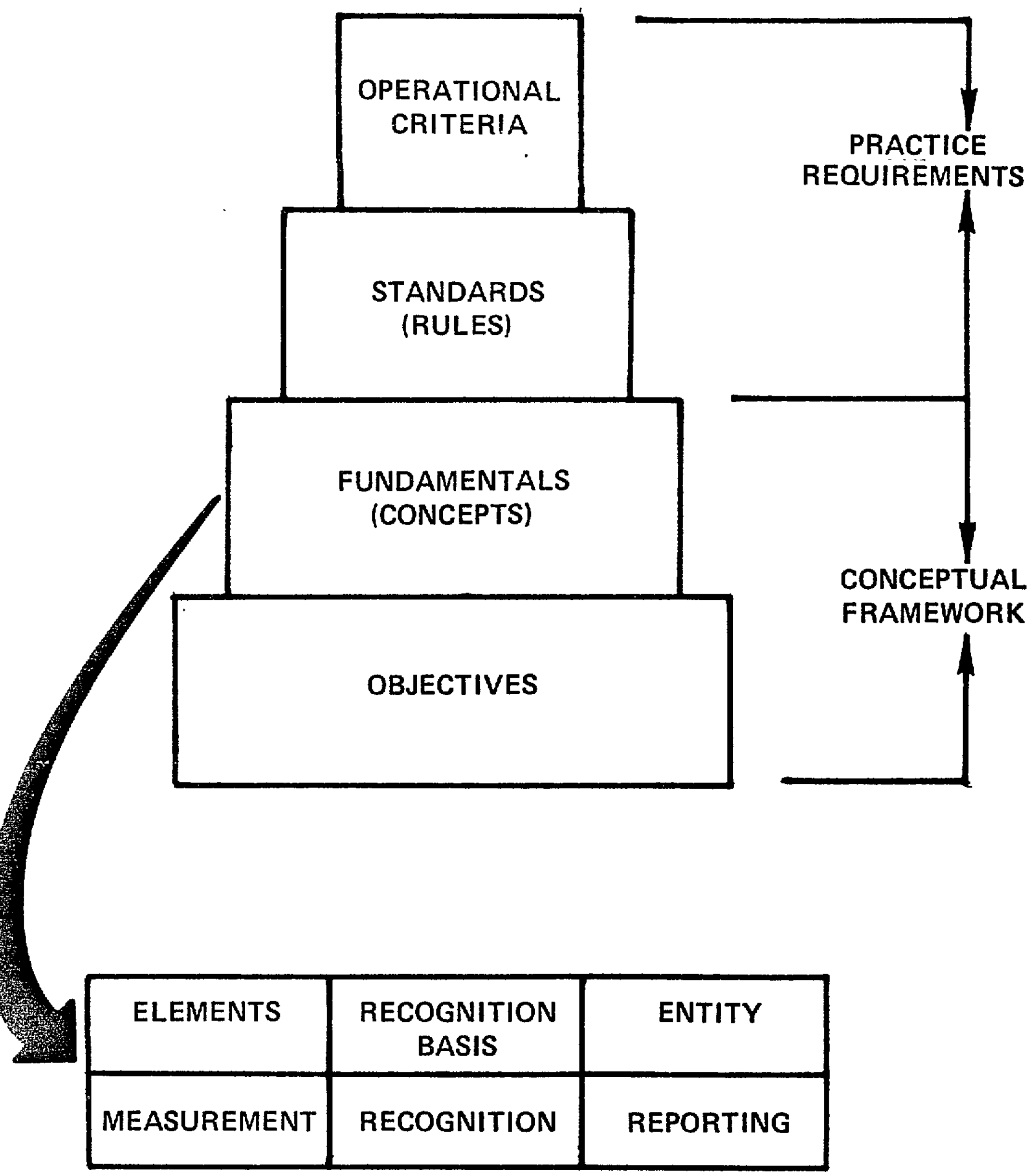


Figure 2

Brief Description of

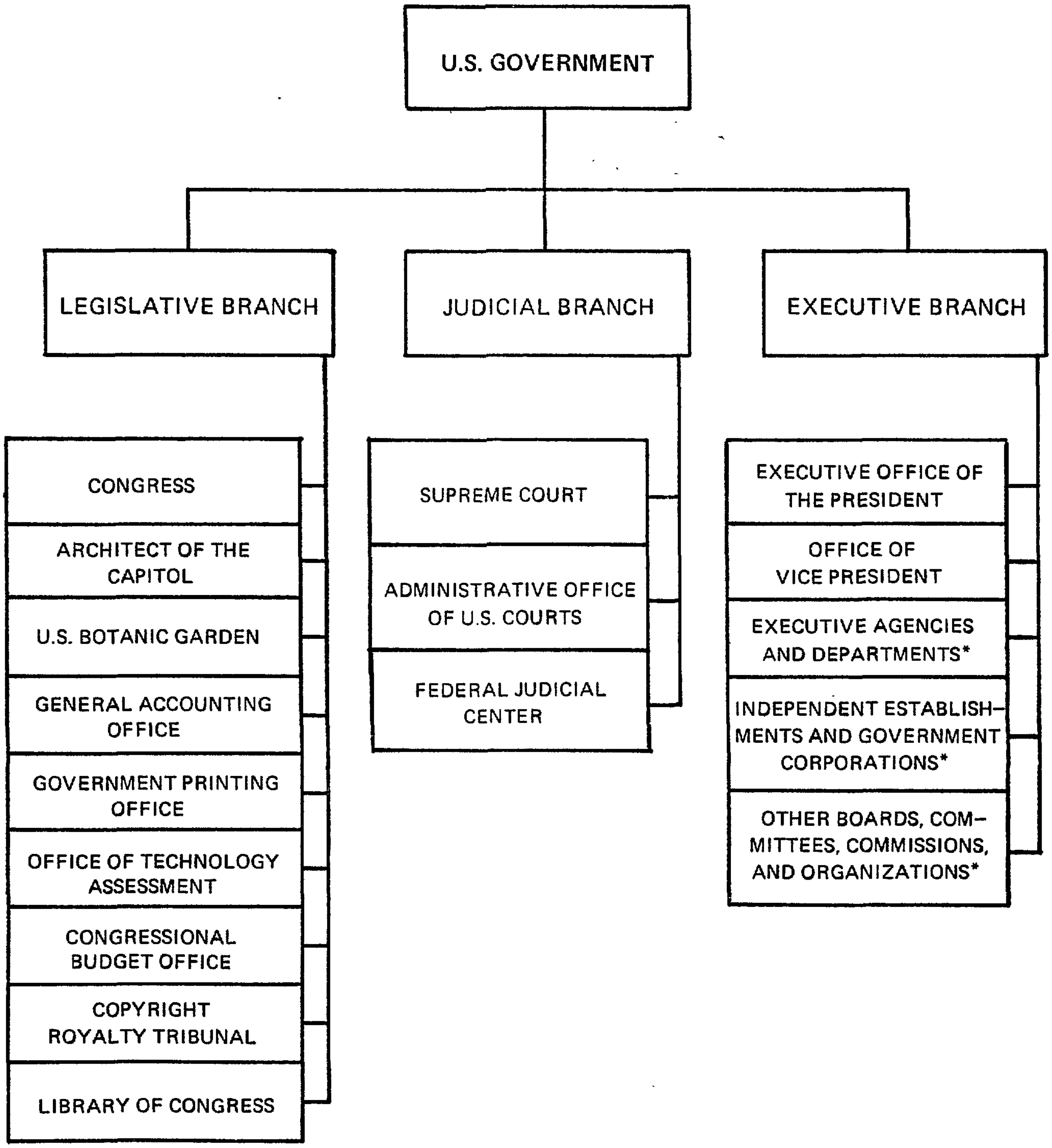
Efforts in the Fundamental Level

1.	Elements statement	Defines and explains components of financial reports. Examples include assets, liabilities, and costs.
2.	Entity statement	Establishes the body or activity about which financial reports will be prepared.
3.	Recognition basis statement a/	Analyzes the three basic theories of financial reporting (funds flow, income determination, and capital maintenance) and recommends one for application to the Federal Government.
4.	Measurement statement	Deals with valuation criteria to be used in establishing and maintaining standards for assigning dollar amounts to elements and components of elements.
5.	Recognition statement a/	Establishes criteria to be used when establishing and maintaining standards for when to report elements and components of elements.
6.	Reporting statement	Establishes the criteria to guide in developing and maintaining standards for report formats and the degree of disclosure required in reports.

a/If the effort required to determine the recognition basis is readily completed, it may be incorporated in the recognition statement.

FIGURE 3

OVERVIEW OF THE FEDERAL GOVERNMENT'S ACCOUNTABILITY



*** Individual departments, agencies and other Governmental organizations are listed in the U.S. Government Manual.**