

## Standards and Issues in Governmental Accounting and Financial Reporting

It is increasingly desirable and even necessary for practitioners and academicians in public budgeting and financial management to understand the contents of government accounting and financial reporting standards, and to evaluate related institutional issues. Both in theory and practice, these fields are highly interdependent, so much so that problems in one cannot be successfully solved without the assistance of the others. However, the development of specialties and their nomenclatures have tended to inhibit communications across disciplinary and professional boundaries. When budgeting and financial management personnel are familiar with the potentials and limitation of governmental accounting, they will be able to effectively use accounting information. In addition, allegations of deficiencies in accounting and financial reporting standards and practices have been linked with a number of well-publicized local governmental financial crises. Some critics have attempted to generalize these instances into a rather pessimistic picture of the current standards and practice. Since accounting and financial reporting are a responsibility and an integral part of financial management, financial managers need the conceptual tools to oversee, evaluate and assist the accounting and financial reporting function.

The purpose of this article is to discuss some important conceptual and institutional issues associated with current accounting and financial reporting standards for state and local government.<sup>1</sup> Special attention is paid to the interactions between these issues and public budgeting and financial management.

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The views expressed in this article are those of the author and should not be ascribed to the members and others on staff of the NCGA, or its institutional and financial sponsors.

## CONCEPTUAL ISSUES IN GOVERNMENTAL ACCOUNTING AND FINANCIAL REPORTING

### *The Scope of the Accounting Function*

Since accounting is fundamentally a service function, its problems generally result from users' demands or accountants' own increasing competence and desire to expand the scope of their services. About 30 years ago, accounting was defined to be:

the art of recording, classifying, measuring and communicating in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof.<sup>2</sup>

This definition probably is still descriptive of most accounting practices today. But it does not indicate what is meant by the "significant manner" in which financial transactions and events should be measured and communicated. One interpretation enjoying much currency, particularly in the academic community, is that accounting information should facilitate economic decision making. One author has gone so far as to state:

Accounting is a measurement and communication system to provide economic and *social* information about an identifiable entity to permit users to make informed judgments and decisions *leading to an optimum allocation of resources and the accomplishment of the organization's objectives* (emphasis added).<sup>3</sup>

This normative view of accounting challenges the accounting profession to consider several important problems: (1) the nature of information it provides; (2) to whom the information is provided; and (3) the purposes for which the information is to be used.

Accounting information traditionally is financial information extracted *from past* financial transactions and, to a lesser extent, economic events. This view regards historical cost as at best an approximation of economic value, but justifies it on grounds of objectivity and verifiability. Even though general price level and specific price increases affect both the private and public sectors, governmental accounting standards have not yet systematically dealt with the impact of inflation. The disclosure of future-oriented financial information has also not been mandated or standardized by current reporting standards.

With respect to nonfinancial information, there has been a lengthy debate within the accounting profession and between accountants and non-accountants.<sup>4</sup> Some contend that accountants lack competence in measuring and evaluating nonfinancial performance. Others feel that this could be overcome by changes in educational requirements. This issue affects not only educational policies of the accounting profession, but also the distribution of organizational resources and power within governments. Accountants are competing with other information specialists (e.g., budget analysts, public policy analysts and operations researchers) for decision makers' attention, and therefore come under scrutiny for what they do, or ought to do.

The issue of scope of the accounting function makes it difficult to say exactly what accounting is or should be. For the sake of discussion, it is assumed that there is an

identifiable, but evolving, accounting discipline and profession. We may then examine the following issues:

- Generally accepted accounting principles.
- General purpose external financial reporting.
- The appropriate reporting entity.
- The relationship between budgeting and accounting.
- The fairness of presentation of financial position and results of operations.

### *Generally Accepted Accounting Principles*

Generally Accepted Accounting Principles (GAAP) should mean that these rules have won the endorsement of most of those who set them or are affected by them. In the public sector the affected parties would include the preparers of financial reports (government officials), auditors attesting to the fairness of the presentation in accordance with applicable standards, and “users.” Acceptance of accounting principles has been deemed necessary because the costs of resolving conflicts and enforcement could be substantial. Because of the diversity of the political and economic interests of those affected by accounting standards, agreement has been difficult to obtain. In addition, the private costs and benefits of participation are such that not all the affected parties are involved to the same extent in the standard-setting process.

While general acceptance is desirable, it has not been universally achieved. It takes a long time for the “survival of the fittest” test to decide which accounting policy is the most accepted. This “social Darwinism” approach has been largely abandoned in favor of creating an “authoritative” body and following “due process.” Due process typically requires exposure and public hearings on proposed standards, and inputs from broad-based advisory councils. Formal voting procedures are also adopted to decide on accepted accounting standards.<sup>5</sup>

Professional associations such as the Municipal Finance Officers Association (MFOA) and the American Institute of Certified Public Accountants (AICPA) have assumed leadership by sponsoring standard-setting bodies. The National Council on Governmental Accounting has been sponsored and to a large extent supported by the MFOA. The AICPA’s Accounting Principles Board subsequently evolved into the Financial Accounting Standards Board, the standard-setting body for the private sector. These accounting standard-setting bodies derive their authoritativeness from one or more of the following sources: (1) the acceptance, or at least acquiescence, of those subject to their rules; (2) the delegation of authority by government agencies possessing statutory power to set accounting standards with respect to certain entities; (3) the recognition by the independent auditing profession; and (4) the endorsement of the capital market and financial intermediaries such as rating agencies.<sup>6</sup>

“Governmental Accounting and Financial Reporting Principles” enunciated by *Statement 1* of the National Council on Governmental Accounting are currently regarded as Generally Accepted Accounting Principles (GAAP) applicable to state and local government.<sup>7</sup> These principles provide for a fund structure of accounts, budgetary comparisons, fair presentation of financial position and results of operations, and a hierarchy of aggregation levels of disclosure to meet perceived user needs. The disclosures required by *Statement 1* in a comprehensive annual financial report are intended primarily to monitor

and enforce public officials' management responsibilities for the resources entrusted to them, and to provide feedback information so that the actual financial performance can be compared with budgets for performance evaluation and for improving subsequent budgetary estimates. However, it is necessary to point out that the term "GAAP" has been used as a basis for recommending the adoption of certain business accounting practices by government, notably consolidated financial statements, depreciation of fixed assets and disclosure of accrued liabilities.<sup>8</sup> Significantly, GAAP has been used by the City of New York to determine the extent of its budget deficit.<sup>9</sup>

In summary, GAAP are developed by designated authoritative policy-making bodies, which follow some form of due process to encourage general acceptance before and after adoption. GAAP are not infallible and need continuing improvements. It is therefore appropriate to examine next some of the key conceptual issues.

### *General Purpose External Financial Reporting*

In the private sector, generally accepted accounting principles govern only "general purpose external financial reporting." The basic rationale is that the managers of individual enterprises have the prerogative of organizing their own management information systems. Also, government regulatory agencies and others having the ability to enforce their information demands can compel firms to prepare "special reports." The role of an accounting standard-setting body, the argument goes, is to assist those members of the society who lack the ability and resources to obtain information needed for their decision making.<sup>10</sup> This concern in business financial reporting has generally been centered on investors and creditors. Current business financial accounting standards are predicated on the theory that the firm is an instrumentality of the owner-investors to earn returns on their investments, and managers are their agents. This view has led to a primary concern for determining the periodic residual income (the "bottom-line") as a predictor of dividend distributions to stockholders. Given the large number of investors and their largely common interest in earning returns on their investments, it appears justifiable and economical to produce general purpose financial reports for this class of users.

As noted earlier, there have been several proposals for the adoption of an investor-oriented financial reporting model in the government sector, particularly for municipalities. Certainly, when state and local governments borrow from the capital market, investor protection is a legitimate concern. Laws and regulations are written, disclosure guidelines are drawn up, and contractual assurances are made for the protection of investors. Their information needs are not being ignored. The existence of debt service funds is an indication of the priority accorded to this class of users of financial information.

However, the automatic application of the investor-oriented reporting model to state and local government is unwarranted on several grounds. There is little evidence that the information needs of investors are shared by other actual or potential users of governmental financial information. Furthermore, the classical theory of the firm is of questionable validity in the private sector.<sup>11</sup> It is even more inappropriate as a normative or descriptive theory of state and local governments in the United States. Besides investors, many other interest groups exchange benefits with state and local governments, including:

<b>Interest Group</b>	<b>Contribution</b>	<b>Inducement</b>
Voters	Legitimacy of government	Public services to selves and general welfare
Taxpayers	Tax dollars	Same as above
Governing and oversight bodies	Authority, policy guidance and monitoring of performance	Power and discharge of accountability to the electorate
Inter-governmental grantors	Financial resources and policies	Services to target populations, control
Employees	Labor services	Compensation and non-financial benefits
Vendors	Goods and services	Payments

These groups also have incentives to use financial information to assess the balance of the inducements offered and contribution required by government.<sup>12</sup> They are therefore likely to be users of information produced or produceable by government.

Each of the above classes of users is not necessarily homogeneous. If each class of users has similar information needs, a case could be made for general purpose reports for each class of homogeneous user group. At this time, however, there is a lack of empirical evidence or a normative theory that would support the validity of a set of general purpose financial reports for all user groups.

Reporting to discharge public accountability to the parties at interest with government is important. At the same time, the information needs of policy makers, budgeting personnel and financial managers responsible for the day-to-day operations of government should not be overlooked. Individuals in these positions need timely, accurate information to carry out their specific managerial responsibilities. Unless a governmental unit's accounting system carries out this management information function competently, the external feedback process may be too slow and too weak to detect and correct mismanagement. A balance has to be struck among the information demands of management and other user groups.

#### *Appropriate Accounting and Reporting Entities*

A major controversy in the government financial reporting literature is the degree of aggregation of funds. Funds or fund types are used as accounting and reporting entities in the public sector because they facilitate budgetary allocations, financial management and control. Recently it has been suggested that investors and the general public should be able to know the financial conditions and operations of the government as a whole, by means of a set of consolidated financial statements.<sup>13</sup> Such statements would overcome, or at least reduce, the information overload resulting from voluminous reporting by fund or fund type. So far the proponents of this approach have relied on the argument that even the largest corporations can, according to GAAP for the business sector, "fairly present"

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their financial picture in a set of consolidated financial statements. This argument fails to recognize that the FASB and its predecessors have set GAAP in the context of the business sector. The applicability of business GAAP to the government is not a foregone conclusion.<sup>14</sup>

There is no evidence to support the argument for a reporting entity concept generally appropriate for all user groups. To taxpayers, the relevant government entities are all those which have taxing authority over them. To creditors, they are only those whose resources (current and potential) are available to pay specific debts. To voters, they are those jurisdictions whose elected officials are elected by them. All of these governmental entities need not be identical. Consequently, the search for *the* relevant reporting entity is likely to be unproductive, be it a fund, fund group, or whole government. A more sensible approach is to identify a homogeneous user group's scope of interest, as illustrated above.

Proponents of detailed reporting fear that consolidated statements would weaken the monitoring of managerial stewardship. On the other hand, it is also recognized that excessive detail is dysfunctional. Consequently, the NCGA has taken the middle-of-the-road approach. That is, detailed fund-by-fund disclosure is made available in a comprehensive annual financial report. Funds of relatively homogeneous character are aggregated in fund types, and accounts into account groups, and presented as "general purpose financial reports" that are liftable from the more voluminous Comprehensive Annual Financial Report (CAFR).

#### *Relationship Between Accounting and Budgeting*

Accounting in the minimal sense of being a score-keeping function derives its utility as the feedback of performance data to facilitate the planning and control functions. A government budget is a resource allocation document, and a planning and control tool. A significant feature of government accounting is the formal incorporation of the legally adopted budget into the government's accounting system. Indeed, an objective of government accounting systems is to facilitate budgetary control and comparisons. This is achieved by using common terminology and a consistent account classification. Estimated revenues and expenditures are recorded in the accounts at the beginning of the fiscal year and periodically compared with actual amounts during the year. This interdependency presents opportunities for cooperation, and also occasions for conflicts between accounting and budgeting.

The common emphasis on short-term financial resources in annual/biennial government budgets is carried over to the accounting for government funds (i.e., the emphasis on expenditures rather than expenses). Clearly, short-term financial resources (including cash) are of critical importance in day-to-day financial operations. But many government financial transactions and events also have major cash consequences beyond the current fiscal year. Indeed, sometimes trade-offs are made to conserve current cash outflows at the expense of future cash outflows, e.g., granting pension benefits in lieu of current salary increases. A dilemma is faced by accounting. On the one hand, the accounting system seeks to be compatible with the budgetary system. On the other hand, accounting standards may call for disclosure of longer-term financial consequences not apparent in a budget prepared on a cash flow basis. Under legal or popular mandates to balance the budget and to limit government spending, government officials are under pressure to employ available devices to achieve a surplus or minimize the deficit. Depending on the definitions of revenues and expenditures/expenses used, the size of the deficit can vary. The issues involve the measurement and disclosure of a government's financial operations and position.

#### *Fair Financial Presentation*

Fair presentation is a basic objective of financial reporting by the government. Generally accepted accounting principles provide the operational criteria for judging the extent of fairness. To see what is meant by fair presentation, it is useful to have an overview of the accounting cycle.

The accounting process begins with an analysis of the financial effects of the transactions or other economic events that have already occurred. This historical perspective is regarded by some people as almost an intrinsic characteristic of financial reporting to external parties. However, one should not presume that historical cost information is necessarily useful to decision making in a dynamic environment. The financial position of an entity at a particular time is represented by the costs of the resources acquired and available for future use, and the claims against those resources, as expressed by the accounting equation,  $\text{assets} = \text{liabilities} + \text{equities}$ .

The result of financial operations is measured by matching the outflows of resources with the inflows of resources. When the emphasis is on the control of periodic spending, as in the case of government funds, the measurement focus is on expenditures (i.e., the decreases in short-term financial resources), and revenues are recognized on a modified accrual basis (when the financial resources are measurable and available to finance the expenditures in the fiscal period). On the other hand, if the objective is to determine the costs of services, as in the case of enterprise funds, the proper matching of expenses and revenues is essential. Expenses are the costs of all the economic resources utilized in providing the goods and services, and would therefore include depreciation on the fixed assets used. Revenue in this context is the sales proceeds from having provided the goods or rendered the services.

Accounting for the inflows and outflows of current financial resources is important for short-term financial management. The concept of expenditure is designed to meet such needs. However, when some of the costs of services received in the current period are deferred for payments in the future and are not funded with current resources, current expenditures alone do not measure the total costs and do not adequately predict future cash outflows. Unfunded pension and other liabilities are significant because they will require future cash outflows and consequently burden some segments of society. Also, they may be symptoms of deterioration of the fiscal strength of a government. That has led to the underfunding of liabilities. The full disclosure of short-term and long-term liabilities, and the use of the broader concept of expense in addition to expenditure, would serve as integral parts of an early warning system about the fiscal health of government. Early warning is needed to stimulate corrective actions and to force long-term budgeting.

A recurring controversy in governmental accounting is the lack of requirements for computing the depreciation expense of fixed assets financed by governmental funds (as contrasted with proprietary funds). Depreciation, in the accounting sense, is the allocation of the original acquisition costs of fixed assets to each period of their useful lives by means of formulas that are intended to approximate the decline of the service potential of the assets. Such cost allocations are arbitrary, but may still serve some useful purposes.<sup>15</sup> For example, it is financially beneficial for a local government to be reimbursed for the “expired” service potentials of the fixed assets used in mandated or assisted programs. The arbitrariness of depreciation computation is due to the patterns of decline of usefulness assumed in the several acceptable depreciation methods.<sup>16</sup> Perhaps the utility of measuring fixed assets (in monetary and non-monetary terms) lies in warning public officials and others about the unfavorable consequences of fixed asset deterioration. Unless capital programs are undertaken to maintain or enhance the service capabilities of fixed assets, the original cost figures in the general fixed asset account group are meaningless. Rather, the cash flow requirements of fixed asset acquisition, replacement, repair and maintenance are more likely to be useful than depreciation expense figures unless these figures serve some identifiable purposes such as cost reimbursement.

## **INSTITUTIONAL ISSUES IN GOVERNMENT ACCOUNTING**

The standards in *Statement 1* of the National Council on Governmental Accounting are regarded as generally accepted accounting principles for state and local governments. However, general acceptance requires persuasive standards as well as education, encouragement and enforcement. An impediment to general acceptance is the role of other sources of standards. These include requirements or recommendations made by legislatures and oversight bodies, the auditing profession, grantors and other standard-setting bodies.

Statutory provisions on accounting and financial reporting carry the force of law, and compliance is mandatory. To the extent they are inconsistent with GAAP, financial officers are put in an uncomfortable position of choosing allegiance. The NCGA *Statement 1* regards both GAAP reporting and legal compliance reporting as “essential” and recommends the preparation of basic financial statements in conformance with GAAP, and, if necessary, additional schedules and explanations to satisfy legal compliance re-



quirements in the comprehensive annual financial report. This state of affairs reflects the reluctance of many legislative and oversight bodies to delegate their legal authority to prescribe accounting standards, and the relatively slow progress made by the accounting profession in securing legislative endorsement for nationwide uniform standards. Legislative, administrative and judicial endorsements would help accounting standards set by professional bodies gain enforceability.

In 1974 the American Institute of CPAs, in response to its members' need for authoritative guidance in auditing state and local governments, issued an audit guide, which was recently made consistent with NCGA *Statement 1*. The AICPA is regarded as a potent enforcer of accounting standards. Indeed, the governing council of the AICPA designates the body whose standards are Generally Accepted Accounting Principles under Rule 203 of the AICPA Code of Professional Ethics.<sup>17</sup> Since CPAs are called upon to enforce accounting standards, the auditing profession has a stake in ensuring the enforceability of those standards. It therefore participates in the current standard-setting process and in determining the future of the process.

Virtually all state and local government units receive federal financial assistance and are therefore subject to the federal government's accounting, financial reporting and audit requirements. The federal government's grant audit requirements call on grantees to prepare financial statements in conformance with GAAP. However, there remains the need to make grant disclosure requirements compatible with GAAP.

The Financial Accounting Standards Board has recently concerned itself with non-business accounting and financial reporting. The non-business sector is defined broadly to include state and local governments, but not the federal government, in deference to the statutory authority of the Comptroller General of the U.S.

It has recently deferred a final decision on whether the objectives of financial reporting by non-business organizations should apply to state and local governments, pending the resolution of the appropriate structure for setting financial accounting and reporting standards for those governments.<sup>18</sup>

The development of accounting standards in the United States has proceeded through the leadership of professional organizations of specialists in codifying preferred practices. As the tasks have become more burdensome and controversial, alternatives to volunteer part-time operations have been sought. The 21-member National Council on Governmental Accounting has had some notable achievements, but it also has had its share of difficulties. With the impetus provided by proposals to create a federal institute to set accounting standards for state and local governments, interested parties have been searching for a non-federal solution to the institutional problem. A wide range of alternative institutional arrangements has been explored. These range from having the FASB set standards for all entities in the U.S. to the creation of an independent government accounting standards board (GASB) coexisting with the FASB structure.

Each of proposals has advantages and disadvantages depending on the interested parties' institutional perspectives. The deliberations progressed to the point where the Government Accounting Standards Board Organization Committee was formed in April 1980 to prepare a report for public comment. The report will be released for public comment in early 1981, followed by a public hearing. Regardless of the Committee's recommendations and subsequent decisions, a number of institutional issues will persist:

- An accounting standard-setting framework consistent with the prevailing relations among federal, state and local governments.
- The need for cooperation among the various interested parties.
- The role of the FASB, if any, in setting standards for the public sector.
- Cooperation between the financial specialists (e.g., accountants, finance officers and auditors) and the generalists (the political leadership and top policy makers).
- The exchange of expertise and perspectives among the information professions, such as accounting, budgeting, and financial management.
- The creation of an institutional framework for users to articulate their information needs and allow greater participation in the policy-making process.

These complex institutional issues demand the attention of multiple professions, levels of government and organizations. Objectives and standards of state and local government are likely to be influenced by normative theories as well as by the interactions of the institutional forces that are both conflicting and complementary. Building and maintaining this fragile network of coalitions to promote progress in state and local government accounting and financial reporting will make for an active agenda in the 1980s.

#### NOTES

1. Current authoritative accounting and financial reporting standards are contained in *Statement I* issued in 1979 by the NCGA as a restatement of the principles of the 1968 *Governmental Accounting, Auditing, and Financial Reporting* (GAAFR). The Municipal Finance Officers Association (MFOA) published a 1980 GAAFR to provide detailed guidance to the application of *Statement I*. All of these publications are available from the MFOA, 180 N. Michigan Avenue, Chicago, Illinois, 60601.
2. American Institute of Certified Public Accountants, Committee on Terminology, *Accounting Terminology Bulletin, No. 1* (New York: AICPA, 1953), p. 3.
3. Harold Q. Langenderfer, "A Conceptual Framework for Financial Accounting," *The Journal of Accountancy* (July 1973), p. 50.
4. This debate was triggered particularly by M.E. Francis, "Accounting and the Evaluation of Social Programs: A Critical Comment," in *The Accounting Review* (April 1973), pp. 245-257. For a most recent report on this topic, see Paul K. Brace, et al., *Reporting of Service Efforts and Accomplishments* (Stamford, Conn.: FASB, November 1980).
5. For a provocative analysis, see Harvey Kapnick, "The Concept of 'Generally Accepted' Should Be Abandoned," in *Institutional Issues in Public Accounting*, Robert R. Sterling (ed.) (Lawrence, Kansas: Scholars Book Co., 1974), pp. 375-393.
6. Standard & Poor's has recently issued a policy statement endorsing governmental financial reporting in accordance with Generally Accepted Accounting Principles—NCGA *Statement I*. It would consider failure to comply with GAAP as a negative factor in its rating process. A research study recently undertaken by S & P came to the conclusion that "the market may be penalizing issuers for deficiencies in financial reporting. Poor accounting may be costing taxpayers many millions of dollars in higher interest costs." "Who's Watching the Books?" *Standard & Poor's Perspective* (November 1980).
7. AICPA, "Audit of State and Local Governmental Units" (1974), and "Accounting and Financial Reporting by Governmental Units"—an amendment to the previous audit guide, *Statement of Position 80-2* (June 30, 1980), p. 3.

8. Coopers & Lybrand and the University of Michigan, *Financial Disclosure Practices of the American Cities: A Public Report* (New York: Coopers & Lybrand, 1976); Sidney Davidson, et al., *Financial Reporting by State and Local Government Units* (Chicago: University of Chicago Graduate School of Business, 1977).
9. Comptroller of the City of New York, *Annual Report*, Fiscal Year 1979, "Foreword."
10. This idea was expressed by the AICPA Study Group on the Objectives of Financial Statements in its report in 1973, and has been affirmed by the FASB.
11. See Herbert A. Simon, "A Comparison of Organization Theories," in *Review of Economic Studies*, Vol. 20, No. 1 (1952-1953).
12. This application is based on the basic ideas proposed by C.I. Barnard, *The Function of the Executive* (Cambridge: Harvard University Press, 1938), and Herbert A. Simon, *Administrative Behavior*, 3rd ed. (New York: The Free Press, 1976), particularly Chapter VI.
13. In addition to the studies cited in note 8, refer also to William H. Holder, *A Study of Selected Concepts for Governmental Financial Accounting and Reporting* (Chicago: NCGA, 1980); John C. Burton, "Public Reporting by Governmental Units: A Revised Financial Reporting Model for Municipalities," in David Solomons (ed.), *Improving the Financial Discipline of States and Cities* (Reston, Va.: The Council of Arthur Young Professors, 1980).
14. Allan R. Drebin, "Governmental vs. Commercial Accounting: The Issues," in *Governmental Finance* (November 1979), pp. 3-8. For another interesting contrasting of viewpoints, see Robert N. Anthony, "Making Sense of Nonbusiness Accounting," and Regina E. Herzlinger and H. David Sherman, "Advantages of Fund Accounting in 'Nonprofits' " in *Harvard Business Review* (May-June 1980).
15. Arthur L. Thomas, *The Allocation Problem in Financial Accounting Theory* (Evanston, 111.: American Accounting Association, 1969).
16. These include straight-line, double declining balance and sum of years' digits, to name just three methods.
17. Rule 203 in essence requires that an AICPA member not express an opinion that financial statements are in conformity with GAAP if such statements contain any departures from the standards promulgated by the body designated by the AICPA Council to establish GAAP, except in unusual circumstances in which a heavy burden of justification and disclosure is imposed. So far only the FASB has been so designated pursuant to the above rule.
18. Financial Accounting Standards Board (FASB), *Statement of Financial Accounting Concepts* No. 4, "Objectives of Financial Reporting by Non-Business Organizations," December 1980.