

Does Full Accrual Accounting Enhance Accountability?

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Introduction

The concept of *full accrual accounting* has swept through non-business reporting over the past decade, both in governments and in non-profit organizations (NPOs). The purported advantage of using full accrual accounting is that this form of accounting enhances accountability and transparency. I believe that many people don't really understand just what 'full accrual accounting' means, and when it may or may not be an improvement over the 'bad' old traditional ways of accounting for NPOs (and governments).

The argument of this paper is that the use of full accrual accounting actually obscures operating accountability and transparency in some types of organizations. This is particularly true when the organization has either (or both) of two characteristics:

1. the funding sources do not correspond with the beneficiaries of the organization's activities, or
2. the organization is delivering *public (collective)* goods and/or services rather than *private* goods/services.

This paper will discuss these two characteristics and their significance for accounting.

The paper will then explain the major concepts that are included in 'full accrual accounting'. Full accrual accounting is not a concept in itself. Instead, it is a group of separate concepts that has developed in private enterprise accounting. These concepts make sense in private enterprise accounting because neither of the characteristics listed above are present. In businesses, (1) revenue comes from those to whom goods/services are being delivered, and (2) the goods/services are for the benefit of individuals (or other businesses) rather than for the common good.

This paper does not argue that full accrual accounting is *never* appropriate for NPOs. Indeed, for some NPOs (and governmental organizations, such as most crown corporations), business-type full accrual accounting is appropriate. The problem is that accounting standards have tended to force all NPOs into a standard form of accounting that is often considered inappropriate because it obscures accountability instead of improving it.

First, however, we will discuss the concept of *accountability* as it relates to financial reporting. This detour is necessary because accountability relates to the *objectives of financial reporting*—the base upon which all accounting practices must be founded.

Accounting and Accountability

Accountability is the current mantra both for non-profit organizations and for governments. What does this mean? There is a wide range of definitions. A few of the many definitions that can be found on the internet are:

1. Accountability has several meanings and is the subject of a broad debate in American governance. Some of the simpler definitions include: responsibility or capable of being held responsible for something; capable of being explained; being held to account, scrutinized, and being required to give an account or explanation.
en.wikipedia.org/wiki/Accountability
2. The responsibility of program managers and staff to provide evidence to stakeholders and funding agencies that a program is effective and in conformance with its coverage, service, legal, and fiscal requirements.
www.cdc.gov/tobacco/evaluation_manual/glossary.html
3. [Accountability] is the capacity to account for one's actions; or as a representative of one's organization, to account for either your actions or the actions of your organization. The term is usually used in the voluntary sector to refer to the responsibility a non-profit organization has to inform donors of the manner in which their gifts were used.
envision.ca/templates/profile.asp
4. [Accountability is] being obliged to answer for one's actions, to an authority that may impose a penalty for failure.
www.hc-sc.gc.ca/english/organandtissue/glossary/
5. [Accountability is] the principle that individuals, organizations and the community are responsible for their actions and may be required to explain them to others.
www2.warwick.ac.uk/services/archive/rm/policies/rmpolicy/glossary/
6. The obligation to demonstrate and take responsibility for performance in light of agreed expectations. There is a difference between responsibility and accountability: responsibility is the obligation to act; accountability is the obligation to answer for an action.
www.hrsdc.gc.ca/en/cs/fas/as/sds/appd_sds03.shtml

Although the context and wording of these definitions vary considerably, their overall sense is that managers are responsible for explaining their actions to outsiders, whether to funders, donors, clients, or the community at large. Definition 2, for example, states that accountability means that “a program is effective and in conformance with its coverage, service, legal, and fiscal requirements.” Of course, only the *fiscal* requirements of accountability can be fulfilled via financial reporting.

In contrast, definition 3 addresses the more specific financial reporting aspects of accountability for NPOs: “The term is usually used in the voluntary sector to refer to the responsibility a non-profit organization has *to inform donors of the manner in which their gifts were used.*” This concept of accountability is usually called *stewardship reporting* in financial accounting—i.e., “what did you do with the money I gave you?” Stewardship reporting is a crucial concept in NPO accountability, a concept that we use later in this paper.

A different concept of accountability is embodied in the Canadian accounting standard on NPO accounting. The *CICA Handbook* asserts that the purpose of the statement of operations

... provides information about the cost of the organization's service delivery activities for the period and the extent to which these expenses were financed or funded by contributions and other revenue. The information provided in the statement of operations is useful in evaluating the organization's performance during the period, including its ability to continue to provide services, and in assessing how the organization's management has discharged its stewardship responsibilities.¹

This paragraph may seem quite reasonable at first reading. However, it contains two quite different objectives of financial reporting:

1. To provide information to the financial statement reader about the cost of service delivery activities; and
2. To enable the reader to assess management’s financial stewardship.

For businesses, these two objectives do not ordinarily conflict. However, when referring to the types of NPOs that embody the two characteristics outlined in the introduction of this paper, these objectives are not mutually compatible, as will be explained later in the paper.

Relationship between Revenue Sources and Program Beneficiaries (Matching)

In business accounting, there is a clear relationship between the revenue sources and the beneficiaries of the business’s goods and services—the goods and services are sold to individuals or other businesses. The revenue comes from the customers, and the company buys goods and services exclusively in order to provide its own goods and services to those customers.

This direct relationship between inputs and outputs gives rise to the concept of *matching*. Expenses are recognized in the same period as are the revenues, so that the amount of profit can be measured reasonably. That is a crucial aspect of accountability in business organizations.²

¹ *CICA Handbook*, Section 4400, “Financial statement presentation by not-for-profit organizations,” paragraph 4400.30. Toronto: Canadian Institute of Chartered Accountants, continuously updated.

² Current thinking by the two major standard-setters (i.e., FASB and IASB) eschews the concept of matching and instead is based exclusively on revenues and expenses as deriving from changes in assets and liabilities. Nevertheless, the implied net result is to achieve matching, although the wording has changed.

If an NPO is providing direct services to its members, then it makes sense to use the same concept in the organization's accounting. This is known as a *club* in economic terms.³

Private Goods vs. Public Goods

A 'private good' is a product or service that is used or enjoyed by individual consumers. Examples of organizations that provide private goods are non-profit electric generating companies, tennis clubs, cooperative associations, faculty clubs, homeless shelters, and health treatment centres. Private goods are those that benefit individuals rather than groups and are considered to have a limited supply; those who benefit from the goods or service will prevent others from benefiting because the resource is limited (e.g., beds in a hostel for the homeless).⁴

In contrast, a 'public good' (also known as a *collective* good) is one that benefits society or groups as a whole, without a limit on supply. For example, a group that campaigns against drinking and driving is trying to improve society for the common good, rather than to provide benefits to specific individuals.

Some NPOs provide both private and public goods. A health treatment centre, for example, may provide direct health care to patients (private goods) and also conduct public health education campaigns (e.g., non-smoking or cancer detection—public goods). Symphony orchestras provide another example because they often provide private goods in the form of concerts as well as public goods through music-for-children and other outreach and educational programs.

Concepts Underlying Full Accrual Accounting

'Full accrual accounting' is an amalgam of several accounting concepts. The major components are *accrual*, *expense basis*, and *interperiod allocation*.

Accrual Accounting

Cash-basis accounting recognizes (or records) transactions and events only when cash is received or paid—*receipts* and *disbursements*. It is safe to say that everyone (except manipulative managers) agrees that cash-basis accounting is inadequate for all but the tiniest organizations. The cash-basis enables managers to hide the true results of operations and the true financial position of the organization by manipulating the cash flow. Liabilities are hidden from view on the financial statements, as are receivables and other assets.

³ Haim Falk discussed this concept extensively in his paper, "Towards a framework for not-for-profit accounting", *Contemporary Accounting Research* 8:2 (Spring 1992).

⁴ T. H. Beechy and B. J. Zimmerman, "Putting the cart before the horse: Accounting standards for NPOs without a conceptual framework." *The Philanthropist* XI:3 (Fall 1992), p. 36.

The alternative to cash-basis accounting is accrual-basis accounting. The problem with cash-basis is that assets and liabilities are not recorded and thus are hidden from outsiders, however, accrual-basis recognizes liabilities when the obligation arises (e.g., amounts owed for goods or services received but not yet paid for) and recognizes financial assets when the organization has the right to receive them (e.g., amounts receivable for goods delivered or services performed). Note that *accrual* pertains to the recognition of assets and liabilities, *not* to revenues and expenses. Revenue and expense recognition is a different issue. When an asset is received (such as inventory items) but not yet paid for, an ‘account payable’ is accrued and the liability is recorded on the balance sheet. The nature of a balance sheet is that it must *balance*. If a liability is recorded, there must be an offsetting effect. Therefore, a second question arises: is the unpaid cost of the inventory an *expenditure*, an *expense*, or an *asset*?⁵

Expense Recognition

Once a liability has been accrued, the offsetting amount must be recorded. In business accounting, there are only two alternatives—*expense* or *asset*. In non-business organizations, however, there is a third alternative: *expenditure*. The distinction between an expense basis of accounting and an expenditure basis is fairly subtle but very important for NPOs and governments:

- *Expenditure basis*: outflows are recognized when liabilities are incurred (i.e., accrual basis) or cash is paid out. An expenditure is “a disbursement, a liability incurred, or the transfer of property for the purpose of obtaining goods or services.”⁶
- *Expense basis*: outflows are recognized when acquired goods and services are *used* or *consumed* in operations. Prior to recognition as an expense, the outflows are recognized as assets. The expense basis arises from the concept of *matching*, as described above.

A purchase of supplies provides a simple example. When supplies are received, the liability for the amount owing to the vendor is accrued. Using an *expenditure* basis, the cost of the supplies is immediately recorded on the statement of operations as an expenditure. Under the *expense* basis, the supplies will be shown as an asset on the balance sheet and transferred from the balance sheet to the statement of operations only when the supplies are used.

When the expenditure basis is used, the statement of operations shows the amount of cash (or other assets) that has been paid (disbursed) or is committed to be paid (accrued). Traditional NPO accounting used an accrual-basis expenditure approach. An expenditure basis was used so

⁵ There is a lot of confusion about this point. The source of the problem is that many introductory accounting textbooks, for the sake of simplicity, define accrual accounting as a process of “recognizing revenue when earned and expenses when incurred.” The implication is that once a liability has been *incurred*, the offset must be an expense. This clearly is incorrect.

⁶ *Terminology for Accountants, Fourth Edition*. Toronto: Canadian Institute of Chartered Accountants, 1992.

that donor could see how the organization's managers used the resources donated or granted during the year.

With an expense basis, many costs are "stored" on the balance sheet until the underlying good or service is used, and only then is the cost transferred or *allocated* to the statement of operations. Expenditures on goods and services that are not used in the period of purchase are recorded as assets on the balance sheet instead of as expenditures on the statement of operations. This includes expenditures for unused inventory and prepaid expenses as well as long-lived assets such as buildings, office equipment, and automobiles.

A widespread misconception is that expenditure accounting does not permit the recognition of assets because everything expended was written off immediately. However, there are methods for recording assets within the framework of traditional expenditure-based fund accounting. The use of expenditure accounting does not mean that all assets disappear from view and therefore from accountability.

Interperiod Allocations

Expense accounting always requires allocations. An allocation is the process of moving a recorded cost from the balance sheet to the statement of operations. This is known as *interperiod allocation*, which can be a very problematic issue in accounting. The complexities and assumptions underlying interperiod allocation are not obvious to a non-accountant.

For example, the expense basis requires that the cost of inventory be moved from the balance sheet to the statement of operations when the inventory items are used. But what cost is transferred? If there are many identical items in inventory, they probably have been purchased at different costs. The process by which inventory costs are moved routinely to expense is known as the *cost flow assumption*, which interacts with the type of *inventory system* in use. Different assumptions and systems will allocate different amounts of cost each period.

Inventory is a fairly simple allocation process. Indeed, allocations for goods and services that will be used up in the next year are usually reasonably transparent and are relatively free from estimates.

The real problem arises from *interperiod allocations* over a long timeframe. The best-known interperiod allocation process is *depreciation* (also called *amortization*).⁷ Part of the cost of a

⁷ Confusion tends to reign around the terms *amortization* and *depreciation*. *Amortization* is the general term used for all types of "rational and systematic" multi-period cost allocations. *Depreciation* is a term that is used only for tangible assets such as buildings and equipment. *Depletion* is used for natural resources. *Amortization* is used for all other long-lived assets, such as intangible assets. However, *amortization* can be used for any such allocation, including tangible assets and natural resources, rather than using *depreciation* and *depletion*.

long-term tangible asset (e.g., equipment) is transferred to the statement of operations each accounting period. The allocation is based both on accounting policy choices and on a series of estimates including the asset's estimated useful life and its final residual value. The accounting policy choice is that of the method of amortization to use, of which the most common are straight-line and double-declining balance. The choice of method is essentially arbitrary; amortization is required only to be 'rational and systematic'.⁸

Interperiod allocations are a big step away from expenditure accounting. The problem with using interperiod allocations in government and NPO accounting was clearly captured almost three decades ago by the Municipal Finance Officers Association:

Unfortunately, the terms "accrual" and "accrual accounting" often are interpreted to mean "income determination accounting" and thus to connote the recognition of depreciation in the course of expense measurement. This misunderstanding likely has arisen because most accounting literature centers on income determination and uses the terms "accrual" and "accrual accounting" in that context. It should be recognized, however, that depreciation and amortization are *allocations*, not accruals, and that "accrual" in a government fund accounting context does not mean that depreciation, amortization and similar allocations should be recognized.⁹

When interperiod allocations are used, the operating statement no longer shows the relationship between resources donated and resources used. The cash flow statement does not do that either, because the cash flow statement is only cash and not accrual; committed expenditures do not show on the cash flow statement.

Interperiod allocations pertaining to tangible assets such as buildings and equipment are fairly easy to understand and are moderately transparent. However, interperiod allocations are involved in many other less obvious ways. Perhaps the most opaque expense allocation in NPOs is for pension expense.¹⁰ Pension expense contains multiple interperiod allocations as well as multiple underlying estimates and assumptions. Under expense-basis reporting under Canada, USA, and IASB GAAP, there is no relationship between pension expense and pension funding.

Summary of Full Accrual Accounting Concepts

Full accrual accounting combines all three of the concepts discussed above: (1) accrual-basis, (2)

⁸ *CICA Handbook* 4430.16. The arbitrariness of interperiod allocations was proven by Arthur Thomas in two American Accounting Association research monographs many years ago: *The Allocation Problem in Financial Accounting Theory* (1969), and *The Allocation Problem: Part Two* (1974). His proof has been vigorously argued against but never disproved.

⁹ National Council on Governmental Accounting, *Statement 1: Governmental Accounting and Reporting Principles*. Chicago: Municipal Finance Officers Association, 1979, p. 12.

¹⁰ NPOs are spared the business corporations' most pathological form of allocations: *interperiod income tax allocation*. This is a second-order allocation that is based on allocations of many other revenue and expense items.

expense-basis, and (3) multiple interperiod allocations. Technically, interperiod allocation is a part of expense-basis reporting. However, the extent of interperiod allocation can, in practice, be modified or limited within the context of expense-basis reporting. Therefore, I have listed these as three distinct concepts.

Implications for Financial Reporting by NPOs

What does all this have to do with the financial reporting of non-profit organizations? For the answer to this question, we must return to the two concepts discussed earlier this paper:

- Beneficiaries vs. revenue providers
- Private vs. public goods and services

Obviously, there are at least four possible combinations of these characteristics. First, let's consider the two extremes.

NPOs Providing Private Goods and Services

A tennis club collects dues from its members. The members are the sole beneficiaries of the club's services. Members use the facilities as part of their basic memberships, and then they pay for additional services such as meals, drinks, tennis clothing, and professional training. There is total consonance between the revenue providers and the service beneficiaries. The members are entitled to know what their dues are used for, and they also are entitled to know what it costs the club to provide the various services. Expenditures are likely to be quite "lumpy"—major building repairs or court resurfacing will occur only occasionally. The dues normally are expected to cover these occasional but normal expenditures. The statement of operations therefore should provide "information about the cost of the organization's service delivery activities for the period and the extent to which these expenses were financed or funded by contributions and other revenue."¹¹

For such an organization, accrual, expense-basis, allocation-basis accounting is appropriate. In other words, full accrual accounting. Costs should be recognized in the statement of operations when the benefits of those costs are realized rather than when the costs are incurred. The cost of long-term facilities should be amortized so that the club management does not spend all of the members' dues without recognizing the necessity to provide for replacement or renewal of the club's assets.

Open (non-club) NPOs Providing Public (collective) Goods

At the other extreme, we have NPOs that are open to anyone who wish to provide resources and to become members. To differentiate them from club-type organizations, this type of NPO is often called a non-club. By definition, collective goods have no private beneficiaries; therefore,

¹¹ *CICA Handbook* 4400.30.

there is no correspondence between the sources of revenue and the beneficiaries of the collective goods.¹² Revenue is provided by government and foundation grants and by individual and corporate donations.

An example is an environmental protection agency that strives to (1) warn the public of the dangers of environmental degradation, (2) pursue legal action against specific heavy polluters, and (3) influence legislation. In this case, the NPO provides no private goods, rather only public goods. The beneficiary is society in general, and there is no limit to the number of people who can benefit from an improved environment. The beneficiaries of the NPO's activities are independent from the sources of funding.

The CICA's primary NPO reporting objective—to provide “information about the cost of the organization's service delivery activities”—implicitly recognizes that an NPO may have no measurable output results by using the phrase “service delivery activities” instead of “outputs” or products. The question is whether the cost of services should be the primary financial reporting objective?

When an NPO is providing public goods, there is no measurable output, and therefore costs cannot be related directly to observable outputs as they can for private goods (and for business enterprises). Only inputs can be measured, such as advertising cost, payroll cost, supplies cost, and so forth. Granted, it may be feasible to track expenses by activity objective—e.g., (1) public education, (2) legal initiatives, and (3) legislative efforts. However, in the absence of measurable outputs, what purpose is served by using an expense-basis and by allocating costs between periods? This is where the matching concept might, on the surface, seem reasonable. However, note that this is a matching of revenue and *expense*. I would argue that the most common concern of donors to public service NPOs is how the NPO spent the money given during the year: matching revenue with *expenditures*. The expense-basis of reporting breaks the stewardship responsibility for reporting on how donations were used during the period—the expenditure basis.

If this expense-expenditure distinction seems insignificant, look at the following financial statement footnote from a social service agency:

Accounting for vacation pay

In accordance with generally accepted accounting principles, the Centre uses the accrual basis of accounting for vacation pay. As a result, the deficit in the Operating Fund amounts to \$209,297 at fiscal year-end, of which \$199,568 relates to the accrual for vacation pay. In accordance with the Ministry's funding policy, vacation pay is funded on a cash basis and therefore the funding related to this liability has not been reflected in these financial statements.

¹² Public/collective goods cannot be equated with government funding as the beneficiary-provided revenue source because the government is not the beneficiary unless the purpose of the NPO is to improve government efficiency.

In other words, the *expense* for vacation pay was \$199,568 higher than the *expenditure* for vacation pay. The actual vacation pay expenditure *was* fully funded by the granting Ministry. When other vacation pay is expended in future years, the Ministry will fund that amount also. The GAAP (Generally Accepted Accounting Principle) considering accrual of vacation pay is based on an irrelevant concept for this agency, and uses an expense basis instead of an expenditure basis which results in less transparent accountability. The reported results are patently misleading.

The vacation pay example demonstrates the general problem with emphasizing cost allocations for public goods. However, the really major issue arises with interperiod allocations for long-lived assets: amortization.

Full accrual accounting requires that the cost of assets be allocated to the accounting periods in which those assets are used. Interperiod allocation means that:

- software purchased for the bookkeeping functions of an NPO must be capitalized and amortized—it cannot be matched to the revenue sources that paid for it;
- buildings must be capitalized and amortized to expense, *even if operating funds cannot be used to cover the cost of buildings*;
- a long-term lease must be accounted for as though the asset was purchased instead of leased—the expenses reported on the operating statement will have no correspondence to the amount actually paid to the lessor in the period, even though the funding requirements are tied to the amount of cash needed for the period;
- pension expense must be reported on the arcane basis required by GAAP, while expenditure-basis pension funding will be on an actuarially-sound basis that has only a vague relationship with pension expense.

These are just a few examples of how the expense basis differs from an expenditure basis. Government grants and other donations are given to fund the NPO's operations in the current period. The expense basis obscures the stewardship reporting function: "what did you do with the money I gave you?" A healthy organization can end up running a large deficit due to the disconnect between expense and expenditure. Financial statement readers are therefore misled about the financial position and accountability of the organization.

At the beginning of this paper, I quoted some definitions of accountability. The definitions (in the same numerical order) include these aspects:

1. being held to account, scrutinized, and being required to give an account or explanation.
2. provide evidence to stakeholders and funding agencies ... in conformance with ... fiscal requirements.

3. inform donors of the manner in which their gifts were used.
4. being obliged to answer for one's actions.
5. responsible for their actions and ... required to explain them to others.
6. demonstrate ... performance in light of agreed expectations.

Each of these definitions indicates that the organization (and its management) must use a reporting framework that permits outside stakeholders to evaluate the extent to which the funders' expectations were met. Financial statements that obscure or obfuscate the true fiduciary performance of the organization are a disservice to both the funders and to the organization itself. Thus, for NPOs providing public (collective) goods, full accrual accounting is the wrong approach.

Mixed Organizations

Many NPOs cannot be classified unambiguously into either of the two categories of club or non-club. Almost all NPOs provide some type of private good, even if it is only a fundraising dinner or a charity auction. Other organizations are more extensively involved in delivering private goods and services. For example:

- a health agency offers direct support to individuals and families (private good) while also working for public education (public good);
- a community centre has outreach programs for troubled youth (private good), education services for new immigrants (private good); and public campaigns for tolerance and understanding of people from different national, ethnic, and religious backgrounds (public good).
- a university maintains student housing (private good) and a bookstore (private good) while also supporting research that benefits society at large (public good).

What kind of accounting should be used in mixed organizations? GAAP generally assumes that one organization should use one type of accounting for all of an organization's activities—full accrual accounting for the organization as a whole.

There is one type of activity that clearly should be reported on an expense basis. These are activities in which a fee is charged that is expected to cover the cost of providing the services. These are *cost-recovery* activities. The revenue is tied to the cost of providing services or, in reverse; the cost is constrained by the level of revenue. Note that the revenue does not necessarily need to be provided by the beneficiary (user) of the services. A city may support a homeless shelter on a per-bed basis or a health agency may provide services that are funded on a

per-patient basis by the provincial or state government. The key is not whether the beneficiary pays for the service, but rather whether the revenue is intended to cover the cost of service.

In a cost-recovery activity, it is important to account on an expense basis—the costs must be recognized in the same period as the relevant revenues in order to assess the ability of the organization to control the costs or to generate sufficient revenue. An expenditure basis of reporting does not achieve revenue-cost matching and also can tempt management to manipulate the reported operating results.

Although an expense basis is appropriate for cost-recovery programs, elaborate multi-period allocations (e.g., amortization, pension costs) may not be appropriate. If facilities are dedicated to the specific use of a cost-recovery program, then it may be logical to allocate part of that cost to the activity itself. But how are the facilities funded? If the facilities are financed by restricted capital grants or through special fund-raising campaigns, it is unreasonable to charge amortization on those facilities to the program. The fee-per-client is not intended to cover the cost of physical facilities; charging amortization to the program will put the program into a permanent deficit position on its operating statement.

Not all private-goods programs are cost-recovery programs. An organization may charge a small fee to the beneficiary in order to discourage frivolous use. The fee may not be related to the cost of supplying services; the service is financed through general fundraising and grants, in which case the program is not cost-recovery in an accounting sense.

In a mixed-program NPO that has cost-recovery programs providing private goods or services, an expense basis should be used for those programs. For programs providing public goods, the expenditure basis is appropriate. The implication of using two different bases of accounting is that the revenues and expenses cannot meaningfully be combined on the operating statement. Different operating statements need to be provided for each general type of activity. GAAP, on the other hand, requires that all activities be reported in a single set of financial statements:

- For each financial statement item, the statement of financial position should present a total that includes all funds reported. [CICA 4400.18]
- ...the total for all funds related to each financial statement item presented in the statement of operations would be reported together with the total excess of revenues over expenses for all funds. [CICA 4400.34]

Canadian GAAP does permit columnar reporting, wherein each major type of program activity is reported in a separate column and then combined in a total column. Columnar reporting can certainly improve accountability and transparency, but the requirement for a total column is disturbing. The total suggests quite clearly that resources are interchangeable. Labour unions

have been known to argue for pay increases on the basis of the total column—“obviously you have enough money to pay significant salary increases.”

On the other hand, columnar reporting is not *required*; only the total column is required. This can tempt managers to conceal the true status of an NPO’s operating fund by showing only totals that include amounts from restricted funds (e.g., endowment funds) that cannot be used for general operations. An organization may look quite healthy when everything is combined and yet be in dire shortage of general operating funds.

Summary and Conclusions

The preceding discussion has been rather complex because it combines three threads of thought:

1. the nature and components of *full accrual accounting*;
2. the relationship between revenue sources and the costs of delivering goods and services; and
3. the distinction between private goods and public (collective) goods.

Full accrual accounting is not a single concept; it is an amalgam of several accounting concepts and practices, including (1) accrual accounting, (2) expense recognition, and (3) interperiod allocation. Every organization should use accrual accounting, but the applicability of the other two concepts depends on the nature of the organization.

Many NPOs provide private goods and services. Private goods are those that can be enjoyed by only a limited number of beneficiaries; their use by some individuals makes them unavailable to others once the supply is used up. Private goods have a determinable output, and therefore a measurable cost.

Often, an NPO that provides private goods and services gets its revenue from one or both of two sources: (1) general revenues contributed by dues or other membership fees, and/or (2) user fees charged for the private goods it delivers. User fees can be paid by either the user or by someone else on the user’s behalf (e.g., by a government unit or by an insurance company). No matter how the fees are paid, they are intended to cover the full cost of providing the services. Therefore, in these situations the expense basis is appropriate.

However, the extent of application of the expense basis is variable. The most important issue is whether the “cost of service” should include an allocation of the cost of physical facilities—i.e., amortization or depreciation. To answer that question, it is necessary to look at how the physical facilities are financed. If, indeed, the NPO must generate enough revenue to cover both the cost of current operations and the cost of the physical facilities, then interperiod allocation of the cost of long-term assets is appropriate.

On the other hand, if the physical facilities are separately financed by special restricted grants by governments, senior organizations, foundations, or other donors, it is not reasonable to charge depreciation to current operations. If depreciation is charged to current operations when the current revenue is not intended to cover the cost of the facilities, the result will be to force the organization into a regular deficit position on each year's statement of operations. It will look as though management is not doing a proper job, and that user fees or other sources of operating revenue must be increased.¹³

For example, a university almost never finances its buildings out of operating funds. Indeed, many jurisdictions specifically prohibit using government operating grants for building projects. If the government is not financing the building, then the funds are raised specifically for the project. It does not benefit accountability or transparency to charge depreciation when the revenue is not intended to pay for those assets.

In contrast, public goods and services (more properly called *collective* goods and services) are available to all potential beneficiaries without rationing, including society at large. Public goods have no directly measurable outputs, only inputs. Therefore, it is not possible to measure the cost of the output, only the costs of the inputs. Accountability consists of showing how the resources were used to pay for the inputs. An expenditure basis of reporting satisfies the dominant financial reporting objective of *stewardship* and thus is the most meaningful way to report the operating results of NPOs that provide public/collective goods.

Finally, what about mixed-type NPOs? For private goods and services that are intended to recover their costs, expense-basis accounting is clearly appropriate. Whether or not depreciation should be charged to that activity depends on where the resources come from and whether the private-goods activity is expected to share a proportion of facilities cost.

For public/collective goods and services, an expenditure basis is preferable for accountability and transparency. When financial statements are prepared for a mixed-type NPO, the results should be reported separately for activities involving private goods and public goods. If resources are interchangeable, then results can be combined in a total column. If resources are restricted to specific programs, a "total" column is illogical and can be quite misleading.

Exhibit 1 attempts to capture these various alternatives.¹⁴ It may look rather intimidating because of the many options, the point is, however, that non-profit organizations operate in

¹³ Canadian accounting standards permit depreciation/amortization to be charged elsewhere on the financial statements under certain circumstances [*CICA Handbook* 4430.22]; charging against operations is not always required.

¹⁴ An alternative matrix form of presentation has been used in previous discussions. See Beechy and Zimmerman, "Costs and the Collective Good", *CA Magazine*, November 1992, pp. 44-49.

different ways than businesses do. Profit-oriented businesses are consistent in their basic operations: (1) they exist to make a profit, (2) they deliver only private goods and services, (3) their expenses derive directly from their efforts to earn those revenues, and (4) the beneficiaries of the private goods and services are identical to those that provide the revenue.

NPOs are more complex and cover a wider range of activities than businesses. Accounting standard-setters have insisted on imposing accounting for businesses on NPOs as well, even though the fit would be awkward at best, and would often be damaging to the organization’s management or to the users of the financial statements, or both. Imposing an expense-basis interperiod allocation approach ignores the wide variation among NPOs. The fact is that most accountants do not understand NPOs and therefore do not understand that the financial statement users’ needs are *not* identical to those of business enterprises.

As a U.S. Secretary of Defense once said, “If it’s good for General Motors, it’s good for the country.” By extension, if full accrual accounting is good for businesses, it’s good for NPOs and governments. NOT!

EXHIBIT 1
Financial Accounting by Type of NPO and
Type of Goods and Services

Nature of Organization and types of goods and services delivered	Accrue receivables and payables	Expense basis	Depreciation/ amortization
1. Delivering private G&S only:			
a. Fees recover costs; revenue sources = beneficiaries	√	√	√
b. Externally subsidized; revenue sources ≠ beneficiaries	√		
2. Delivering public/collective G&S only	√		
3. Delivering both private and public G&S:			
a. Private G&S, cost-recovery basis; physical facilities paid by the program	√	√	√
b. Private G&S, cost-recovery basis; physical facilities financed separately	√	√	

	c. All other programs	√		
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About the Author

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