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Nonsophisticated Users of Local Government
Financial Reports

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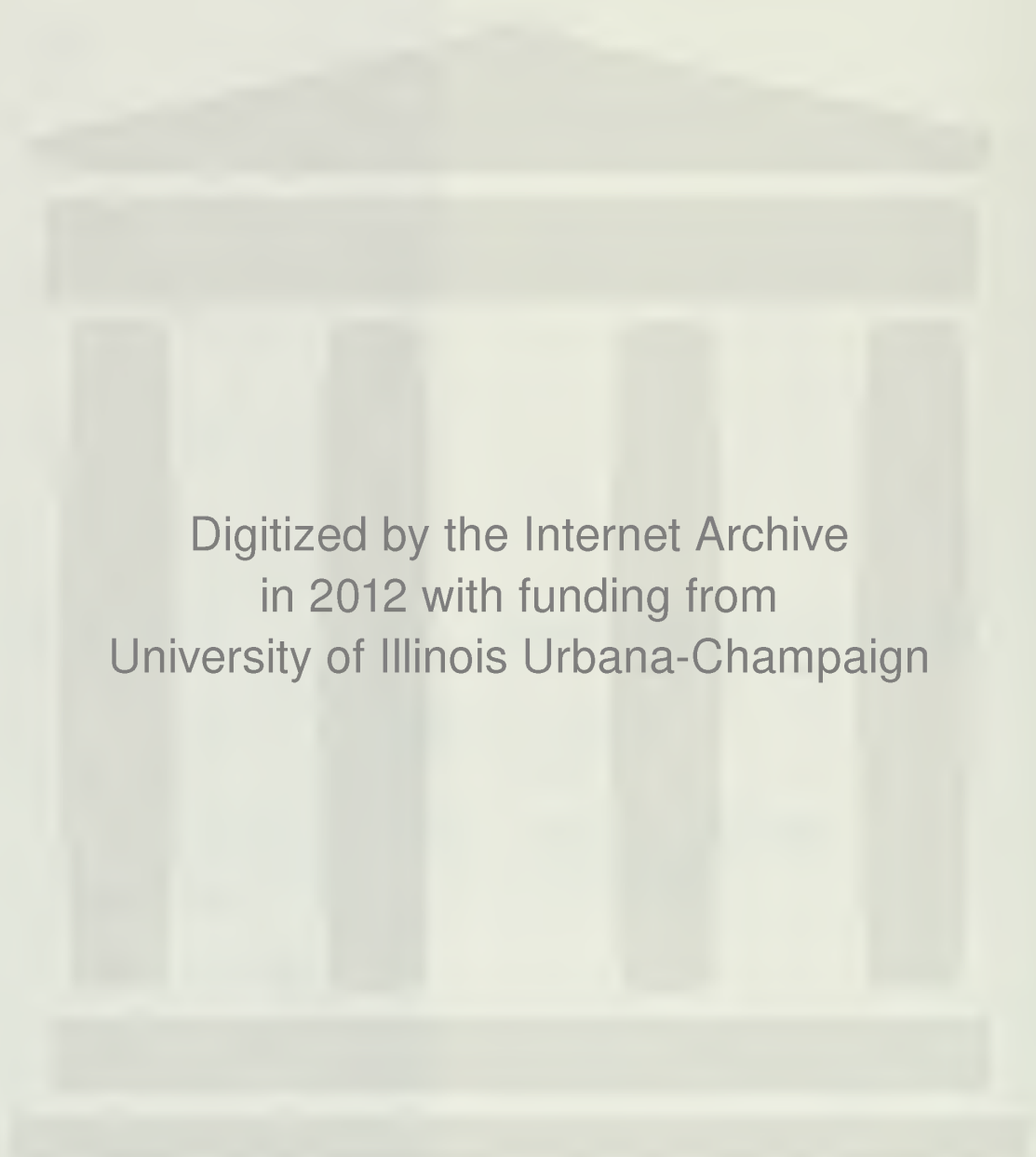
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November 1986

Alternative Reporting Formats: A Focus on Nonsophisticated
Users of Local Government Financial Reports

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ALTERNATIVE REPORTING FORMATS:
A FOCUS ON NONSOPHISTICATED USERS OF LOCAL GOVERNMENT FINANCIAL REPORTS

Abstract

The purpose of this paper is to stimulate discussion of the manner in which the accounting profession can serve the needs of nonsophisticated users -- decision makers outside of government management who have a vested interest in government financial affairs, but who cannot be expected to have training or experience required to analyze financial reports as currently presented. Ideally, the annual financial report should provide information relevant to the decisions nonsophisticated users make about government finances. Realistically, however, government financial reports may be underutilized because decision makers do not understand them. We investigate the need to devise a financial report understandable to nonsophisticated users and suggest some broad guidelines for establishing the objectives, content, and format of an abbreviated report directed toward this group.

ALTERNATIVE REPORTING FORMATS:
A FOCUS ON NONSOPHISTICATED USERS OF LOCAL GOVERNMENT FINANCIAL REPORTS

Ideally, the annual financial report should serve as a primary source of information supporting decisions about government finances. Realistically, however, government financial reports may be underutilized because decision makers do not understand them. The notion that government accounting techniques greatly limit the usefulness of financial reports has been popular for several decades.¹ Just recently, the Wall Street Journal (Murray, 1986) reported the now-familiar story that antiquated accounting and reporting methods make it a wonder that governments can function at all. Equally familiar and popular is the suggestion that the understandability and usability of government financial information would be enhanced immeasurably if the public sector would conform to private sector accounting methods.² An assumption implicit in such discussion is that the users of government financial reports are relatively sophisticated and knowledgeable in the use of government accounting information. Resolution of the current major technical controversies in government accounting would do little to reduce the high level of sophistication required for routine use of government financial reports.

This paper extends discussion of the understandability of government reports to consider the needs of "nonsophisticated users", decision makers who have a vested interest in government financial affairs but who lack the training or experience necessary to use reports prepared in accordance with current GAAP. This set of users is significant both in numbers and in terms of the capacity in which they must deal with information. It may include elected and appointed community leaders, representatives of community interest groups, local employee union representatives, and individual voters. Theoretical and

practical support for developing a standardized, abbreviated financial report directed toward these nonsophisticated users is presented in the next section of the paper. This is followed by a discussion of factors requiring consideration in developing a model for communication of financial information to nonsophisticated users. Finally, we outline suggestions for additional research.

Understandability: Accountants' Responsibility or Users' Burden?

Obviously, financial reporting cannot facilitate decision making if decision makers do not understand the information presented in the financial reports. On a theoretical level, the accounting profession generally has acknowledged the obligation to provide financial information in a manner understandable to the least sophisticated users.³ Some have even suggested that meeting the understandability criterion may require multiple financial reporting formats, each consistent with the level of financial training and experience possessed by a particular group of potential users (e.g., Staubus, 1976, p. 280).

In practice, however, the burden of understanding financial statements has rested with the users of such reports. Although the GASB (1986, para. 40) acknowledges that the general purpose financial report may not meet the needs of nonsophisticated investors, standard setting bodies historically have done little to enhance financial report understandability. Instead, the increasing complexity of financial reports reflects the increasing complexity of both the activities reported in, and many of the decisions based on, government financial information.

Standard setters may be justified in focusing their attention on the needs of sophisticated users if the needs of nonsophisticated users are being

met indirectly through intermediaries rather than directly from the financial statements. The model on information flows presented in Figure 1 from the joint U.S./Canadian Federal Government Reporting Study (FGRS) completed in 1986 supports this view. This study finds that, in general, nonsophisticated groups do not use federal government financial reports. Instead, citizens, corporate managements, and even legislators and other government planners rely on the reports and commentaries from media and analysts who do use government financial reports (p. 5):

[The media and analysts] are the most frequent direct users of federal government financial reports, the major source of information about the [federal] government for citizens and corporations, and an important source of information for legislators. ...the media and analysts are the users best able to define clearly the nature of the financial information about [the federal] government that they need and the characteristics that such information should have to suit their needs best. (pp. 5-6)

 Insert Figure 1 here

Although an intermediary system may ensure that understandable information about the federal government is available for anyone interested in using it, several factors indicate that media and analysts are less likely to act as evaluators and disseminators of financial information at the local level. First, intermediaries are less likely to exist at the local reporting level. The Statistical Abstract of the United States: 1986 states that there were over 82,000 local government units in 1982. These units included approximately 28,000 special districts, 19,000 municipalities, 17,000 townships, 14,000 school districts, and 3,000 counties. In 1983, over 97% of the 19,000 U.S. cities had populations of less than 50,000. Over half the counties represented populations of less than 25,000. The sheer number of

units, in conjunction with the small, overlapping constituencies, indicates the small likelihood that knowledgeable intermediaries regularly review and interpret the financial reports of a significant number of these governments for other interested decision makers. Also, relatively few local units come under the scrutiny of professional financial analysts as a result of public bond issues. Finally, the part-time elected or appointed officials who administer many of the smaller governments have little time to extend their expertise in the use and translation of government financial information.

Some user groups do have intermediaries to act on their behalf. Even in these instances, however, the intermediaries are not as specialized as described in the FGRS findings. At a recent symposium on governmental accounting research, two such groups were discussed. A recent survey of teacher union representatives (Ward, 1985) indicated that local union officials who participate in contract negotiations are largely unable to glean the data from local school board financial statements that would be useful in negotiations. This finding is consistent with union officials being drawn from the populations they represent: their expertise is in their area of employment, which does not generally include the training necessary to analyze complex financial reports. Thus, the groups represented by these intermediaries may fail to benefit fully from the information in government financial reports. A "good government" citizens organization representative who prepares summary reports for public distribution also described the difficulties she faces in culling information that is presumably available in state and municipal financial statements (Green, 1985). She described it as a process requiring several iterations of personally checking with government officials to see if the information has been correctly interpreted. In this instance, the

intermediary is not acting as an interpreter of information found in the financial reports, but must rely on the interpretation of the report issuers.

These specific cases illustrate the need to focus on the information needs of nonsophisticated users of government financial statements. Many of these users are citizens obligated by law to contribute taxes to the operation of government and are concerned with the proper use of those funds or with the future requirements for funds. They may be employees whose livelihood is tied to the financial future of the government. The lack of understandability of government financial reports to nonsophisticated users is inconsistent with the general recognition that citizens, taxpayers, voters, and other nonsophisticated groups be well-informed (NCGA, Vol. II, Ch. 4). It is also inconsistent with the GASB's proposed objective that "[f]inancial reporting should provide a means of demonstrating accountability to the citizenry and should enable the citizenry to assess that accountability" (1986, para. 52). Finally, it would seem that the spirit of "freedom of information" laws requires that the information provided be understandable whenever possible.

Many individual government units have stepped in to fill nonsophisticated users' need for financial information. Peyer and Lonergan (1976) and Glick (forthcoming) note that reporting financial and operating information to nonsophisticated users outside the traditional comprehensive financial report is an extensive and long-standing practice. However, because these reports are issued outside the traditional accounting model, the fairness and completeness of the picture presented by the information is open to question, and there is no consistency across reporting units. Thus, the involvement of the accounting profession is necessary to standardize reports and to ensure that they meet generally accepted criteria for financial reporting. The objective of the accounting profession's developing such a report is to ensure that the

supplementary report provides a complete and fair representation of government finances, consistent across reporting units, and subject to the same independent confirmation as the comprehensive financial report. In the next section, we suggest an approach for developing an abbreviated, supplementary accounting report understandable to nonsophisticated users.

An Abbreviated Financial Report for Nonsophisticated Users

For the accounting profession to develop an abbreviated report useful to nonsophisticated users, three factors require consideration. To what kinds of decisions will the report contribute? What financial information should the report contain? How should the report be presented? Each of these three questions is addressed below.

Report Objective

The generally accepted objective of financial reports is the communication of economic information relevant for the decisions made by report users. Unfortunately, there is no empirically based taxonomy of the judgments nonsophisticated individuals make, the kinds of judgments nonsophisticated individuals would make given the requisite information, or the information needs of nonsophisticated individuals. Several public sector studies theorize the types of decisions potential users should be making (for example, NCGA, 1981), while other studies report information needs suggested by user surveys (see GASB, 1985 for a review). However, these studies have not differentiated between sophisticated and nonsophisticated users, and they have not differentiated among types of decisions in terms of their relative importance or frequency. An additional limitation of surveys, as noted by GASB (1985, pp. 25-26), is the inability of individuals who are not current users to

articulate their information needs or to envision the information that could be useful for some decision. As a result, these studies are most likely to confirm the usefulness of currently reported information and, perhaps, to identify additional perceived needs of sophisticated users. They are unlikely to identify needs for summarization or simplification of information for the nonsophisticated user.

An alternative approach to determining nonsophisticated decision makers' information needs is to focus initially on the most general judgments made by all report users. The initial objective would be an abbreviated financial report that facilitates nonsophisticated users' attainment of a basic understanding of governmental finances. Examples of specific decisions involved in formulating a broad picture of government financial affairs include an assessment of the unit's financial position; a judgment as to whether that position is getting better or worse; a determination of whether operations are expanding or contracting; and a determination of whether the unit is in compliance with budgetary and other financial restrictions. Meeting this fundamental objective will provide a foundation for exploring the more specific decisions and information needs of specific groups.

Report Content

Ideally, the optimal content of an abbreviated financial report would meet the information needs of the maximum number of specific user groups. An approach parallel to determining decision needs common to all users, as suggested in the previous section, is to seek a relatively small information set from which nonsophisticated users can gain an understanding of government finances. Initially, then, the primary need is to establish a "core" of information from which nonsophisticated users can derive a basic understanding of government finances. This core can then be used as a foundation for

exploring the extent to which the report information can be altered to meet more specific decision needs without seriously impairing nonsophisticated users' understanding of an entity's finances.

The data already generated by the accounting systems of governmental units reporting in accordance with GAAP provides a reasonable starting point for investigating appropriate report content. Use of this data set is consistent with findings that many government units have difficulty accumulating the data prescribed by GAAP, much less accumulating additional data (see, for example, Coopers & Lybrand, 1978). Recasting currently available information presents a practicable alternative for serving the nonsophisticated user as well as the sophisticated user.

As discussed below, several sources in the literature suggest that a limited information set within GAAP accounting records may facilitate a general understanding of an entity's finances by the least sophisticated decision maker. This information set consists of comparative operating statements for the major funds, a statement of municipal debt, and a comparison of actual operating results with the original budget. Although this information set is much smaller than suggested elsewhere (see, for example, GASB [1985] and user need surveys cited therein), the discussion below indicates that it may provide a sufficient basis for assessing accountability, the current state of government finances, and the direction of changes in financial condition.

Wall (1963, pp. 30-31) suggests limiting the number of operating statements presented in order to highlight the major entity activities required for a general overview, while excluding information necessary only for more detailed analyses. For many entities, the general fund may be the only fund for which an operating statement is presented. Wall (p. 31) and the FGRS (1986, p. 12) suggest that presentation of financial statements on a

comparative basis over a relatively long time period would facilitate trend analysis.

Wall (1963, pp. 30-31) also suggests a single statement of municipal debt, which would summarize debt information scattered throughout various funds and supplemental schedules in the Comprehensive Annual Financial Report. Included in this statement would be the aggregate amount and detail of the debts, their payment schedules and interest rates, any call provisions and restrictive covenants, assets pledged, and debt ceilings. This statement would thus provide a clear illustration of total debt and proximity to debt limits. Another useful element of this statement would be management's assurance that the unit complied with debt restrictions or an explanation of failures to comply. The combined information should signal possible overcommitment and help the nonsophisticated user assess the general direction of government financial position.

A budget-to-actual comparison of operating results and an explanation of significant budget amendments were two of the four items receiving greater than 95% support by public finance researchers and members of the media and citizen advocacy groups responding to the GASB's user needs survey (1985 p. 55). Since the public is actively involved in formulating the original budget, the financial report must illustrate management's adherence to the original plan of action and explain any significant deviation from that plan. In addition to demonstrating accountability, this comparison draws attention to possible changes in the availability of resources, in costs, or in the extent of service provision. All these are potentially important in performing trend analysis. Thus, the budget-to-actual comparison is useful for assessing both accountability and the direction of the unit's financial position.

Since a special report for nonsophisticated users is an abbreviated version of the complete reporting as required by GAAP, care would have to be taken that the required information not provide a misleading picture. This might best be satisfied by the use of further disclosure of any information in the abbreviated report that could be misleading or materially inconsistent with the financial picture presented in the full report. Finally, for any reader interested in obtaining additional information, complete references for obtaining the comprehensive report should be included.

Report Format

Format is an element greatly contributing to, or detracting from, the understandability of the financial report to nonsophisticated users. Freeman and Shoulders (1985) recognize this importance in discussing the need to present the operating statement in a format that minimizes misleading subtotals and highlights key operating figures. Respondents to the GASB's survey (1985, p. 58) affirm this importance, again providing better than 95% support for a specific, clear identification both of the annual surplus or deficit and of nonrecurring revenue and expense items. This response also supports Freeman and Shoulders' recommendation that the operating statement be presented in a manner that highlights the excess of revenues and other financing sources over (under) expenditures and other financing uses.

In addition to presenting the information in financial statement format, a narrative analysis of operations would provide an additional means of enhancing the correspondence between user understanding and the report issuer's message. In this narration, attention can be directed toward key statement items, significant differences between budgeted and actual results can be explained, and indicators of changing operations or financial condition can be described.

This analysis would not involve drawing conclusions from the data, but would involve providing a guide to readers in utilizing the financial statement data to formulate their own judgments. However, narration can detract from the understandability of statement data if the message is hidden within a mass of technical jargon or if, as found in a study of municipal reports cited by Wall (1963, p. 39), college level reading skills are required. Clear, concise prose is most likely to be read by potential users and is most likely to assist in their financial statement utilization.

Summary and Suggestions for Future Research

This paper is intended to stimulate discussion of the manner in which the accounting profession can serve the needs of nonsophisticated users, and to initiate research efforts to realize the potential of nonsophisticated decision makers as regular users of government financial reports. Nonsophisticated decision makers have previously been identified as potential primary users of financial information, and the importance of their being cognizant of government financial affairs has been recognized. However, the process required to convert these potential users into actual users has not been explored.

We have investigated the need to devise a financial report understandable to nonsophisticated users and have suggested some broad guidelines for establishing the objectives, content, and format of an abbreviated report directed at nonsophisticated users. We propose that initial study be directed toward choosing a limited information set and a simplified format that can assist nonsophisticated users to gain a general understanding of the state of an entity's finances. An investigation of the literature suggests that, within a subset of the information currently available from local government

accounting systems, these abbreviated financial statements include comparative operating statements for the major funds, a statement of municipal debt, and a comparison of actual and budgeted performance. It is also possible that the usefulness of special reports could be extended to meet the more specific decision needs of individual nonsophisticated users.

A recommendation for the use of a particular special report to best meet the information needs of nonsophisticated users cannot be seriously considered without empirical support. Reports based upon the preceding discussion must be developed and compared to various alternatives, including current GAAP statements. Several approaches might be taken to investigate the relative usefulness of these reports. Judgments by sophisticated or experienced users could be used as a benchmark against which to compare judgments by nonsophisticated users receiving different financial reports. Another basis for evaluation might be consensus among users. Other issues of concern include the sensitivity of user judgments to changes in information content and format; identification of nonsophisticated user decisions beyond a broad evaluation of government finances; and identification of specific issues of interest to specific user groups and the means of addressing those interests through special financial reports.

The optimal information set to be included and the best format to be used in special reports to nonsophisticated decision makers may not be determinable. However, some form of special reporting is necessary to meet the needs of nonsophisticated decision makers. Empirical investigation and continuing discussion as suggested above will result in a heightened awareness of what is required in order to meet the information needs of nonsophisticated decision makers and will provide direction for beginning to meet those needs.

NOTES

- ¹ See Hylton (1957), Wright (1958), AAA (1971), Givens (1979), Burton (1980)
- ² See Coopers & Lybrand (1976), Davidson et al (1977), Anthony (1980), Greene (1980)
- ³ For example, the Trueblood Committee Report (AICPA, 1973, p. 17) proposed that financial reports should meet primarily the needs of decision makers who have "limited access to information and limited ability to interpret it." This proposal clearly places the burden for understandability on the accounting profession. Bedford and Baladouni (1962, p. 654) stress that "the accountant is invested with the responsibility of producing accounting statements that will carry informative messages to the users of accounting statements." Included in this responsibility are determining user needs, providing information relevant to those needs, and ascertaining that the statement users understand financial report information.

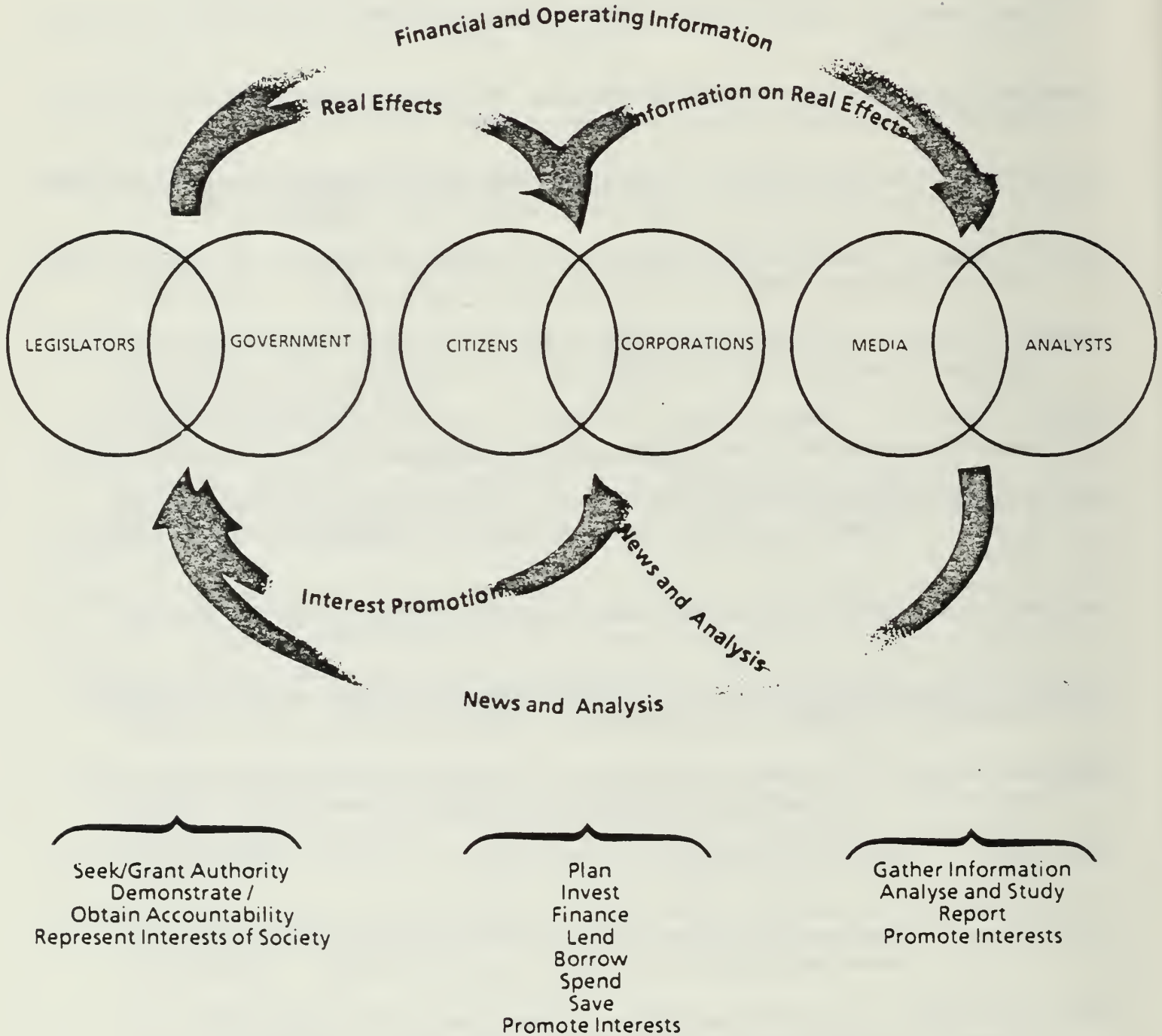
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Figure 1

USER ACTIVITIES AND MAJOR INFORMATION FLOWS



Source: Lyle Osland, "FGRS: A Canadian Perspective" Opinions, Office of the Auditor General of Canada (December 1985/January 1986): page 15

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