Not all organizations have shareholders or residual claimants. In this chapter we examine the structure of, and control in, organizations without shareholders. They represent a significant part of the economy in all countries of the world. Differences in structure of organizations arise primarily from the economic characteristics of their output markets. When the discipline imposed by output prices is weaker, the modification of contracts and decision rights becomes necessary to maintain control. Differences in accounting and control systems across a variety of organization types can be understood and explained by the nature of their output. The preceding chapters have focused on organizations whose output is a pure private good. In this chapter, we shall center on the other polar case of organizations whose output is a pure public good. As a practical matter, few organizations lie at either extreme.

Nomenclature and Classification

Organizations in which individuals or other organizations have an equity claim are called for-profit, commercial, or open corporations. Equity claims are capitalized and traded. The right to trade is included in the shareholder’s contract. The existence of a residual interest and the alienability of this interest from the shareholders who own them are the characteristic features of such organizations. These alienable residual interest organizations are called business firms, and have been discussed in the preceding chapters.

The primary concern of this chapter is accounting and control in the large number and variety of organizations that are not business firms. Governmental organizations at federal, state, and local levels are a part of, or are constitutionally
linked to, the sovereign organization of the land. Local government units, for example, include counties, townships, municipalities, school districts, and special districts for water, sanitation, port, industrial development, and soil conservation. There are more than 80,000 governmental units in the United States alone.

Not-for-profit organizations include many hospitals; colleges and universities; community health, welfare, and social service organizations; cultural, trade, and professional associations; museums; and organizations for scientific research and development, performing arts, and religion. Some of their functions are shared with, or partly supported by, grants from governmental organizations. Both not-for-profit and governmental organizations could be called non-business organizations except that both can, and often do, engage in businesslike activities—the sale of private goods or services for a price—and even compete with business organizations. For our purposes, all these organizations can be conveniently grouped under the label Non-Residual Interest Organization (NRO), because they do not have alienable residual interest. In contrast, Hansmann defines the presence of profit distribution constraints as the distinguishing economic characteristic of the not-for-profit organizations. He does not consider governmental organizations.¹

When organizations are seen as a set of contracts, the description of NROs as not-for-profit organizations is somewhat misleading. The profit of each agent is his or her gain in welfare from participation. This gain or profit accrues to all agents, albeit in different forms. The not-for-profit label is inaccurate even if a narrower concept of monetary profit is used. Employees, lenders, and vendors receive cash and make money on their transactions with such organizations. The difference between the for-profit and the so-called not-for-profit organizations is not the monetary nature of profit, but the presence in the contract set of shareholders who have a residual interest. The absence of such interest characterizes the contract set of such organizations, and we shall call them NROs for this reason. Why is such interest absent?

### Economic Characteristics of NROs

Like other organizations, NROs, too, are contracts among rational economic agents. What are the special characteristics that influence the design of their accounting and control systems? Briefly, they produce public goods, or private goods sold in markets in which they have substantial market power, and therefore face little product market discipline that typically confronts business organizations. The absence of residual rights reduces the flexibility of an organization in the presence of uncertainty. In business firms, shareholders absorb the risk associated with claims to residual wealth, making it possible to design the contractual entitlements of other agents to be relatively rigid. In the absence of residual interests, all contracts must yield some to absorb shocks of uncertainty.
Markets for Resources

The two types of organizations face different product markets. Business firms such as General Motors produce private goods for paying customers. They must convince their customers that their product is worth the price. Customers can withhold revenue if they are not satisfied. Customers can effectively discipline such organizations. NRIOSs, on the other hand, either produce public goods, or are natural monopolies. Public-good-producing organizations have beneficiaries, not customers. Beneficiaries cannot discipline the organization by engaging in negotiated exchanges or by withholding revenues as the customers can. The lack of competition attenuates the ability of customers of natural monopolies to discipline them through the price system.

To provide public goods, capital must be raised either from taxes (e.g., national defense) or donations (e.g., public broadcasting). Individual beneficiaries cannot be charged for goods provided to them, and borrowed capital can only smooth the interperiod imbalance between taxes and contributions on one hand and the cost of producing these goods on the other. Neither tax nor donated capital is raised through the market mechanisms that govern the capital resource flows of business firms.

Thus, NRIOSs and business firms face different environments in the product and capital markets. Though the labor market is similar for both types of organizations, the product and capital markets necessitate different contractual forms, managerial incentives, and accounting and control systems.

Agents

Buyers of salable goods and services probably constitute the most numerous class of agents in NRIOSs. The sale of postage stamps, hunting licenses, car parking, university education, symphony tickets, and hospital care are examples of such contractual arrangements. Individual transactions of this type are hardly distinguishable from transactions of business firms. The delivery of output and the receipt of its price are exchanged practically simultaneously, the exchange rate is posted or negotiated in advance, and there are no major uncertainties in measuring the contribution of each agent to the organization and the agent’s entitlement from the organization. Therefore, NRIOSs account for such transactions in the same manner as business firms, using cash registers or invoices and the associated bookkeeping and internal controls.

The provision of public goods and services is a special preserve of NRIOSs. Most NRIOSs provide some public goods, whether or not they provide private goods and services. National defense, flood control, clean and lighted streets, accounting standards, and basic scientific research are examples of public goods. Emergency medical care, national parks, and judicial, religious, and child welfare services are often provided free of charge, or at subsidized prices, even though
they are not pure public goods. Consumers of public goods do not make explicit payments linked directly to what they receive from the NRIOs. Their entitlement from the organization is defined in general terms and they do not have a right to enforce this entitlement directly because, as individuals, they cannot withhold any resources from the NRIOs. Accounting and control plays no significant role in the enforcement of the rights of the beneficiaries of public goods.

To pay for the unreciprocated outflow of resources to the beneficiaries of public goods, government organizations gather their capital either as taxes or as grants or revenue sharing from superior units of government. Governmental and nongovernmental organizations borrow from private investors. Nongovernmental organizations also receive contributions, donations, or grants from individuals, business firms, foundations, and governments.

Since NRIOs as well as business firms borrow capital from the same markets under similar conditions, the measurement of the input of creditors, their entitlement to interest and principal, and financial information about the organization is similar. Bookkeeping for debts is also similar; they appear as credits in the financial statements. The commonality of markets from which debt capital is raised induces a commonality of accounting for debt across organizations. Indeed, following the financial problems of the New York City government in the early 1970s, most of the demand for introducing business accounting practices into governmental organizations has originated from their bond-holders.

Citizens at large receive public goods in exchange for their collective tax contributions. The obligation of taxpayers to contribute taxes arises either from specific transactions (e.g., sales, income, excise taxes, and customs duties) or accrues with time (e.g., property and wealth taxes). Neither type of tax is an individual quid pro quo for the public goods received.

To measure the taxpayer obligation arising out of specific transactions, the government would theoretically need to keep account of all relevant transactions of all taxpayers. Even with the help of computers, this would be a formidable task. Tax collectors substantially rely on taxpayers’ own accounting records, retaining the right to audit the accounts in order to control cheating. Accounting requirements for taxes accrued with time are less onerous, and governments often maintain records of individual property transactions and values to measure taxes due on them. In any case, revenue records constitute an important part of the governmental accounting system.

Not-for-profit organizations receive at least a good part of their capital from membership dues, contributions, donations, legacies, and so on. A part of such contributions, especially for membership dues, represents the price of goods or services available for sale (e.g., admission to concerts), while the balance is a donation. Donations do not give rise to an immediately identifiable financial obligation to the contributor. A contributor may receive a position on the governing board, a nameplate, fame, or gratitude. The out-of-pocket financial cost (as distinct
from opportunity cost) of these obligations is relatively small and difficult to quantify, and the accounting system is not used to measure and report such entitlements.

Thus, the role of an accounting system in measuring entitlements is largely confined to one out of the three major classes of capital contributors—the creditors. Considering that so many aspects of the designs of the accounting systems of business firms is driven by the need to measure the entitlement of shareholders, it is hardly surprising that, in the absence of equity interest, the accounting systems of NRIOS differ in significant respects.

Managers supply their skills to NRIOS in exchange for compensation, just as they do in business firms. However, the absence of two important factor markets, markets for capital and products, leads to significant changes in the form of managerial contracts, and the role of accounting in managerial performance evaluation and control.

To recapitulate our discussion of business firms in Chapters 3–5, the inducements of all agents, except the shareholders and the top managers, are fixed as a function of their measured contribution. Shareholders are entitled to the residual resources. Because the contribution of top managers is difficult to measure, their entitlement is made to depend partly on the shareholders’ entitlement. The income number is not only the residual entitlement of the shareholders, but also a vital clue to the continued viability of the organization under the current contractual arrangements. Income informs all participating agents about what is likely to happen at the next contract negotiation. To the extent that business firms transact in reasonably well-functioning resource markets, each agent can bargain directly to protect his or her interests. The dependence of top managerial compensation on income, combined with a partial external audit, ensures that the top managers will pay heed to shareholders’ interests. It also induces them to exercise appropriate control over the middle- and lower-level managers to behave in like fashion by devising appropriate controls and incentives for them. The self-enforcing characteristics of this arrangement minimize the need for nonmanagerial agents to participate in the design of middle- and lower-level controls. Income at the top, and income-like surrogates at the lower levels of management, are crucial for effective control in business firms.

In NRIOS, no single class of agents bears a substantial part of the operational risk by accepting the residual as their entitlement. In the face of uncertainty, all agents share the risk. Suppliers of resources that are acquired from relatively well-functioning markets can protect themselves from risk-bearing. The absence or weakness of product markets in NRIOS forces their beneficiaries to bear a greater part of the risk.

The input of managers to NRIOS cannot be evaluated on the basis of the residual. It is relatively easy for the managers to boost the residual by cutting back on the supply of public goods. Because the product is not sold through bargained
transactions, beneficiaries cannot withhold revenue from the organization. The evaluation of managers on the basis of the residual would induce them to minimize the public goods produced and distributed to the beneficiaries. This reduction defeats the purpose of the benefactors of the organization, who would be inclined to cut back their capital contributions to the organization. This sequence of events would end in cessation of the production of the public good and the dissolution of the organization. If benefactors of the organization are willing to pay for the continued provision of the public goods it produces, it would be counterproductive for them to evaluate their hired managers on the basis of the residual income. Thus, NRIOs require an alternative design (relative to business firms) for their managerial performance evaluation and accounting system so that they can continue to produce the public goods in equilibrium.

One such alternative is to evaluate NRIO managers on the basis of unit cost of output: the lower the unit cost, the better the assessed performance of the manager. Although the absence of benchmarks for comparison due to the monopolistic nature of the NRIOs’ product markets renders this criterion impractical for evaluating top management, it can be used for the evaluation of the lower-level managers. Unfortunately, the governing board of NRIOs may have no independent data for setting standards of cost performance. Furthermore, it is difficult to get a reliable measure of the quantity and quality of many NRIOs’ output. In the absence of competition and reliable benchmarks, unit cost standards simply lead to deterioration in the quality of public goods.

A solution to the problem of control in NRIOs turns out to be quite similar to the solution employed by business firms for the evaluation of middle-level managers. There is some similarity between the organizational units run by the middle-level managers of business firms and the top managers of NRIOs. The former often transact in factor markets internal to the firm, and these internal markets share the imperfections of the external markets in which NRIOs operate. Goods processed by one division of a business firm may be received from another division and dispatched to a third, all inside the same corporation. Often, these intermediate goods have no external markets, and they are transferred at negotiated, budgeted, or standard prices without reference to any competitive market price. Similar weaknesses exist in “markets” in which NRIOs “sell” their products. A division manager in a business firm receives capital from the corporate management at a cost that may have no reference to the cost of capital determined in a competitive market. Similarly, NRIOs receive tax and donated resources outside the discipline of a competitive market, and are therefore controlled through budgets, segregation of funds, and multiple performance criteria. The weakness or absence of product market discipline in NRIOs forces their governing boards or legislatures to play an extensive role in controlling the details of their activities, something that the board of directors of business firms do not do. Differences in the accounting and control systems of the two types of organizations originate in this functional necessity.
Characteristics of Accounting in Public-Good Organizations

What are the special features of the accounting and control systems of public-good organizations? Defining the accounting entity for such organizations is more complicated. Most of these entities use fund accounting to prepare segregated statements of stocks and flows for each of their activities. Accrual accounting is not always used, and when it is, the criteria for recognizing revenue and expense vary. The most glaring differences appear in accounting for long-term assets and liabilities, especially in the depreciation of fixed assets. Even for closely related accounting entities controlled by the same governing apparatus, the consolidation of financial statements is not necessarily more desirable. The role of a budget is more extensive in governmental units than in business firms. Finally, in spite of the large number of agents who interact with each organization of this type, the financial reports of NRIOS rarely receive broad exposure and remain largely confined to a narrow circle of experts. These differences are not mere historical accidents. They arise to help implement and enforce the distinct contract sets of business firms and NRIOS.

Entities and Funds

The separation of accounts into several classes called funds is a distinctive feature of the accounting and control methods of NRIOS. Each fund is associated with a specific public good or service included in the mandate of the organization. Even if resources in two or more funds are managed by the same governing boards, legislatures often place restrictions on their use and transfers across activities. These restrictions prevent the managers from treating the resources in various funds as if they belonged to a single pool. Business firms rarely impose such restrictions on their managers. Two or more such funds may still be operated by the same manager for the sake of administrative economy. However, the lack of fungibility creates multiple accounting entities within a single organization. While all NRIOS segregate funds to some degree, this segregation is enforced more strictly in government organizations.

Since the segregation of funds arises from the restrictions imposed on managers, a key step in understanding fund accounting is to understand the reason for such restrictions. It is difficult to specify unambiguous criteria of performance evaluation for the managers in the absence of well-functioning markets and a residual interest in the firm. As a result, agents who deal with the organization through poorly functioning markets protect their interests by seeking representation on the governing body and by placing appropriate restrictions on managerial discretion.

To fix ideas, let us look at the recommendation of the National Council on Governmental Accounting for the use of eight types of funds under three categories:
Government Funds

General Fund: to account for all resources except those accounted for in another fund.

Special Revenue Fund: to account for revenue restricted to specified uses by law or administrative action. This fund does not include special assessments, expendable trusts, or major capital projects.

Capital Projects Funds: to account for financial resources segregated for major capital facilities, excluding those financed by enterprise funds or special assessments. A separate fund is usually created for each major project.

Special Assessment Funds: to account for the financing of public improvements or services that benefit identifiable properties or parties against which special assessments are levied. Long-term liabilities are included in this fund.

Data Service Funds: to account for the accumulation of resources for and the payment of interest and principal on general long-term debt. The general long-term debt itself is not a part of this fund.

General Fixed Asset Account Group: a set of accounts carrying the general fixed assets, excluding proprietary and fiduciary fixed assets.

General Long Term Debt Account Group: a set of accounts carrying the general long-term obligations, excluding proprietary, fiduciary, and special assessment long-term liabilities.

Proprietary Funds

Enterprise Funds: to account for natural monopoly and any other operations in which cost is recovered from the customers through the direct sale of goods or services. Fixed assets and long-term debt related to these operations are included.

Internal Service Funds: to account for goods and services provided by a service department within the organization to other departments (e.g., computer service, transportation). Both fixed assets and long-term debt related to these operations are included in this fund.

Fiduciary Funds

Trust and Agency Funds: resources held by a governmental unit as trustee or agent for individuals, nongovernmental organizations, or other governmental units.

Expendable Trust Funds

Non-Expendable Trust Funds

Pension Trust Funds

Agency Funds

A similar separation of funds is found in the accounts of nongovernmental NRIOs, though the classification is simpler.
Current Unrestricted Fund: analogous to the general fund for governments.

Current Restricted Fund: to account for resources that have been designated by the donor for specific use.

Endowment Fund: analogous to nonexpendable trust funds of governments. Income, and sometimes the principal of these funds, is available for restricted or unrestricted use.

Custodian Fund: analogous to agency funds of governments.

Annuity and Life Income Funds: to account for resources segregated to make periodic stipulated payments to named beneficiaries.

Loan Fund: revolving fund to advance student loans in universities.

Land, Building and Equipment Fund: to account for the acquisition, renewal, and replacement of fixed assets.

Governing bodies restrict the use of resources to ensure that the public goods are produced in agreed-upon quantities and provided to agreed-upon parties. Segregated financial reports enable the constituent agents of the organization to assess the fulfillment of its mandate to provide specific public goods to specific constituencies. This segregation is particularly important for those agents who transact with the organization through relatively weak markets. Special revenue, special assessment, trust, agency, and loan funds are of interest to specific classes of agents. Unless they are segregated from the rest, these agents would find it costly, or even impossible, to obtain this information elsewhere. In contrast, labor and nonmanagerial employees, whose interests in business firms and NRIOs are essentially similar, can and do privately negotiate for their wages and benefits. The part of the financial statements that concerns them directly is their pension fund. No other separately reported special funds have a special significance for this class of agents.

Consolidation and Detail

In 1993, AT&T, consisting of many separate legal entities, employed 308,700 people, had a gross revenue of $67 billion, and used twenty-three pages (including ten pages of an explanation of the company’s operations) to present its operating results and financial position. In the same year, a city with gross revenues of $4 billion and only 50,000 employees needed more than two hundred pages to report its results. Is there an economic explanation of this difference, beyond a facile condemnation of bureaucratic inefficiency?

First, consider the possible incompetence of managers as an explanation of detailed disclosure of data by NRIOs. They simply failed to do the additional work to aggregate data. But disclosure of additional detail can only bring additional scrutiny and criticism to managers. In governmental as well as nongovernmental organizations, managers rarely disclose more than what they have to, unless it serves their own interests.
A second possible explanation is that the managers of these organizations were required to disclose greater detail by their contracts. In business firms, bookkeeping entries are adequate to serve most of the interests of all agents, except the investors for whom financial statements are prepared by aggregating these entries. Parties other than the investors are not usually represented on their boards of directors. In NRIOs, on the other hand, many classes of agents have representation on the governing bodies, and they all seek to scrutinize organizational performance from their own point of view. They direct the managers of such organizations to prepare multiaspect reports. Financial statements oriented to income and owners' equity satisfy the shareholders, but not the variety of agents who have a stake in NRIOs. These agents would be unable to protect their interests in the absence of detailed reports. If it does not serve their interests, they will abandon the organization, leading to its dissolution.

NRIOs have been criticized for their failure to present consolidated financial statements of all entities within the control of the same management. If business firms can do it, why can't the NRIOs?

A brief answer is that consolidation is useful when the resources of the consolidated entities are fungible or their transfer is within the control of the managers. Consolidation is carried out in business firms as well as in NRIOs when the management has such control. When management's control over resource transfers is weak or absent, neither business firms nor NRIOs consolidate. Such control is absent in mutual funds managed by the same managers and in the government. Neither type of organization produces consolidated financial statements. It is possible to prepare consolidated statements for the governmental units with some computational effort. Even after appropriate eliminations, they would be no more useful to the participating agents than the consolidated statements for a family of mutual funds would be to agents who hold shares in only one or two of these funds.

**Recognition and Accrual**

NRIOs' procedures for recording transactions and their criteria for recognizing revenue differ from the practices of business firms. These differences can be understood in terms of the imperfection of the markets in which the former operate, and the consequent external budgetary control imposed on their transactions.

Business firms recognize revenue when (1) the service to be performed has essentially been completed and (2) the amount to be received can be estimated reasonably accurately. These criteria assume that revenue is earned by delivering goods or services in direct exchange transactions. NRIOs that are natural monopolies use similar revenue recognition criterion and match expenses to revenues. However, if their output is a public good, there is no direct transaction, and the link between revenues (taxes, contributions, wills, legacies, fines) and the outlays necessary to produce and distribute the public good is remote. NRIOs are often criticized for their failure to use accrual accounting. How can the accrual method be
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used in the absence of direct exchange transactions when such transactions form the very basis of the accrual method?

Tax revenues are recognized when received in cash, except in those instances (e.g., property tax) where the amount due from an individual taxpayer can be estimated in advance and billed. In this latter case, tax revenue is recognized in the period in which it is levied. Contributions or donations, are recognized as revenue when pledged (subject to an allowance for uncollectibles), unless uncertainty associated with collections is too large and recognition is delayed until cash is collected. Commercial practice is followed in recognizing revenue from direct exchange transactions. Fundamentally, revenue recognition criteria in NRIOs are no different from those in business firms when revenue-generating exchange transactions can be identified.

Unlike business firms, the revenue of an NRIO is not a gross increase in the shareholders’ equity or entitlement. It is a gross increase in the resources controlled by the organization for a specified fund or purpose. Although the accounting term used in both types of accounting systems is the same, its meaning is quite different.

This difficulty becomes more acute in accounting for the resource outflows. Since the accounting and control of business firms is oriented to the measurement of all resource flows in order to arrive at the net change in resources (income) the shareholders are entitled to, resource outflows are recorded as either assets or expenses, depending on when the revenue corresponding to this outflow is recognized. When an organization is engaged in producing public goods, there is no immediate link between resource outflows and inflows. In the absence of better criteria, the receipt of cash becomes the point of recording resource inflow, while the disbursement of cash becomes the point of recording the outflow of resources. Actual practice differs from the cash basis when the receipt and disbursement of resources in forms other than cash (pledge of donation for inflow, receipt of ordered supplies from the vendor to be paid for in cash for outflow) are reasonably accurate predictors of cash flows that will follow. NRIOs retain the term revenue for resource inflow. The matching criterion that links revenues to expenses is dropped. This linkage, so crucial to accounting for business, is severed in NRIOs, and expenses is replaced by expenditures. Note that expenditures are not the same as disbursements, but in many cases, there is no difference between the two. For public-good-producing organizations, there seem to be no accounting alternatives that are clearly superior to this practice.

**Fixed Assets, Depreciation, and Long-Term Liabilities**

To understand NRIOs’ accounting for fixed assets and long-term debt, it is useful to start with an explanation of how and why such resources and obligations are accounted for by business firms. Businesses record the acquisition of assets at cost and the issuance of debt obligations at cash proceeds. These transactions have no immediate effect on the residual interest (i.e., the entitlement of the shareholders).
As the remaining service potential of the fixed asset declines with time and use, the original acquisition cost is gradually amortized to reduce the shareholders' residual interest in resources of the firm. The statistical inaccuracy of reported changes in residual interest due to mechanical depreciation rules (e.g., straight-line depreciation) is the price a diffuse body of shareholders pays to obtain objective information. Managers have incentives to understate depreciation because managerial compensation is often linked to net income. Accounting blocks managers from misleading shareholders into believing that their residual interest in the firm is substantial while the plant is reduced to a rusting heap of junk. In calculating product costs, depreciation is entered as an estimate of the long-run opportunity cost of capital plant and serves as a basis of production and marketing decisions by the management.

The natural monopoly NRIOS' accounting for fixed assets is similar to the accounting practice of business firms. Although they have no residual interest, they face similar product pricing and managerial evaluation problems. In the production of pure public goods, however, all three rationales for traditional fixed asset accounting disappear—there is no residual interest, goods are not sold through negotiated transactions for a price, production-investment decisions are made by the governing bodies of these organizations instead of by the management, and managerial compensation is not linked to the residual or surplus. NRIOS have no practical advantages from adopting business firms' accounting practice for fixed assets. Without fixed assets and depreciation in the accounting system, business firms will not operate efficiently. This is not so for the public-good-producing NRIOS, and they should not be expected or forced to use the fixed asset accounting practices of business firms.

NRIOS cannot return to the taxpayer to finance capital projects as business firms can do by selling additional stock. NRIOS set cash aside from their annual tax collections to meet the cost of capital projects, renewals, or replacements. Not surprisingly, depreciation is widely seen in these organizations as a means of setting cash aside to replace capital facilities.

**Budgets, Appropriations, and Encumbrances**

Unlike the boards of directors of business firms, governing bodies that control NRIOS approve budgets that give detailed and specific directions to managers in various spheres of activity. Budgetary comparisons also provide a multidimensional basis for the performance evaluation of managers. While the use of budgets for evaluation of middle- and lower-level managers in business firms is relatively recent, their use in the government is quite old. Variations on this technique—performance budgets, the planning programming budgeting system (PPBS), and zero-based budgeting—all originated in the government sector.

Unlike business firms, budgets in governmental organizations are integrated into the accounting system and bookkeeping. Item-by-item appropriations approved by the legislature are entered into the account books as the amount avail-
able for spending on each item during the year. As these appropriated funds are committed (e.g., by placing an order for supplies with a vendor), an encumbrance entry is made in the account to avoid the possibility of making commitments that may cause expenditures to exceed the appropriation in any account. This feature of accounting and control ensures that the will of the governing body is not thwarted by executive error or design.

The preparation and approval of detailed budgets outside the executive branch of government, and the integration of budgets into the accounting system, are designed to ensure that the organization’s actions correspond closely to the expectations of the contracting agents. In public-good-producing organizations, the discipline of the budget is the substitute for the absent discipline of the marketplace. Budgets constrain the behavior, creativity, and innovation of managers. Managers in NRIOS receive fixed salaries, but no performance bonus or stock options. They do well for themselves if they stick close to the budget and take a hostile stance toward risk and deviations. The system is deliberately designed to discourage innovative behavior, given the distributional consequences of deviation from the budget in such organizations. The compartmentalization of resources through fund accounting is a part of the design to achieve this end.

**NRIO and Business Accounting Interaction**

Accounting systems of businesses and NRIOS are interdependent. Organizations that produce private goods as natural monopolies have been pressured to introduce accrual accounting concepts. When public-good-producing organizations branch out into private-good business, they often lag in adjusting their control system to the private-good environment. The difficulties of applying accrual concepts to the making of public goods are real, but replacement of cash accounting by accrual systems to record private-good transactions is delayed by the inertia of past practice.

NRIOS are often asked to produce consolidated financial statements to provide readers with an overall perspective across all fund entities. Unlike the demand for accrual accounting in private goods NRIOS, this demand is not well-founded. Business accounts are consolidated across legal entities because the economic substance (of control) is supposed to dominate the legal form of separate entities. Accountants in governmental bodies object to consolidation, not because they prefer the legal fine print to economic realities, but because the legal limitations on the control and discretion of managers on various funds often transcend the appearance of common control. The dominant economic characteristic of NRIOS as well as the substance over form criterion call for separation of funds if their use is not fungible.

The preceding chapters assumed that each participating agent strives to design his or her own contractual (including accounting) participation in an organization in such a way as to maximize personal welfare. Every aspect of accounting sys-
tems does not serve all agents. In segregated funds statements, at least, each agent can find what she or he wants. Consolidated statements of a business firm furnish a better picture of an agent’s residual interest to the shareholder. In NRIOs, bondholders who may lend to the organization as a whole are the only such beneficiary of consolidation.

Interaction between NRIOs and business accounting has been a two-way street. Financial reports of NRIOs, known for their length, detail, and complexity, are forbidden territory for all but the experts. Business financial statements have grown in length, detail, and complexity with the size of such organizations. As more and more agents demand various types of information through a nonmarket mechanism (e.g., the FASB), they slowly yield and issue pronouncements that cumulatively add to the complexity of financial statements. Unless the securities regulators (e.g., the SEC) change their stance, it may be only a matter of time before annual reports of large publicly held corporations vie with the federal budget for honors in length and complexity. Fortunately, the SEC has approved the use of summary financial statements in annual reports, allowing the full set of financial statements to be included in the 10-K filings.

Business firms have not only borrowed budgeting as a tool for managerial control from the NRIOs, their increasing size and complexity is leading them to use similar techniques to ensure legal and policy compliance within the organization. The Foreign Corrupt Practices Act of 1977 made it illegal for publicly held corporations in the United States to fail to maintain adequate internal controls on the firm’s resources. Such controls have always been required in governmental accounting systems.

Summary

The control requirements of organizations that produce public goods or produce private goods under conditions of natural monopoly are fundamentally different from the control requirements of those that produce private goods and sell them under competitive conditions. Many of the differences among the accounting and control systems of these three types of organizations can be understood in terms of the economic characteristics of the markets in which they transact and the consequent differences in the design of contracts. Nothing is perfect, and it is always possible to improve any system, including the accounting for NRIOs. However, the differences between accounting methods of NRIOs and business firms do not constitute prima facie evidence that the former are defective and should be altered to conform to the latter.
Notes


2Pure public goods are defined to have two properties: (1) marginal cost of producing the public good for consumption of one additional person is zero and (2) no one can be

excluded from consuming the public goods. While few goods and services are purely public in this sense, many are public at least in part.


Additional Reading


