This chapter sets the stage for understanding governmental accounting by explaining some of the important concepts that comprise the framework of governmental accounting and financial reporting. Specifically, this chapter will discuss the following:

- What are generally accepted accounting principles?
- Who sets generally accepted accounting principles?
- Do governments need to comply with generally accepted accounting principles?
- Why is governmental accounting and financial reporting different from commercial and not-for-profit accounting and financial reporting?
- To what entities do governmental generally accepted accounting principles apply?

Understanding these broad concepts will help put in context the more specific discussions and explanations of financial statements and accounting rules described in later chapters of this book.

WHAT ARE GENERALLY ACCEPTED ACCOUNTING PRINCIPLES?

Generally accepted accounting principles (commonly referred to as GAAP) are basically the accounting rules and conventions that
are used to prepare financial statements. They provide guidance to financial statement preparers to tell them how to account for various types of transactions, how various types of transactions (as well as assets and liabilities) are to be reflected in the financial statements, and what disclosures are required to be included in the financial statements. The next section describes who determines what accounting principles are GAAP. However, it is important for the reader to know that the accounting principles that comprise GAAP come from a variety of sources. In some cases GAAP may result simply from common practices that have been used by financial statement preparers over a long period of time. These rules are said to have *general acceptance* meaning that you cannot go to an authoritative accounting rule book and find an accounting rule that results in that specific accounting principle. On the opposite side of the spectrum, accounting rule makers (discussed in the next section) issue accounting standards that specify accounting treatments for specific types of transactions. In between these two extremes are various authoritative accounting resources that provide interpretations and analyses of existing accounting rules to assist financial statement preparers in applying these rules to various types of transactions.

More often than not, GAAP consists of accounting *principles* rather than specific rules for accounting for specific types of transactions. Recent accounting scandals that have grabbed national attention have generated a debate as to whether GAAP needs to be even more principle-based and less rule-based. The reason supporting more principle-based GAAP is that, in some instances, the accounting scandals involved transactions that were accounted for technically within the letter of the law known as GAAP. In other words, transactions were structured in ways that met the technical requirements of GAAP, but were accounted for in misleading ways—they violated the spirit or intention of the GAAP requirements. Shifting to an even more principle-based approach reduces the risk that clever accountants will find ways to circumvent GAAP rules that violate GAAP principles. Others in the debate would argue that to avoid financial statement preparers circumventing accounting rules, what is needed are better and tougher rules, rather than increased flexibility afforded by a principles-based approach.
Why should the reader of this book care whether GAAP is principle-based or rule-based? There are two primary reasons. First, the reader should understand in learning about GAAP used by governments that GAAP usually does not specifically address every accounting situation that a financial statement preparer encounters. Often GAAP has to be interpreted using guidance provided for other similar transactions to determine the appropriate accounting treatment for a specific transaction entered into by a government. The variety and nuances of specific transactions are too many to expect to find a specific accounting answer in GAAP to every accounting question. Interpretation is often required. Second, the reader should understand that technical compliance with a GAAP requirement does not always result in the best accounting for a specific transaction, all other factors being considered. Governments do structure transactions in specific ways for the express purpose of enabling a desired accounting treatment in conformity with GAAP. This is not necessarily a bad thing. The reader just needs to be aware that it happens.

Another feature of GAAP that needs to be understood is that in a number of instances there is more than one acceptable way to account for a specific type of transaction. For example, later chapters will describe the accounting for capital assets that are depreciated by governments. Depreciation expense can be calculated using any of several accepted methods. One method charges depreciation expense in equal amounts each year over the life of the asset—this is called straight-line depreciation. Another method charges more depreciation expense in the early years of a capital asset’s life and less depreciation expense each year in the later years of a capital asset’s life—this is called accelerated depreciation. Both of these methods are acceptable under GAAP. As accounting rule makers address more and more accounting issues, the existence of more than one acceptable method of accounting for the same transaction is gradually, but steadily, declining. Often accounting rule makers select accounting areas to address because there is a diversity of accounting treatments for the same type of transaction. In other words, their purpose in these cases would be to eliminate the diversity of accounting treatments for similar transactions. Accordingly, once an accounting area is addressed by an accounting rule maker, usually only one acceptable method of accounting for this area results.
However, the reader should not be surprised by the remaining flexibility in some accounting treatments when trying to understand and compare the accounting for the same transaction by two different governments. It is also interesting to try to understand why a government selected a particular accounting method to use when there are several alternative acceptable methods.

One final note on GAAP is that these accounting principles apply only to *material* items. If an accounting transaction is not material to the financial statements, the financial statements need not follow GAAP in recording and presenting that transaction in the financial statements. Before jumping to conclusions that this concept will permit a tremendous amount of flexibility in recording relatively small transactions, an understanding of what is meant by being material to the financial statements is necessary.

Materiality is a concept that accountants have long struggled to define. The broad concept is that an item is material to the financial statements if its improper recording would have an impact on an informed reader of the financial statements. Applying this concept to individual circumstances in practice clearly results in the need for a good deal of judgment. It is not easy to try to anticipate what an “informed reader” of the financial statements will be affected by in reading the financial statements.

Accountants and independent auditors have attempted to provide quantitative measurements to determine when a misstatement of the financial statements would be considered material to those statements. For example, a common measure for determining whether a misstatement was material to the statement of financial position was to determine whether the amount of the misstatement was more than ten percent of total assets. Similarly, a common measure for determining whether a misstatement was material to the statement of activities (operations) was to determine whether the amount of the misstatement was more than five percent of the net increase or decrease in net assets (similar to what is often referred to as “net income” outside of the governmental accounting world.

Accountants have come to recognize, however, that materiality also has qualitative aspects. In other words, misstatements that do not meet quantitative measures, such as the five and ten percent measures described above, may still be considered material because of one or more qualitative aspects. For example, say that
a city’s general fund has just barely underspent its budgeted expenditures for a fiscal year. (Later chapters will provide much more information about funds, but the reader should not need this information to understand this example.) As part of “closing its books” for the year, the accountants discover an expenditure that should have been recorded in the general fund, but was not. This expenditure is clearly not material from any quantitative measure to the city’s financial statements. However, if this expenditure was properly recorded in the general fund, the general fund would go from slightly underspending its budget to slightly overspending its budget. Depending on the specific circumstances of the government, this may be important or it may not be important. The point is that a strict quantitative approach to materiality will not always provide enough information to make intelligent decisions about what is material to a government’s financial statements.

**WHO SETS GENERALLY ACCEPTED ACCOUNTING PRINCIPLES FOR GOVERNMENTS?**

Generally accepted accounting principles for governments are basically set by the Governmental Accounting Standards Board, or as it is commonly called, the GASB. The GASB is a private organization that is financially controlled by the Financial Accounting Foundation (FAF), which is a not-for-profit organization. Readers with some familiarity with commercial accounting or not-for-profit accounting might be somewhat familiar with the Financial Accounting Standards Board, or as it is commonly called, the FASB. The GASB does for governments what the FASB does for commercial and not-for-profit organizations. The GASB was created in 1984 and is currently located in Norwalk, Connecticut. The GASB is composed of seven board members. The Chair of the GASB is a full-time board member, while the other six members serve on a part-time basis. The GASB has full-time technical staff, which reports to its Director of Research.

**Note** The reader might be wondering whether the GASB and the FASB are identical in terms of their standard-setting roles. The
GASB and the FASB perform similar functions in terms of establishing GAAP, but structurally and economically there is a divergence between these two boards. The reason is that the FASB sets the accounting principles that are used by publicly traded companies. Legally, this responsibility is that of the United States Securities and Exchange Commission (SEC), which delegated this responsibility to the FASB. The accounting scandals that occurred which resulted in the passage of the Sarbanes-Oxley Act of 2002, created the Public Company Accounting Oversight Board (PCAOB), which, as an arm of the SEC, is charged with setting auditing standards for public companies. The SEC continues to delegate accounting standards setting to the FASB. However, under the Sarbanes-Oxley Act of 2002, the FASB no longer receives its funding from the FAF, but rather is funded by a charge or fee levied on publicly traded companies. The GASB has no such “legal” type standing for its accounting principles, nor is it funded from these fees charged to publicly traded companies.

The reader might encounter the names of several other organizations that might lend some confusion as to what organization sets the accounting rules for governments and governmental entities. The National Council on Governmental Accounting (NCGA) was the name of the organization that set accounting principles for governments prior to the creation of the GASB. Some of its accounting principles resulting from its “municipal accounting standards” and other standards are still in use today. The NCGA, which no longer exists, was sponsored by the Government Finance Officers Association (GFOA). The GFOA is still in existence today and periodically issues a new version of its book, Governmental Accounting, Auditing and Financial Reporting (commonly referred to as the GAAFR). Prior to the establishment of the GASB, the GAAFR was an authoritative source of accounting principles. Today, the GAAFR is used by the GFOA to establish the rules for its Certificate of Achievement for Excellence in Financial Reporting. This is a voluntary program for governments that prepare Comprehensive Annual Financial Reports (described later in this book) and that desire to
obtain this award from GFOA to demonstrate their ability to prepare and issue excellent financial reports.

While the quick answer to the question of who sets accounting principles for governments is “the GASB,” the GASB sets these accounting principles and provides interpretations and implementation guidance through several different mechanisms. This is done by several different types of documents and mechanisms that together comprise what is termed the “GAAP hierarchy” for governments. Not all of the documents and mechanisms used by the GASB to set accounting principles and standards have the same weight and importance, hence the term hierarchy which implies that some are going to be more important than others.

The GASB recently issued Statement No. 55, “The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments” (GASBS 55) which formally brings the hierarchy of those pronouncements and documents comprising generally accepted accounting principles into the GASB’s purview. Previously, the hierarchy was set by the auditing standards used by independent auditors performing audits of financial statements. The hierarchy remains essentially the same as used in the past and is lettered A through D (with A being the highest level of authority) and consists of the following documents:

**Level A**

- GASB Statements (currently numbered 1 through 56)
- GASB Interpretations (issued by the GASB to provide an interpretation of accounting guidance for an accounting standard that already exists)

**Level B**

- GASB Technical Bulletins (These are prepared by the GASB staff to provide guidance on applying an existing accounting principle. Technical Bulletins are reviewed by the GASB board and a majority of the board members must not object to their issuance.)
- AICPA Audit Guides and Statements of Position that are made specifically applicable to governmental entities by the AICPA and that have been cleared for issuance by the GASB (The AICPA Audit and Accounting Guide “Audits of Statement and Local Governments” is an example of this type of document.)

**Level C**

- AICPA Practice Bulletins if specifically made applicable to governmental entities and that have been cleared by the GASB

**Level D**

- Implementation Guides that have been published by the GASB staff (These are typically in a question-and-answer format and are issued more frequently in recent years than in the past.)
- Practices that are widely recognized and prevalent in state and local governments (This category includes those accounting practices that are generally used by governments, but are not the result of a specific accounting standard issued by the GASB or its predecessors.)

In the absence of a pronouncement or another source of accounting literature, the financial statement preparer may consider what is termed *other accounting literature*. Other accounting literature includes a variety of different sources ranging from GASB Concepts Statements (which are GASB documents that describe the conceptual framework from which GASB Statements arise) on the more authoritative side to accounting textbooks and articles on the less authoritative side. In between these extremes, other accounting literature includes such items as FASB pronouncements not made applicable to governments, various AICPA Issue Papers and Practice Aids, and International Public Sector Accounting Standards, among many others.

The message that the nonaccountant should take away from the above discussion about the sources of generally accepted ac-
accounting principles for governments is that in many cases, analysis of an accounting issue is not an exact science and the selection of the most appropriate accounting treatment for a particular transaction is often based on a broad range of accounting principles that do not precisely fit the transaction at hand.

DO GOVERNMENTS NEED TO COMPLY WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES?

There are both legal and practical answers to this question. There is virtually no way that it can be answered on a global basis for all governments and governmental entities in the United States because there is no national requirement for state, local, and other governmental entities to issue financial statements in accordance with generally accepted accounting principles. Unlike publicly traded corporations that are subject to SEC requirements that require audited, GAAP financial statements on an annual basis, there is no such requirement for governments. The SEC, because of states’ rights issues that are well beyond the scope of this book, does not have the same ability to dictate accounting requirements for governments. This is so even though governments sell their debt securities to the public. As such, there is no national, legal requirement for governments to prepare GAAP-based financial statements.

At the state or local government levels, however, many governments’ charters, constitutions, enabling legislation, and so on do require the issuance of GAAP-based financial statements. These governments would have a legal requirement to issue financial statements prepared in accordance with GAAP. In addition, there may be instances where states or state comptrollers prescribe the accounting requirements for municipalities and other types of local governments within a state. In these cases, these municipalities and local governments would also be required to prepare GAAP financial statements.

In the absence of legal requirements to prepare GAAP financial statements, there may well be practical requirements that would cause governments to prepare GAAP financial statements. The best example would be the issuance of debt. Governments that sell debt to finance operations, capital projects, or other re-
source needs may find it necessary to issue GAAP financial statements in order to facilitate the sale and marketing of the debt. In some cases, debt covenants may require periodic reporting of financial statements in accordance with GAAP.

Beyond a specific example such as selling debt, a government may find that it must provide accountability for its collection and use of resources by issuing financial statements. GAAP-based financial statements provide the fullest picture of a government’s financial position and the results of its activities, as well as in some instances, its compliance with certain financial requirements to which it may be subject. While not all government accountants agree with every aspect of GAAP for governments, by and large, GAAP financial statements are the most widely accepted means of conveying information about a government’s financial position and the results of its activities. In other words, if a government is going to issue annual financial statements, it may simply make more sense to issue GAAP financial statements rather than justify why GAAP financial statements were not prepared.

Note that preparing GAAP-based financial statements does not mean that a government needs to prepare its budgets on a GAAP basis. As we will examine later in the book, a government’s general fund and certain other funds that legally adopt a budget are required to present budget-to-actual financial information along with the GAAP-based financial statements. The budget-to-actual financial information is presented using whatever accounting basis is used to prepare the budget, meaning that there is no accounting requirement that this information be prepared in accordance with GAAP.

**WHY IS GOVERNMENTAL ACCOUNTING AND FINANCIAL REPORTING DIFFERENT FROM COMMERCIAL AND NOT-FOR-PROFIT ACCOUNTING AND FINANCIAL REPORTING?**

This is an important question for someone trying to understand the basic concepts that underlie the accounting used by governments and governmental entities. In fact, it was one of the earliest questions addressed by the GASB soon after its creation in 1984. The newly formed GASB undertook a project and issued a re-
sulting Concepts Statement (GASB Concepts Statement No. 1, “Objectives of Financial Reporting,” or GASBCS 1) in 1987 that addressed what the objectives of governmental accounting and financial reporting should be. In examining this, the GASB identified various characteristics of the environment in which governments and governmental entities operate and distinguished this environment from those of other types of organizations. The following paragraphs describe these distinguishing characteristics:

- **The primary characteristics of a government’s structure and the services it provides.** Governments derive their authority from the citizenry and are commonly based on a separation of power from three branches (i.e., the executive, legislative and judiciary). There are also various layers of government and there are usually substantial amounts of resources that flow between the layers. For example, there are three basic layers of government that consist of the federal government, state governments, and local governments. Local governments may consist of further layers, such as cities, towns, or villages that are part of a county, which has its own government. Finally, there are distinguishing characteristics as to the relationship between a government’s taxpayers and the government as well as the relationship with the services that they receive. GASBCS 1 highlights these differences:

  - Taxpayers are involuntary resource providers. They cannot choose whether to pay their taxes.
  - Taxes paid are generally based on factors such as property values or income, rather than the value of services received by individual taxpayers.
  - There is generally no exchange relationship between resources provided and services received. Most individuals do not pay for specific services.
  - The government generally has a monopoly on the services provided.
  - It is difficult to measure the optimal quality or quantity for many services provided by governments. Those re-
ceiving services generally cannot decide the quantity or quality of a particular service of a government.

- **Control characteristics resulting from a government’s structure.** Governments usually prepare a budget for the “general” or main operating fund. This budget is an expression of public policy as well as a control mechanism for operating the government. Underspending the budget in a particular area might be considered a good thing, if the expected level of service was provided to constituents. However, underspending a budgeted amount for a particular area when service levels are below the expected levels might indicate that the “public policy” features of the budget were not adhered to. Another unique aspect of budgets in the government environment is that when a budget is recommended by a government’s executive branch and adopted by the legislative branch, a legal authority for spending the government’s resources is established. In this case, the government may legally spend only what is authorized in the budget. In the commercial environment, budgets are more often targets rather than legal spending authorizations.

- **Use of fund accounting for control purposes.** Users of governmental financial statements are accustomed to the government reporting information about its funds, particularly the major (or more important, larger) funds. As we will see later in this book, sometimes governments are legally required to set up separate funds for certain sets of transactions, whereas other times governments set up funds for their own control and financial reporting purposes. Regardless of the reason, reporting information by fund is now unique to the governmental environment. Readers familiar with not-for-profit accounting may recall that not-for-profit organizations were formerly required to present fund information in their financial statements. Financial reporting for not-for-profit organizations was changed a number of years ago to eliminate the need to report fund information, although some not-for-profit organizations continue to use fund accounting for internal control purposes.

- **Dissimilarities between similarly designated governments.** This aspect of governmental accounting highlights that
comparing the financial statements of two different governments at the same level—such as the financial statements of two counties—may be the equivalent of comparing apples to oranges. The range of services provided to constituents as well as the sources of revenues from which those resources are obtained may vary greatly between two entities that are both called “counties.”

- **Significant investment in non-revenue-producing capital assets.** Capital assets of a government usually include its buildings, equipment, vehicles, and so on. Capital assets also include infrastructure, such as roads, bridges, parks, piers, and so on. Governments do not purchase or construct capital assets because they expect a direct monetary return on their investment. Building a new school building will not directly generate revenue from its use. Rebuilding Main Street will not generate revenue from its use (unless, of course, it is a toll road). Commercial enterprises invest in many of their capital assets because they generate a rate of return, such as a new factory or a new retail store. While the new school and rebuilt Main Street may make a jurisdiction a more attractive place to live and work, resulting at some point in higher tax revenues, the resulting revenues are not directly related to these investments in capital assets made by this hypothetical government.

- **Nature of the political process.** There is an inherent conflict in governments between the citizens’ demand for services and the citizens’ willingness to pay for those services. There is a concept in the government accounting world called *interperiod equity*. This concept means that the current citizens should be paying for the services they are currently receiving. Governments can sometimes not live up to this principle, many times by borrowing money (which will be repaid by future citizens) to pay for the current operating expenses (whose benefit the current citizens are enjoying). GASBCS 1 concludes that to help fulfill a government’s duty to be accountable, government financial reporting should enable the financial statement user to assess the extent to which operations were funded by nonrecurring revenues or long-term liabilities were incurred to satisfy current operating needs.
• **Users of financial reporting.** The users of governmental financial reporting and financial statements are different from those of commercial enterprises. GASBCS 1 identifies three primary groups as the users of governmental financial reports.

  • The citizenry (taxpayers, voters, and service recipients), the media, advocate groups, and public finance researchers
  • Legislative and oversight officials, such as members of state legislatures, county commissions, city councils, boards of trustees, school boards, and executive branch officials
  • Investors and creditors, including individual and institutional investors, municipal security underwriters, bond rating agencies, bond insurers, and financial institutions

• **Uses of financial reporting.** As governments have different users of financial reporting, it is logical to expect that there will be differences in the uses of their financial reports. In addition to assessing the accountability of the government, governmental financial reports are used for economic, political, and social decisions. These uses can be viewed as falling into the following broad categories:

  • Comparing actual financial results with legally adopted budgets
  • Assessing financial condition and the results of operations
  • Assisting in determining compliance with finance-related laws, rules, and regulations
  • Assisting in evaluating the efficiency and effectiveness of the government. (This last category is sometimes referred to as service efforts and accomplishments [or performance] reporting, which uses financial and nonfinancial information to assess whether the government’s “service efforts” actually result in “accomplishments.” This is currently a controversial area in government accounting. Not all interested parties believe that this is an area that should be part of the financial reporting required by the GASB under generally accepted accounting principles or an area
for which the GASB should be providing guidance for voluntary reporting.)

When all of the differences and nuances of governmental financial reporting are examined, the GASB concludes in GASBCS 1 that the cornerstone of financial reporting by governments is accountability. Accountability requires that governments answer to the citizenry in order to justify the raising of public resources and the purposes for those resources. Accountability is based on the general belief that the citizenry has a right to know financial information and has a right to receive openly declared facts that may lead to a public debate by the citizens and their elected representatives.

GASBCS 1 highlights the concept of interperiod equity (discussed earlier) as a significant part of accountability and notes that it is fundamental to public administration. Accordingly, as encouraged by GASBCS 1, the concept of interperiod equity is reflected in many of the accounting requirements established by the GASB since its creation.

TO WHAT ENTITIES DO GOVERNMENTAL GENERALLY ACCEPTED ACCOUNTING PRINCIPLES APPLY?

Throughout this chapter there have been a number of references to accounting principles followed by governments and governmental entities compared to accounting principles applied to commercial enterprises and not-for-profit organizations. The reader should have a clear understanding of what types of entities are considered to be governments or governmental entities in order to be clear as to which types of accounting and financial reporting requirements are to be applied by any particular entity.

The following is a listing of the entities that, in general, are covered by governmental generally accepted accounting principles:

- State governments
- Local governments such as cities, counties, towns, and villages
• Public authorities, such as housing finance, water and other utilities, economic development, and airport authorities
• Governmental colleges and universities
• School districts
• Public employee retirement systems
• Public hospitals and other health care providers

Throughout this book, when governmental entities or governments are mentioned, the reference is to these types of entities. Governments covered by governmental accounting principles are sometimes distinguished as general-purpose governments (which includes states, cities, towns, counties, and villages) and special-purpose governments. Special-purpose governments are those that are other than general-purpose governments. Both general-purpose and special-purpose governments are covered by the governmental generally accepted accounting principles that are the subject of this book.

A special word is needed about distinguishing governmental entities from not-for-profit organizations. As a rule, not-for-profit organizations are not covered by generally accepted accounting principles for governments. Not-for-profit organizations follow accounting principles prescribed by the FASB. For the most part, this distinction is fairly obvious. It does create some apparent discrepancies, such as a state university following governmental accounting principles while a private university follows accounting principles for not-for-profit organizations prescribed by the FASB. Even though the state university and the private university are basically in the same business, the state university follows GASB accounting rules and the private university follows FASB accounting rules.

In some cases, however, distinguishing between a government and a not-for-profit organization is not so simple. For example, a local government may set up an economic development corporation that has many characteristics of a not-for-profit organization, including federal tax-exempt status under section 501(3) of the Internal Revenue Code. However, these organizations are usually considered governmental not-for-profit organizations that should follow governmental generally accepted accounting principles. The AICPA Audit and Accounting Guide Not-for-Profit Organizations (the AICPA Guide) defines gov-
ernmental organizations (i.e., ones that should follow accounting principles for governments) as “public corporations and bodies corporate and politic.”

Public corporations are created for the administration of public affairs and include instrumentalities created by the state, formed and owned in the public interest, supported in whole or in part by public funds, and governed by managers deriving their authority from the state. Other organizations are governmental organizations under the Guide’s definition if they have one or more of the following three characteristics:

- Popular election of officers or appointment (or approval) of a controlling majority of the members of the organization’s governing body by officials in one or more state or local government
- The potential for unilateral dissolution by a government with net assets reverting to the government
- The power to enact or enforce a tax levy

Using the economic development corporation example mentioned earlier, in a common scenario, the mayor appoints the majority of the corporation’s board of directors, meeting the first criterion described. Similarly, if the city decided to dissolve this economic development corporation and received all of the corporation’s net assets upon dissolution, the second criterion would be met. Accordingly, the hypothetical economic development organization should follow GAAP for governments.

SUMMARY

The purpose of this chapter is to describe a broad framework and context about accounting principles used by governments so that more specific information about accounting principles can be understood. Governments are unique entities and the accounting principles applied by these entities need to be reflective of the environment and types of activities in which these organizations engage.