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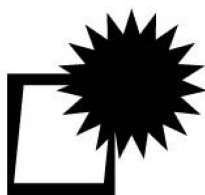
Interpretation and Application of
GENERALLY ACCEPTED
ACCOUNTING PRINCIPLES
for State and Local Governments

Warren Ruppel

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2017



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PREFACE

Governmental accounting is a specialized area that has undergone significant changes over the past few decades. As governmental accounting standards have developed, the complexities of preparing financial statements for governmental entities have greatly increased. Providing meaningful financial information to a wide range of users is not an easy task. Adding to these challenges, the Governmental Accounting Standards Board (GASB) brought sweeping changes to the governmental financial reporting model and is now continuing the process of addressing many important accounting areas related to that model.

Given this rapidly changing environment, the financial statement preparer needs a technical resource that provides more than accurate, competent technical information. The resource needs to be written to fit today's governmental accounting environment. It needs to take a fresh look at some of the long-standing accounting questions faced by governments and to provide meaningful up-to-date information on recently issued and soon-to-be-issued accounting pronouncements.

The purpose of this book is to meet these needs by providing a useful, complete, and practical guide to governmental accounting principles and financial reporting. Throughout, the book will provide the reader with:

- An understanding of the concepts and theories underlying each topic discussed.
- A complete, authoritative reference source to assure the reader that all aspects of a particular topic are covered.
- Practical guidance to allow financial statement preparers and auditors to meet the requirements of generally accepted accounting principles for governments and to efficiently and effectively implement new requirements.

The approach used in this book is to provide the reader with useful information in a usable format. Accounting theory must correspond with practical examples to be useful, because theory seldom matches the specific situation. For technical information to be usable, it must be clearly presented without clutter and unnecessary repetition. The substance of accounting requirements must also be understood in order for them to be properly applied. Understanding the reasons why technical requirements exist is an important ingredient in properly applying accounting standards.

The 2017 edition of this book begins with an overview of governmental accounting principles and a description of the various types of funds currently in use by governmental entities. It then describes basic financial statements and provides guidance for reporting various assets, liabilities, revenues, and expenses/expenditures. Finally, it examines the accounting and financial reporting requirements for several specific types of governmental entities. The book also includes a "Disclosure Checklist," which should prove very helpful in determining the completeness of a governmental entity's financial statement disclosures.

This book would not have come to fruition without the hard work and perseverance of a number of individuals. John DeRemigis of John Wiley & Sons had the confidence to work with me in developing the original concept for the book and in ensuring its continuing quality and success. Pam Reh's efforts in producing past editions of the book are greatly appreciated, as are the current members of the Wiley team.

Of course, the time and effort needed to write and maintain this book would not be possible without a supportive family, for which I am grateful to my wife, Marie, and my sons, Christopher and Gregory.

Warren Ruppel, CPA
Woodcliff Lake, NJ
March 2017

ABOUT THE AUTHOR

Warren Ruppel, CPA, is a Partner at Marks Paneth LLP, New York, in the firm's Nonprofit, Government and Healthcare Group, where he serves as the Practice Leader for Government Services. He formerly was the assistant comptroller for accounting of the City of New York, where he was responsible for all aspects of the City's accounting and financial reporting. He has over 35 years of experience in governmental and not-for-profit accounting and financial reporting. He began his career at KPMG after graduating from St. John's University, New York. His involvement with governmental accounting and auditing began with his first audit assignment—the second audit ever performed of the financial statements of the City of New York. From that time he served many governmental and commercial clients until he joined Deloitte & Touche in 1989 to specialize in audits of governments and not-for-profit organizations. Mr. Ruppel has also served as the chief financial officer of an international not-for-profit organization.

Mr. Ruppel has served as an instructor for many training courses, including specialized governmental and not-for-profit programs and seminars. He has also been an adjunct lecturer of accounting at the Bernard M. Baruch College of the City University of New York. He is the author of five other books, *OMB Circular A-133 Audits*, *Not-for-Profit Organization Audits*, *Not-for-Profit Accounting Made Easy*, *Government Accounting Made Easy*, and *Not-for-Profit Audit Committee Best Practices*. He is also the government specialist for SmartPros online *CPA Report*, in which he appears quarterly to provide a governmental accounting and auditing update.

Mr. Ruppel is a member of the American Institute of Certified Public Accountants as well as the New York State Society of Certified Public Accountants, where he serves on the board of directors and chairs its Audit Committee. He also serves on the Governmental Accounting and Auditing Committee and is a past president of the Foundation for Accounting Education. He is a past president of the New York Chapter of the Institute of Management Accountants. Mr. Ruppel is a member of the New York State Government Finance Officers Association, where he serves on its Accounting, Auditing and Financial Reporting Committee. He also serves on the Special Review Committee of the national Government Finance Officers Association. In addition, he is a member of the Executive Advisory Board to the Department of Accounting and Taxation of St. John's University.

1 NEW DEVELOPMENTS

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INTRODUCTION

The 2017 Governmental GAAP Guide incorporates all of the pronouncements issued by the Governmental Accounting Standards Board (GASB) through February 2017. This chapter is designed to keep the reader up to date on all pronouncements recently issued by the GASB and their effective dates, as well as to report on the Exposure Drafts, Preliminary Views, and Invitations to Comment for proposed new statements or interpretations that are currently outstanding. This chapter also includes relevant information on the GASB's Technical Agenda for the upcoming year to give readers information as to potential areas for future GASB requirements.

RECENTLY ISSUED GASB STATEMENTS AND THEIR EFFECTIVE DATES

<i>GASB Statement</i>	<i>Effective Date</i>	<i>Where in This Book</i>
72 <i>Fair Value Measurement and Application</i>	Periods beginning after June 15, 2015	Chapter 12
73 <i>Accounting and Financial Reporting for Pensions and Related Assets That Are Not within the Scope of GASB Statement 68, and Amendments to Certain Provisions of GASB Statements 67 and 68</i>	Fiscal years beginning after June 15, 2016, for pensions not within the scope of GASB 68 Fiscal years beginning after June 15, 2015, for asset reporting and GASB 67 and 68 Amendments	Chapter 17
74 <i>Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans</i>	Fiscal years beginning after June 15, 2016	Chapter 22

75	<i>Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions</i>	Fiscal years beginning after June 15, 2017	Chapter 17
76	<i>The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments</i>	Periods beginning after June 15, 2015	Chapter 2
77	<i>Tax Abatement Disclosures</i>	Periods beginning after December 15, 2015	Chapter 9
78	<i>Pensions Provided through Certain Multi-Employer Defined Benefit Plans</i>	Periods beginning after December 15, 2015	Chapter 17
79	<i>Certain External Investment Pools</i>	Periods beginning after June 15, 2015	Chapter 12
80	<i>Blending Requirements for Certain Component Units—An Amendment of GASB Statement No. 14</i>	Periods beginning after June 15, 2016	Chapter 11
81	<i>Irrevocable Split-Interest Agreements</i>	Periods beginning after December 15, 2016	Chapter 12
82	<i>Pension Issues—An Amendment of GASB Statements No. 67, No. 68, and No. 73</i>	Periods beginning after June 15, 2016	
83	<i>Certain Asset Retirement Obligations</i>	Periods beginning after June 15, 2018	Chapter 14
84	<i>Fiduciary Activities</i>	Periods beginning after December 15, 2018	Chapter 8

The GASB has a number of Exposure Drafts and Preliminary Views that it has issued, which will affect future accounting and financial reporting requirements when final standards are developed. The following provides a brief synopsis of what is being covered by each Exposure Draft and Preliminary Views document. Readers should always be aware that the GASB often modifies proposal stage literature based upon its continuing deliberations and consideration of comments that it receives on each Exposure Draft and Preliminary Views document.

EXPOSURE DRAFTS

Exposure Drafts—Implementation Guides

The GASB has two Exposure Drafts related to implementation guides. The first, which was issued in November 2016, will result in an annual update to the GASB's Comprehensive Implementation Guide. The second, which was issued in December 2016, will contain implementation guidance for GASB Statement Nos. 74 and 75 on Other Postemployment Benefits.

GASB Implementation Guides are considered authoritative GAAP for governments and consist of a series of very specific questions and answers that are designed to assist financial statement preparer and auditors implement GASB Statements. In some cases they address practice questions that arise; in other cases they address questions that the GASB chose not to specifically address in a GASB Statement itself.

Exposure Draft—*Omnibus 201X*

The GASB issued this Exposure Draft in September 2016 to address certain specific issues across a wide variety of topics. Specifically, the Exposure Draft states that its objective is to address practice issues that have been identified during implementation and application of certain GASB Statements. The Exposure Draft addresses a variety of topics including issues related to component unit presentation, goodwill, fair value measurement and application, and postemployment benefits (pensions and other postemployment benefits [OPEB]).

Specifically, a Statement resulting from this Exposure Draft would address the following topics:

- Blending a component unit in circumstances in which the primary government is a business-type activity that reports a single column for financial statement presentation.
- Amounts reported as goodwill and “negative” goodwill.
- How to classify real estate held for both operations and investment purposes by insurance entities.
- Measuring certain money market investments and participating interest-earning investment contracts at amortized cost.
- Timing of the measurement of pension and OPEB liabilities and related expenditures recognized in financial statements prepared using the current financial resources measurement focus.
- Recognition of on-behalf payments for pensions or OPEB in employer financial statements.
- Presentation of payroll-related measures in required supplementary information for purposes of reporting by OPEB plans and employers that provide OPEB.
- Classification of employer-paid member contributions for OPEB.
- Simplifications related to the alternative measurement method for OPEB.
- Accounting and financial reporting for OPEB provided through certain multiple-employer defined benefit OPEB plans.

Effective Date

The requirements of this proposed Statement would be effective for reporting periods beginning after June 15, 2017. Earlier application would be encouraged.

Exposure Draft—Certain Debt Extinguishment Issues

The GASB issued this Exposure Draft in August 2016. Its Summary highlights the following items that are addressed.

Accounting and Financial Reporting for In-Substance Defeasance of Debt Using Only Existing Resources

Statement No. 7, *Advance Refundings Resulting in Defeasance of Debt*, requires that debt be considered defeased in substance if the debtor irrevocably places refunding debt proceeds with an escrow agent in a trust to be used solely for satisfying scheduled payments of both principal and interest of the defeased debt. The trust also is required to meet certain conditions for the transaction to qualify as an in-substance defeasance. This Exposure Draft would establish essentially the same requirements if a government places only existing resources in a trust to extinguish the debt. Any difference between the reacquisition price (the amount required to be placed in the trust) and the net carrying amount of the debt defeased in substance using only existing resources would be recognized as a separately identified gain or loss in the period of the defeasance in financial statements using the economic resources measurement focus.

Governments that defease debt using only existing resources would provide a general description of the transaction in the notes to the financial statements in the period of the defeasance. In all periods following an in-substance defeasance of debt using only existing resources, the amount of that debt that remains outstanding at period-end would be disclosed.

Prepaid Insurance Related to Extinguished Debt

For governments that extinguish debt, whether through a legal extinguishment or through an in-substance defeasance, this Exposure Draft would require that any remaining prepaid insurance related to the extinguished debt be included in the net carrying amount of that debt for the purpose of calculating the difference between the reacquisition price and the net carrying amount of the debt.

Notes to Financial Statements for In-Substance Defeasance Transactions

One of the criteria for determining an in-substance defeasance is that the trust be limited to holding only monetary assets that are classified as being essentially risk free. If the substitution of essentially risk-free monetary assets with monetary assets that are not essentially risk free is not prohibited, governments would disclose that fact in the period in which the debt is defeased in substance. In subsequent periods, governments would disclose the amount of debt defeased in substance that remains outstanding for which that risk of substitution exists.

NOTE: One implementation question not addressed by this Exposure Draft is how could an in-substance defeasance be accomplished if monetary assets that are not essentially risk free are used to defease the debt? Having disclosure requirements related to monetary assets that are not essentially risk free results in this question.

Effective Date and Transition

The requirements of this proposed Statement would be effective for reporting periods beginning after June 15, 2017. Earlier application would be encouraged.

Exposure Draft—Leases

The GASB issued this Exposure Draft in January 2016. A Standard resulting from this Exposure Draft will result in significant changes in the accounting for leases. This project is similar to a project completed by the FASB, although the accounting requirements are not at all identical.

The Summary of the Exposure Draft provides the following information.

Definition of a Lease

A lease would be defined as a contract that conveys the right to use a nonfinancial asset (the underlying asset) for a period of time in an exchange or exchange-like transaction. Examples of nonfinancial assets include buildings, land, vehicles, and equipment. Any contract that meets this definition would be accounted for under the proposed leases guidance, unless specifically excluded.

Lease Term

The lease term would be defined as the period during which a lessee has a noncancelable right to use an underlying asset, plus the following periods, if applicable, covered by a lessee's option to:

- a. Extend the lease if it is reasonably certain, based on all relevant factors, that the lessee will exercise that option.
- b. Terminate the lease if it is reasonably certain, based on all relevant factors, that the lessee will not exercise that option.

A fiscal funding or cancellation clause would be considered in determining the lease term only when it is reasonably certain that the clause will be exercised.

Lessees and lessors would reassess the lease term only if the lessee does either of the following:

- a. Elects to exercise an option even though the lessor or lessee had previously determined that it was reasonably certain that the lessee would not exercise that option.
- b. Elects to not exercise an option even though the lessor or lessee had previously determined that it was reasonably certain that the lessee would exercise that option.

Lessee Accounting

A lessee would recognize a lease liability and a lease asset at the beginning of a lease, unless the lease is a short-term lease or transfers ownership of the underlying asset. The lease liability would be measured at the present value of payments expected to be made for the lease term. The lease asset would be measured at the amount of the initial measurement of the lease liability, plus any payments made to the lessor at or before the beginning of the lease and certain indirect costs.

A lessee would reduce the lease liability as payments are made and recognize an outflow of resources for interest on the liability. The lessee would amortize the lease asset in a systematic and rational manner over the shorter of the lease term or the useful life of the underlying asset. The notes to the financial statements would include a description of leasing arrangements, the amount of lease assets recognized, and a schedule of future lease payments to be made.

Lessor Accounting

A lessor would recognize a lease receivable and a deferred inflow of resources at the beginning of a lease, with certain exceptions (including a short-term lease or a lease that transfers ownership of the underlying asset). A lessor would not derecognize the asset underlying the lease. The lease receivable would be measured at the present value of lease payments expected to be received for the lease term. The deferred inflow of resources would be measured at the value of the lease receivable plus any payments received at or prior to the beginning of the lease that relate to future periods.

A lessor would recognize interest revenue on the lease receivable and an inflow of resources (for example, revenue) from the deferred inflow of resources in a systematic and rational manner over the term of the lease. The notes to the financial statements would include a description of leasing arrangements and the total amount of revenue recognized from leases.

NOTE: This is a significant departure from the FASB standard, which does not significantly change lessor accounting for what are currently referred to as operating leases.

Contracts with Multiple Components and Contract Combinations

Generally, a government would account for the lease and nonlease components of a lease as separate contracts. If a lease involves multiple underlying assets, lessees and lessors generally would account for each underlying asset as a separate lease contract. To allocate consideration required under the contract to different components, lessees and lessors would use contract prices for individual components if reasonable based on observable stand-alone prices. Under certain circumstances, multiple components in a lease contract would be accounted for as a single lease unit. Contracts that are entered into at or near the same time with the same counterparty and meet

certain criteria would be considered part of the same lease contract and would be evaluated in accordance with the guidance on contracts with multiple components.

NOTE: Nonlease component might involve maintenance contracts that are part of a rental payment.

Short-Term Leases

A short-term lease would be defined as a lease that, at the beginning of the lease, has a maximum possible term under the contract of 12 months or less, including any options to extend, regardless of its probability of being exercised. Lessees and lessors would recognize short-term lease payments as outflows of resources or inflows of resources, respectively, based on the payment provisions of the contract.

NOTE: Provisions in the Exposure Draft will discourage constant rollover of short-term leases, particularly between related entities, to avoid the accounting requirement summarized herein.

Lease Terminations and Modifications

An amendment to a lease contract would be considered a lease modification, unless the lessee's right to use the underlying asset decreases, in which case it would be a partial termination. A lease termination would be accounted for by reducing the carrying values of the lease liability and lease asset by a lessee, or the lease receivable and deferred inflow of resources by the lessor, with any difference being recognized as a gain or loss. A lease modification generally would be accounted for by remeasuring the lease liability and adjusting the related lease asset by a lessee, or remeasuring the lease receivable and adjusting the related deferred inflow of resources by a lessor.

Subleases and Leaseback Transactions

Subleases would be treated as transactions separate from the original lease. The original lessee that becomes the lessor in a sublease would account for the original lease and the sublease as separate transactions as a lessee and lessor, respectively.

A transaction would qualify for sale-leaseback accounting only if it includes a qualifying sale. Otherwise, it is a borrowing. The sale and leaseback portions of a transaction would be accounted for as separate sale and lease transactions, except that any difference between the carrying value of the capital asset that was sold and the net proceeds from the sale would be reported as a deferred inflow of resources or a deferred outflow of resources and recognized over the term of the leaseback.

A lease-leaseback transaction would be accounted for as a net transaction. The gross amounts of each portion of the transaction would be disclosed.

Effective Date and Transition

The requirements of this proposed Statement would be effective for reporting periods beginning after December 15, 2018. Earlier application is permitted. Leases would be recognized and measured using the facts and circumstances that exist at the beginning of the period of implementation (or, if applied to earlier periods, the beginning of the earliest period restated). However, lessors would not restate the assets underlying their existing sales-type or direct financing leases. Any residual assets for those leases would become the carrying values of the underlying assets.

INVITATION TO COMMENT

Financial Reporting Model Improvements—Governmental Funds

In December the GASB issued this ITC to address the accounting used by governmental funds, currently the modified accrual basis of accounting and the current financial resources measurement focus. This ITC requests commentary on three different replacement models for the current model. These are the near-term financial resource model (near-term meaning 60–90 days), the short-term resources model (short-term meaning one year) and the long-term financial resources model (similar accounting to what is used in the government-wide statements, except that capital assets would not be recorded.)

The ITC also requests comments on alternative presentations for the resource flows statement, the requirement for presenting a cash flows statement, and a proposed simplification between the government-wide and governmental fund financial statements.

While this is a very preliminary phase of this project, it seems almost certain that there will be changes made to the basis of accounting and measurement focus used by governmental funds.

GASB PROJECT PLAN

The GASB has a number of additional important projects on its agenda that will likely affect governmental accounting and financial reporting in the future. Some of the more significant projects are as follows.

Financial reporting model. The ITC discussed earlier in this chapter is part of this project, which is taking a fresh look at the basic financial reporting model required by GASBS 34, as amended, to determine if it is working effectively and whether any changes to the model need to be made.

Revenue and expense recognition. This project is somewhat in response to a recent FASB standard on revenue recognition. The GASB is examining whether a similar standard should be adopted for governments. The GASB has also added expense recognition to this project.

SUMMARY

The GASB, as always, maintains an active agenda, and the accounting and financial reporting standards for governments are consistently evolving. Financial statement preparers need to keep an eye on emerging new GASB pronouncements to ensure that they have adequate time to plan for their implementation, as well as to inform financial statement users about their potential impacts.

2 FOUNDATIONS OF GOVERNMENTAL ACCOUNTING

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INTRODUCTION

The field of governmental accounting and financial reporting has undergone significant growth and development over the last 30 years. Generally accepted accounting principles for governments were once a loosely defined set of guidelines followed by some governments and governmental entities, but now have developed into highly specialized standards used in financial reporting by an increasing number of these entities. Because of this standardization, users are able to place additional reliance on these entities' financial statements. The Governmental Accounting Standards Board (GASB) has designed a model for financial reporting by governments that results in a significantly different look to governmental financial statements from those of the past, as well as from those of commercial organizations. There have also been substantive changes in the accounting principles used by governments. Governmental financial statement preparers, auditors, and users must have a complete understanding of these requirements to fulfill their financial reporting obligations.

CHAPTER OVERVIEW

This chapter provides a background on the development and purpose of governmental accounting standards. The topics in this chapter follow.

- Entities covered by governmental accounting principles.
- Overview of the history of governmental accounting standards setting.

- Objectives of governmental accounting and financial reporting.
- Communication methods.
- Elements of financial statements.
- Hierarchy of governmental accounting standards.

ENTITIES COVERED BY GOVERNMENTAL ACCOUNTING PRINCIPLES

This book addresses this topic in much more detail throughout its later chapters as specific types of entities are discussed. However, in general, the following entities are covered by governmental generally accepted accounting principles:

- State governments.
- Local governments such as cities, towns, counties, and villages.
- Public authorities such as economic development, parking, housing, water and sewer, 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 include states, cities, towns, counties, and villages) and special-purpose governments (which is a term used in GASBS 34, *Basic Financial Statements—and Management’s Discussion and Analyses*, to refer to governments and governmental entities other than general-purpose governments). Both general-purpose and special-purpose governments are covered by governmental generally accepted accounting principles and by this book.

Not-for-profit organizations are not included within the scope of governmental accounting standards unless they are considered governmental not-for-profit organizations (discussed in detail below), nor are the federal government and its various agencies and departments. Not-for-profit organizations and the federal government are sometimes confused with the governments that this book is addressing when they are homogenized into something commonly referred to as the “public sector.” Not all public-sector entities (as described above) are subject to governmental accounting principles and standards.

Distinguishing a Governmental Entity from a Not-for-Profit Organization

Some organizations are difficult to categorize as either a governmental entity or not-for-profit organization. For example, local governments may set up economic development corporations that have many characteristics of not-for-profit organizations, including federal tax-exempt status under Section 501(c)(3) of the Internal Revenue Code. However, these organizations are usually considered governmental not-for-profit organizations that should follow generally accepted accounting principles for governments. A definition of a governmental not-for-profit organization (subject to the accounting standards promulgated by the GASB) is found in the AICPA Audit and Accounting Guide *State and Local Governments* (the Guide). The Guide defines governmental organizations as “public corporations and bodies corporate and politic.” Other organizations are

governmental organizations under the Guide's definition if they have one or more of the following 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 governments.
- The potential for unilateral dissolution by a government with the net assets reverting to a government.
- The power to enact or enforce a tax levy.

In applying the above definitions, a public corporation is described in the Guide as an artificial person, such as a municipality or a governmental corporation, created for the administration of public affairs. Unlike a private corporation, it has no protection against legislative acts altering or even repealing its charter. Public corporations include instrumentalities created by the state, formed and owned in the public interest, supported in whole or part by public funds, and governed by managers deriving their authority from the state. Exhibit 1 provides some consensus examples of public corporations often found at the state and local government level.

Furthermore, entities are presumed to be governmental if they have the ability to issue directly (rather than through a state or municipal authority) debt that pays interest exempt from federal taxation. However, entities possessing only that ability (to issue tax-exempt debt) and none of the other governmental characteristics may rebut the presumption that they are governmental if their determination is supported by compelling, relevant evidence.

The Guide provides that entities are governmental or nongovernmental for accounting, financial reporting, and auditing purposes based solely on the application of the preceding criteria and that other factors are not determinative. As an example the Guide provides that the fact that an entity is incorporated as a not-for-profit organization and exempt from federal income taxation under the provisions of Section 501 of the Internal Revenue Code is not a criterion in determining whether an entity is governmental or nongovernmental for accounting, financial reporting, and auditing purposes.

NOTE: GASBS 34 eliminated some of the apparent inconsistencies that existed in the past about financial reporting for governmental not-for-profit organizations. Under GASBS 34, they are special-purpose governments that should follow the accounting guidance as delineated under GASBS 34 and all other applicable GASB pronouncements.

Exhibit 1

The following are examples of "public corporations" that are often found at the state and local government level. These organizations would usually be considered governmental entities when the definition provided in the Guide is applied.

- Public hospital.
- Public college or university.
- Economic development corporation.
- Housing authority.
- Water and sewer utility.
- Electric or gas utility.
- Industrial development authority.
- Educational construction authority.

Typically, these organizations are created by acts of state legislatures. Their continued existence and legal authority to operate can generally be changed at the discretion of the state legislature.

GASBS 39, Determining Whether Certain Organizations Are Component Units—An Amendment of GASB Statement No. 14, resulted in more not-for-profit organizations being included within the financial reporting entity of a government or governmental entity. In these cases, GASBS 39 does not require that these not-for-profit organizations comply with the financial reporting requirements for governments. Despite their inclusion within a government's reporting entity, many of these types of organizations (such as fundraising foundations) would not be considered governmental organizations and would still report their separately issued financial statements using the standards of the Financial Accounting Standards Board (FASB). The financial statement preparer should incorporate the not-for-profit organization's financial statements (reported using FASB principles) within the governmental reporting model (using GASB principles) which may require that the not-for-profit organization actually be reported somewhat separately from the primary government, such as on a separate page. Appendix E of GASBS 39 provides an illustration of including a not-for-profit organization foundation with a governmental university. GASBS 39 is more fully discussed in Chapter 11.

OVERVIEW OF THE HISTORY OF GOVERNMENTAL ACCOUNTING STANDARDS SETTING

Understanding how governmental accounting standards were developed appears difficult at first because it seems that so many different entities and organizations were involved in the standards-setting process. Working from the current process through history is the easiest way to understand the interrelationships of the various entities involved. Currently, governmental accounting standards are established by the GASB. The GASB is a “sister” organization to the Financial Accounting Standards Board (FASB). The FASB establishes accounting standards for private-sector entities, including both commercial entities and not-for-profit organizations. Both the FASB and the GASB are overseen by the Financial Accounting Foundation (FAF), an independent, private-sector organization that, among other things is responsible for the oversight, administration, and finances of the GASB and FASB.

NOTE: One significant difference between the GASB and the FASB is the FASB's role in setting accounting principles for public companies. Under the Sarbanes-Oxley Act of 2002, accounting standards for public companies are the responsibility of the US Securities and Exchange Commission (SEC). The SEC continues to recognize accounting standards promulgated by the FASB.

Prior to the formation of the GASB, governmental accounting standards were promulgated by the National Council on Governmental Accounting (NCGA). The NCGA was an outgrowth of a group called the National Committee on Governmental Accounting, which itself was an outgrowth of a group called the National Committee on Municipal Accounting (NCMA). These groups were sponsored by the Government Finance Officers Association (GFOA), originally known as the Municipal Finance Officers Association (MFOA).

The first of several collections of municipal accounting standards issued by the NCGA in 1934 became known as the “blue book.” Subsequently, a second blue book was issued by the NCGA in 1951, and a third was issued in 1968, entitled *Governmental Accounting, Auditing, and*

Financial Reporting (GAAFR). Subsequent versions of this book were issued in 1980, 1988, and 1994. In 2001, the GFOA issued a major revision of the GAAFR to incorporate the changes to governmental financial reporting as a result of GASBS 34. Another update was published in 2005 to include the new standards for accounting and reporting for postemployment benefits other than pensions established by GASBS 43 and 45. A 2012 update includes reporting deferred inflows and outflows of resources under GASBS 63 and 65. However, these later blue books were different from the 1968 and prior blue books in that they were not meant to be authoritative sources of governmental accounting standards. None of the 1988 through 2012 blue books would be an authoritative source of accounting standards, since the GASB was created in 1984 to serve this purpose; thus the GFOA no longer has the ability to issue authoritative accounting standards. Even with the issuance of the 1980 blue book, the GFOA (then known as the MFOA) decided not to use the blue book as a means of promulgating new accounting standards. Rather, the focus of the blue book was changed to provide financial statement preparers (and their auditors) with detailed and practical guidance to implement authoritative accounting standards. The blue book continues to be used by the GFOA to set the requirements for its “Certificate of Achievement for Excellence in Financial Reporting” program, covered in Chapter 9.

NOTE: The FASB world of accounting standards has recently been dominated by a move to “converge” standards with International Financial Reporting Standards (IFRS) as promulgated by the International Accounting Standards Board. The reader may wonder if there is an equivalent process in place in the world of government accounting standards. The answer is yes, although there is not nearly the same momentum or drive to converge the US standards with the international standards. Rather, the International Public Sector Accounting Standards Board (IPSASB) has a strategy to converge its International Public Sector Accounting Standards (IPSAS) with IFRS, which are issued by the International Accounting Standards Board. As part of this strategy, IPSASB has developed guidelines for modifying IFRS for application by public sector entities. As discussed later in this chapter, the hierarchy of accounting principles for governments includes IPSAS standards as “other accounting literature.” The FAF, along with the GASB and FASB, has recently developed a strategic plan, which mentions increased involvement of the GASB in international standards as a goal.

OBJECTIVES OF GOVERNMENTAL ACCOUNTING AND FINANCIAL REPORTING

In describing the history of the governmental accounting standards development process, one could logically ask the question, “Why were separate accounting and financial reporting standards needed for governments?” The answer to this depends on the identities of the groups of readers and users of the financial statements of state and local governments, the objectives of these readers and users, and the overall objectives of governmental financial reporting.

GASB Concepts Statement 1

The GASB addressed this basic question relatively soon after it was created to serve as an underpinning for all of its future standards-setting work. The GASB issued Concepts Statement 1, Objectives of Financial Reporting (GASBCS 1), which identifies the primary users of the financial statements of state and local governments and their main objectives.

To determine the objectives of governmental financial reporting, the GASB first set forth the significant characteristics of the governmental environment. These characteristics are listed in Exhibit 2.

Exhibit 2: Characteristics of the governmental environment under GASB Concepts Statement 1

- Primary characteristics of a government's structure and the services it provides.
- Control characteristics resulting from a government's structure.
- Use of fund accounting for control purposes.
- Dissimilarities between similarly designated governments.
- Significant investment in non-revenue-producing capital assets.
- Nature of the political process.
- Users of financial reporting.
- Uses of financial reporting.
- Business-type activities.

Each of these characteristics is described in the following pages.

Primary Characteristics of a Government's Structure and the Services It Provides

- **The representative form of government and the separation of powers.** This emphasizes that the ultimate power of governments is derived from the citizenry. The most common forms of government used in the United States are based on a separation of power among three branches of government: executive, legislative, and judiciary.
- **The federal system of government and the prevalence of intergovernmental revenues.** This characteristic describes the three primary levels of government: federal, state, and local. Because of differences in abilities to raise revenues through taxes and other means, many intergovernmental grants result in revenues passing from one level to another. For example, federal funds for the Temporary Assistance for Needy Families (TANF) program start at the federal level and flow through the states to local governments, where the program is actually administered.
- **The relationship of taxpayers to service receivers.** In terms of impact on the objectives of financial reporting, this characteristic of governments may be the most significant. Following are some interesting points that the GASB included in GASB CS 1 that may affect financial reporting objectives:
 - Taxpayers are involuntary resource providers. They cannot choose whether to pay their taxes.
 - Taxes paid by an individual taxpayer generally are based on the value of property owned or income earned and seldom have a proportional relationship to the cost or value of the services received by the individual taxpayer.
 - There is no exchange relationship between resources provided and services received. Most individual taxes do not pay for specific services.
 - The government generally has a monopoly on the services that it provides.
 - It is difficult to measure optimal quality or quantity for many of the services provided by governments. Those receiving the services cannot decide the quantity or quality of a particular service of the government.

Control Characteristics Resulting from a Government's Structure

- **The budget as an expression of public policy and financial intent and a method of providing control.** In the commercial world, revenues exceeding budget and expenses under budget would almost always be considered good things. In the governmental environment, higher revenues might indicate that taxes are set too high. Even more problematic, expenditures below budget might indicate that levels of spending for public

purposes are not achieved because the budgeted funding level is a matter of public policy. Politically speaking, expenditures below budget might not be a good thing, unless the reductions were achieved by unanticipated efficiencies.

- **The budget is a financial plan or expression of financial intent.** This is a similar concept to the public policy question, but also brings into consideration the fact that the budgets of governments generally need to be balanced; for instance, revenues should equal expenditures, highlighting the concept that governments need to live within their means.
- **The budget is a form of control that has the force of law.** Since governments' budgets generally are subject to approval of both executive and legislative branches (similar to the process for other forms of legislation), violation of the budget's spending authority can be construed as a violation of the law.
- **The budget may be used as a mechanism to evaluate performance.** This characteristic is generally less useful in the government environment than in the commercial environment, since performance evaluation is not viewed as the primary purpose of the budget. To be effective, comparison of budgeted to actual results over time would have to be made, as well as consideration of the government's service efforts and accomplishments.

Use of fund accounting for control purposes. Most governments are required by law to use a fund accounting structure as a means to control use of resources. In some cases, bond indentures may require establishing and maintaining funds. In other cases, the government may decide to use fund accounting not because it is required, but simply because it can provide a useful control mechanism for distinguishing various components of its operation.

Regardless of the reason for the use of fund accounting, when examining the objectives of financial reporting for governments, the predominant use of fund accounting must be considered to properly recognize the potential needs of financial statement users.

Dissimilarities between similarly designated governments. GASBCS 1 concludes that the differences in the organization of governmental entities, the services they provide, and their sources of revenues all need to be considered when developing financial reporting objectives. For example, different governments at the same level (for example, county governments) may provide significantly different services to their constituents. The levels and types of services provided by county governments depend on the services provided by the cities, towns, villages, and so forth, within the county, as well as by the state government under which the counties exist. In other unique examples, such as the city of New York, there are five county governments located within the city. Beyond boundary differences, the level of provision of services (such as human services and public safety) varies from county to county. In addition, counties also derive their primary revenues from different sources. Some counties may rely primarily on a county tax on real property within the county. Other counties may rely more heavily on a portion of a sales tax. The important point is that there is a high degree of variability among governments that are at comparable levels.

NOTE: This dissimilarity, while an important characteristic to consider when determining financial reporting objectives, is not unlike that encountered in the commercial environment. A financial statement reader of commercial entities encounters many dissimilarities among the nature of the operations of companies in seemingly identical industries.

Significant investment in non-revenue-producing capital assets. Governments do not determine their capital spending plans based strictly upon return-on-investment criteria. In fact, governments invest in large, non-revenue-producing capital assets, such as government office

buildings, highways, bridges, sidewalks, and other infrastructure assets. In many cases, these assets are built or purchased for public policy purposes. Along with this capital investment is a capital maintenance assumption that governments have an obligation to maintain their capital assets. A government's implicit commitment to maintain its assets and its ability to delay maintenance and rehabilitation expenditures (particularly for non-revenue-producing capital assets) were important considerations in GASBCS 1.

Certainly return on investment is considered. Where governments engage in fee-for-service activities, these considerations are not unlike those found in commercial company accounting. For example, should the public water utility invest in a new piece of equipment that will reduce its costs by \$XX or enable it to serve XX number of new customers and generate more revenue? In addition to the business-type decisions, however, governments also make cost/benefit decisions in other seemingly non-revenue-producing activities. For example, a town may decide to invest in new sidewalks and street lighting in its shopping district to raise property values of the businesses in this district, as well as the overall appeal of the town itself. While this investment is non-revenue-producing in the strictest sense, the long-term strategy of the town is the maintenance and enhancement of its property values, and accordingly, its property tax revenues. At the same time, the government may reduce its judgments and claims costs as the number of trip-and-fall lawsuits decreases because of the improved infrastructures.

Nature of the political process. Governments must reconcile the conflict between the services desired by the citizens and the citizens' desire to provide resources to pay for those services. The objectives of the citizenry are to obtain the maximum amount of service with a minimum amount of taxes. These conflicts are handled by politicians whose relatively short terms in public office encourage the use of short-term solutions to long-term problems. Accordingly, governments are susceptible to adopting the practices of satisfying some service needs by deferring others, paying for an increased level of services with nonrecurring revenues, and deferring the cash effect of events, transactions, and circumstances that occur in a particular period. GASBCS 1 concludes that to help fulfill a government's duty to be accountable, financial reporting should enable the 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. GASBCS 1 identifies three primary groups as the users of governmental financial reports:

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

While these three user groups have some overlap with the commercial environment, clearly the citizenry and legislative users are somewhat unique to governments.

NOTE: As will be further examined in Chapter 10, which examines the governmental budgeting process, the budget to actual reporting that is considered by many as inherently necessary in governmental financial reporting is designed to meet the needs of the citizenry and legislative users. These groups are somewhat unique to governments as users of financial reporting. This is why budget to actual financial reporting is included where budgets are legally adopted by governments, whereas this reporting has no counterpart in the commercial accounting (or even the not-for-profit accounting) environment.

For example, the expenditures budgeted in a government's general fund represent the amounts that the citizens/taxpayers have authorized the government (through their legislators) to spend from that fund. In order for the government to demonstrate its financial accountability to the citizens and legislators, information is needed within governmental financial reporting that compares the amounts actually spent with the amounts that were legally authorized to be spent.

Uses of financial reporting. The uses of financial reporting by governments center upon economic, political, and social decisions, as well as assessing accountability. These uses are accomplished by the following means:

- **Comparing actual financial results with the legally adopted budget.** Spending in excess of budget may indicate poor financial management, weak budgetary practices, or uncontrollable, unforeseen circumstances. Underspensing may indicate effective cost containment or that the quality or quantity of services provided by the government could have been increased without going over budget.
- **Assessing financial condition and results of operations.** Each of the three user groups described above has a different primary reason for assessing a government's financial condition and results of operations. For example, investors and creditors are interested in the financial condition of a government in order to assess whether the government will be able to continue to pay its obligations and meet its debt service requirements. Similarly, these users look to a government's results of operations and cash flows for indications of whether the financial condition of the government is likely to improve or worsen. As another example, the citizenry is interested in the financial condition and operating results of a government as indications of the need to change the rate of tax levies or increase or decrease the levels of services provided in the future.
- **Assisting in determining compliance with finance-related laws, rules, and regulations.** Governmental financial reports can demonstrate compliance with legally mandated budgetary controls and controls accomplished through the use of fund accounting. For example, if the government is legally required to have a debt service fund, and the existence and use of such a fund is clear from a financial statement presentation, compliance is demonstrated. Similarly, compliance with debt covenants, bond indentures, grants, contracts, and taxing and debt limits can also be demonstrated by governmental financial reporting.
- **Assisting in evaluating efficiency and effectiveness.** Governmental financial reporting may be used to obtain information about service efforts, costs, and accomplishments. Users of this information are interested in the economy, effectiveness, and efficiency of a government. This information may form the basis of their funding or voting decisions.

NOTE: In the governmental financial reporting model promulgated by GASBS 34, the GASB concluded that both government-wide and fund financial statements were necessary in order for the financial reporting model to meet the financial reporting objectives and needs of users as described in GASB 34. The objectives described in GASB 34, including the needs of the various user groups described above, were driving forces in determining how the financial reporting model promulgated by GASBS 34 took shape.

Business-type activities. In addition to the general governmental characteristics that must be considered in determining the appropriate objectives of financial reporting, circumstances in which governments perform business-type activities must also be examined. Activities are

considered “business-type” not solely because they resemble those performed by the private sector but because there is an exchange involved between the receiver and provider of the service; for instance, the receiver or consumer of the services is charged for those services.

The environment for the provision of business-type activities has some overlap with the traditional governmental environment described above. However, the elements of customer and service provider bring different characteristics into the environment that must be considered in determining financial reporting objectives. The following list describes those characteristics that were considered by the GASB in GASB CS 1:

- **Relationship between services received and resources provided by the consumer.** For business-type activities, there is frequently a direct relationship between the charge for the service and the service itself. This exchange relationship causes users of financial information to focus on the costs of providing the service, the revenues obtained from the service, and the difference between the two.

NOTE: The fact that a charge is assessed for a service does not imply that the charge covers all of the costs of a service. There may be a conscious decision on the part of the government to subsidize the costs of particular services with revenues from other sources that are not part of the exchange transaction. Less frequently, the government may also decide to charge more than the cost of the service to provide a “profit” to be used for some other non-business-type or governmental activity.

- **Revenue-producing capital assets.** Many of the capital assets purchased or constructed by governments for business-type activities are revenue-producing. Many business-type activities are capital intensive, and the need for information concerning those assets must be considered when developing financial reporting objectives for governments.
- **Similarly designated activities and potential for comparison.** There is generally a greater potential for comparability among business-type activities performing similar functions than there is among governmental-type activities. Governmental business-type activities generally only perform a single function, such as supplying water. The problems, procedures, and cost components of obtaining, treating, and delivering water are similar, regardless of whether the function is performed by a commercial enterprise, a public authority, an enterprise fund, or as part of a government’s basic operations.

NOTE: More information to help the reader distinguish among these differences is provided in Chapter 7. These similarities facilitate comparison of financial reporting among entities (or parts of entities) providing similar services.

- **Nature of the political process.** Business-type activities are generally regarded as less influenced by the political process because their fee-for-service operations take them out of the budgetary debate to which governmental activities are subject. However, in many cases, the business-type activities are subsidized by the government in order to keep the fees lower than cost or market values. The rate-setting process then ensues and subjects the business-type activities to pressures from the political process experienced by general governmental activities. Similar influences from the political process develop when the general government furnishes capital funds, even when there is no direct operating subsidy.
- **Budgets and fund accounting.** Business-type activities generally do not have legally adopted budgets. Budgets are more likely to be used as internal management tools rather than as a revenue and spending plan with the force of law. In addition, since business-type