



## Chapter 1

# The Governmental Environment and GAAP

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### Learning objectives

- Recognize the unique aspects of the governmental accounting environment.
  - Identify which organizations must follow GASB standards.
  - Recognize authoritative guidance on generally accepted accounting principles (GAAP).
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### Governmental accounting versus for-profit accounting

The practice of state and local government accounting can be succinctly distinguished from that of for-profit accounting, which is already familiar to many of us. Several elements of governmental accounting are very distinct from for-profit accounting. One core difference is that the purpose of government is not to make a profit but to provide services to the citizenry. There are different users of the financial statements than in the for-profit sector. The accounting is different — there is even a different standards-setting board, the GASB, which typically issues new rules each year. Like the FASB, however, the GASB is subject to the auspices of the Financial Accounting Foundation (FAF).

This course focuses on the fundamentals of governmental accounting. *Governmental accounting* is the composite activity of analyzing, recording, summarizing, reporting, and interpreting the financial transactions of governments.

# Governmental environment

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## Key environmental differences between government and business

The state and local governmental environment is different in several ways from the business environment. These differences influence financial reporting objectives. The GASB's white paper, *Why Governmental Accounting and Financial Reporting Is – and Should Be – Different*, identifies the following five environmental differences between governments and for-profit businesses<sup>1</sup>:

- *Organizational purposes.* Businesses are in the business of making money. The purpose of governments is to enhance or maintain the well-being of citizens by providing public services. Many of these services are provided with no direct relationship to how much recipients pay. For example, a local library is supported by tax revenue, not by fees charged to the people who actually use the library.
- *Sources of revenue.* One difference between government and business is their revenue streams. Governments receive substantial revenue from nonexchange transactions, such as taxes and grants. Taxes are provided by involuntary resource providers. The primary source of revenue for businesses is voluntary exchange transactions.
- *Potential for longevity.* The legal structure of the government is also different from that of a business. Each state has its own requirements pertaining to the roles and responsibilities among the different levels and branches of government. Because governments have the ability to tax, they rarely go out of business. This longevity is reflected in a long-term view in financial reporting.
- *Relationship with stakeholders.* Citizens delegate government operations to elected officials. The public has the right to hold the government to a higher standard of accountability for raising and spending of public funds. Accountability says that these elected officials must provide information about both stewardship and interperiod equity, which addresses a question: Are current-year revenues sufficient to pay for services provided that year or will future taxpayers be required to assume the burden of paying for services long since provided?
- *Role of the budget.* Control over the level of taxes and the spending of those resources is achieved by budgets legally adopted by elected officials. *Demonstrating accountability with budget authority* is a key objective of governmental financial reporting.

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## Knowledge check

1. Which statement is accurate regarding the governmental environment?
  - a. The state and local governmental environment is different from business in a number of ways, and these differences influence financial reporting objectives.
  - b. Few governments' resources come from taxes.
  - c. The organizational purpose of a government is identical to a business.
  - d. Governments are often concerned with going out of business.

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<sup>1</sup> To download a copy of the white paper, revised in April 2013, go to <http://gasb.org/jsp/GASB/Page/GASBSectionPage&cid=1176156741271>.

2. Which statement accurately describes the relationship between the government and its stakeholders?
  - a. The primary source of revenue for a government is voluntary exchange transactions.
  - b. A similarity between government and business is how resources are provided.
  - c. Governments are accountable to citizens and taxpayers and must provide them information on how financial resources are used.
  - d. Budgets are rarely legally adopted by elected officials.

 <b>Exhibit 1-1: Key environmental differences between government and for-profit organizations</b>	
	Organizational purposes
	Sources of revenues
	Potential for longevity
	Relationship with stakeholders
	Role of the budget

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## Objectives of financial reporting

These and other differences in the respective environments result in governments having unique financial reporting objectives. *Accountability* becomes the *paramount objective* of financial reporting. The GASB states that financial reports should include information that can be used for the following:

- Comparing actual financial results with the legally adopted budget (*budgetary information*)
- Assessing financial condition and results of operations (*financial information*)
- Assisting in determining compliance with finance-related laws, rules, and regulations (*compliance information*)
- Assisting in evaluating efficiency and effectiveness (*performance information*)

These financial reporting objectives for governments are much broader than those for businesses. To meet these objectives, governments are required to produce several different types of financial statements that include an expansive amount of information.

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## Users of financial statements

The primary users of governmental financial statements are

- taxpayers and citizens,
- oversight and legislative bodies, and
- investors and creditors.

Although not a primary user, the government's management often relies on the financial statements for planning and monitoring purposes.

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## Elements of financial statements

GASB Concepts Statement No. 4, *Elements of Financial Statements*, establishes definitions for the seven elements of historically based financial statements of state and local governments. See exhibit 1-2.



## Exhibit 1-2: The seven elements of state and local government financial statements

Elements of a statement of financial position	
1	<b>Assets</b> are resources with present service capacity that the government presently controls. A <i>resource</i> is an item that can be drawn on to provide services to the citizenry.
2	<b>Liabilities</b> are present obligations to sacrifice resources that the government has little or no discretion to avoid.
3	A <b>deferred outflow of resources</b> is a consumption of net assets by the government that is applicable to a future reporting period.
4	A <b>deferred inflow of resources</b> is an acquisition of net assets by the government that is applicable to a future reporting period.
5	<b>Net position</b> is the residual of all other elements presented in a statement of financial position.
Elements of the resource flows statements	
6	An <b>outflow of resources</b> is a consumption of net assets by the government that is applicable to the reporting period.
7	An <b>inflow of resources</b> is an acquisition of net assets by the government that is applicable to the reporting period.

GASB Concepts Statement No. 4 elements differ from the 10 interrelated elements described in FASB Concepts Statement No. 6, *Measurement of Elements of Financial Statements*. FASB Concepts Statement No. 6 applies to business and not-for-profit organizations. The 10 interrelated elements are assets, liabilities, equity or net assets, investments by owners, distributions to owners, comprehensive income, revenues, expenses, gains, and losses.

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## GASB Statement No. 63

GASB Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, provides financial reporting guidance for deferred outflows of resources and deferred inflows of resources. GASB Concepts Statement No. 4 introduced and defined those elements as a consumption of net assets by the government that is applicable to a future reporting period and an acquisition of net assets by the government that is applicable to a future reporting period, respectively. Previous financial reporting standards, however, do not include guidance for reporting those financial statement elements, which are distinct from assets and liabilities.

GASB Concepts Statement No. 4 also identifies net position as the residual of all other elements presented in a statement of financial position. GASB Statement No. 63 amends the net asset reporting

requirements in GASB Statement No. 34, *Basic Financial Statements – and Management’s Discussion and Analysis – for State and Local Governments*, and other pronouncements by incorporating deferred outflows of resources and deferred inflows of resources into the definitions of the required components of the residual measure and by renaming that measure “net position” rather than “net assets.” GASB Concepts Statement No. 4 also resulted in the amendment of paragraph 31 of GASB Concepts Statement No. 3, *Communication Methods in General Purpose External Financial Reports That Contain Basic Financial Statements*, to reflect all elements of GASB Concepts Statement No. 4 and to conform the language of GASB Concepts Statement No. 3 to GASB Concepts Statement No. 4.

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## **GASB Statement No. 65**

GASB Statement No. 65, *Items Previously Reported as Assets and Liabilities*, establishes accounting and financial reporting standards that reclassify — as deferred outflows of resources or deferred inflows of resources — certain items previously reported as assets and liabilities. This statement also recognizes — as outflows of resources or inflows of resources — certain items previously reported as assets and liabilities.

In addition, GASB Statement No. 65 provides that reporting a deferred outflow of resources or a deferred inflow of resources should be limited to those instances identified by the GASB in authoritative pronouncements that are established after applicable due process. Prior to the issuance of this statement, only two such pronouncements have been issued. GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, requires the reporting of a deferred outflow of resources or a deferred inflow of resources for the changes in fair value of hedging derivative instruments; GASB Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*, requires a deferred inflow of resources to be reported by a transferor government in a qualifying service concession arrangement. This statement amends the financial statement element classification of certain items previously reported as assets and liabilities to be consistent with the definitions in GASB Concepts Statement No. 4.

GASB Statement No. 65 also provides other financial reporting guidance related to the impact of the financial statement elements, deferred outflows of resources and deferred inflows of resources, such as changes in the determination of the major fund calculations and limiting the use of the term “deferred” in financial statement presentations.

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## **Unique concepts in government accounting**

Several unique accounting practices have evolved for state and local governments because of their unique environment, the need to meet financial reporting objectives, and the financial statement elements detailed earlier. Several aspects of the system of accounting used by governments are similar to those used by businesses, such as the use of debits and credits, journals, and ledgers. Additionally,

many transactions continue to be recorded under government accounting in the same way that they are recorded in for-profit accounting. Still, there are several key differences, as follows:

- **Measurement focus and basis of accounting (MFBOA).** The activities of government can be broadly grouped into two categories, each of which uses a different MFBOA. The two categories are as follows:
  - *Business-type activities.* These are the activities a government carries out primarily to provide specific services in exchange for a specific user charge. These user fees are often intended to cover the cost of providing such services. Common examples of business-type services are water and sewer services. Accounting for this type of activity is very similar to a for-profit organization.
  - *Governmental activities.* These are the activities that occur in a government organization related to the acquisition, use, and balances of spendable financial resources and related current liabilities, **except for** those activities accounted for as business-type or fiduciary activities. Police services and education are common examples of government services that qualify as governmental activities. Accounting for these types of activities requires a different MFBOA.
- **Fund accounting.** To assist in demonstrating accountability, governments have long reported activities in separate funds. A fund is a fiscal accounting entity with a self-balancing set of accounts in which cash and other financial resources, all related liabilities and residual equities (or balances), and changes therein, are recorded and segregated to carry on specific activities or attain certain objectives in accordance with special regulations, restrictions, or limitations. Funds are used to separately account for financial activities based on legal requirements or management needs.
- **Budgetary reporting.** To meet one of the financial reporting objectives, governments must be able to compare actual financial results with the legally adopted budget. Budgets represent much more than a plan for a government: they represent a legally binding document and are often recorded in the accounting system.

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## Knowledge check

3. Which statement is accurate regarding budgetary reporting?
- a. To meet one of the financial reporting objectives, governments must be able to compare actual financial results with the legally adopted budget.
  - b. Budgets are never recorded in the accounting system.
  - c. Budgets are generally reviewed by a government every five years.
  - d. Budgets are nonauthoritative plans for governmental operations.

# Which organizations are required to follow GASB standards?

The GASB is responsible for accounting standards for state and local governments. Before covering accounting standard process, let's cover which organizations must follow these standards:

- **General-purpose governments.** State, city, county, and town governments follow these rules and are referred to as *general-purpose governments*. Such governments are government organizations that provide a wide range of services to their citizens (such as police, firefighters, road construction and maintenance, and public works).
- **Special-purpose governments.** Other independent governmental entities are considered *special-purpose governments*. Such governments provide only a single function or a limited number of functions. The most common examples are independent school districts, water and sewer authorities, and other special districts set up to provide a variety of other types of services.

A summary of the types of governments found in the United States, based on the 2017 *Census of Governments*, follows:

Counties	3,031
Municipalities	19,495
Towns and townships	16,253
Independent school districts	12,754
Special districts	38,542
Total	90,075

Other entities also may have to follow the accounting standards for state and local governments. For example, some not-for-profit museums, colleges, libraries, commissions, and boards may meet the definition of a government and, therefore, must follow GASB standards.

Entities that meet at least one of the following criteria must follow GASB standards:

- Officers of the entity are popularly elected.
- A controlling majority of members of the entity's governing board is appointed (or approved) by officials of at least one state or local government.
- A government is able to unilaterally dissolve the entity, with the entity's net assets reverting to a government.
- The entity has the power to enact and enforce a tax levy.
- The entity has the ability to directly issue federally tax-exempt debt.

If the only criterion met is the ability to directly issue federally tax-exempt debt, the presumption that an entity is governmental may be rebutted based on compelling, relevant evidence.



# GAAP and standards-setting organizations

For external financial statements to be useful, they must be prepared consistently over time and be comparable with those of other similar entities. To this end, external financial statements must be prepared in accordance with generally accepted accounting principles (GAAP). The following is a list of organizations that have responsibility for setting accounting standards for different types of organizations:

- The GASB has the primary responsibility for setting accounting standards for state and local governments (see earlier criteria for organizations that must follow GASB standards).
- The FASB has the primary responsibility for setting accounting standards for nongovernmental entities.
- The Federal Accounting Standards Advisory Board (FASAB) has the primary responsibility for setting standards for all agencies of the federal government.
- The International Accounting Standards Board (IASB) has been recognized by the Council of the AICPA as the body to establish international financial reporting standards for both private and public entities.

Additionally, a consultative body, the Governmental Accounting Standards Advisory Council, assists the GASB. The council consists of representatives who have an interest in governmental accounting and reporting.

In November 2013, the FAF adopted a new policy that clarifies the characteristics of the information that the GASB may address in setting standards for financial accounting and reporting for governments. A brief summary of the *GASB Scope of Authority: Consultation Process Policy* follows:

- a. Governmental stakeholder's debate: (a) the types of reporting that should (and should not be) subject to GASB standards and guidelines and (b) the GASB's appropriate role.
- b. The FAF established the GASB to carry out the FAF's mission with respect to the governmental accounting and financial reporting information.
  - i. Governmental standard-setting responsibility was given to the GASB; however, FAF trustees retained oversight of that responsibility.
- c. The FAF and GASB will institute processes and procedures to clarify the GASB's authority to issue concepts, statements, and guidance (scope).
- d. The GASB's and FAF's Standard-Setting Process Oversight Committee will consult (consultation) on the pre-agenda phase about meeting certain characteristics that the GASB determines may be included in potential standard-setting activity.
- e. The consultation will focus on whether information the GASB is considering for standard-setting activity is financial accounting and reporting information within the context of its standard-setting mission.
- f. The consultation will not focus on a specific standard-setting project.

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## The GAAP hierarchy

Historically, the GAAP hierarchy for state and local governments resided in the AICPA auditing literature rather than GASB accounting literature. Following a move by FASB in 2008, the GASB issued in 2009

GASB Statement No. 55, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, to place the GAAP hierarchy in GASB literature. In June 2015, the board issued GASB Statement No. 76, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, to replace GASB Statement No. 55. An important feature of GASB Statement No. 76 is the elevation of GASB implementation guides in the GAAP hierarchy. The following illustration summarizes the GAAP hierarchy for state and local governments.

### GAAP Hierarchy

#### Category A

Officially Established Accounting Principles – Governmental Accounting  
Standards Board (GASB Statements)<sup>2</sup>

#### Category B

GASB Technical Bulletins, GASB Implementation Guides, and literature of  
the AICPA cleared by GASB

In searching for the proper treatment of an item under GAAP, one would start by looking at category A of GAAP and then category B. For example, if the accounting treatment for a transaction or other event is not specified by a pronouncement in category A, a governmental entity should consider whether the accounting treatment is specified by a source in category B.

If the accounting treatment for a transaction or other event is not specified within a source of authoritative GAAP as described in categories A or B, a governmental entity should consider accounting principles for similar transactions or other events within categories A or B, and then may consider nonauthoritative accounting literature from other sources that does not conflict with or contradict authoritative GAAP. A governmental entity should not follow the accounting treatment specified in accounting principles for similar transactions or other events in cases in which those accounting principles either prohibit the application of the accounting treatment to the particular transaction or other event or indicate that the accounting treatment should not be applied by analogy.

Nonauthoritative accounting literature includes the following:

- GASB concepts statements
- The pronouncements and other literature of the FASB
- The pronouncements and other literature of the FASAB
- The pronouncements and other literature of the International Public Sector Accounting Standards Board
- The pronouncements and other literature of the IASB
- AICPA literature not cleared by the GASB

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<sup>2</sup> All GASB Interpretations heretofore issued and currently in effect also are considered as being included within Category A and are continued in force until altered, amended, supplemented, revoked, or superseded by subsequent GASB pronouncements.

- Practices that are widely recognized and prevalent in state and local government
- Literature of other professional associations or regulatory agencies
- Accounting textbooks, handbooks, and articles

The appropriateness of nonauthoritative accounting literature depends on its relevance to particular circumstances, the specificity of the guidance, and the general recognition of the issuer or author as an authority. For example, GASB concepts statements would normally be more influential than other sources in this grouping.

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## **GASB statements, updates, and current projects**

This course reflects GASB statements issued through GASB Statement No. 91, *Conduit Debt Obligations*.

Current major GASB projects include the following:

- Conceptual Framework – Disclosure Framework
- Conceptual Framework – Recognition
- Financial Reporting Model
- Public-Private Partnerships and Availability Payment Arrangements
- Revenue and Expense Recognition

# The governmental environment and GAAP

As we have established, state and local governments operate in a different environment than do businesses. Because of these differences, state and local governments have different reporting objectives, follow different accounting methods, and have an expanded list of financial statement users. Accounting standards are set by the GASB for entities that meet the definition of a government.

Key foundational points	
1	Governmental accounting is the composite activity of analyzing, recording, summarizing, reporting, and interpreting the financial transactions of governments.
2	The governmental environment has a strong influence on the financial reporting for this sector of the economy.
3	The GASB sets the accounting standards for state and local governments.
4	The state and local governmental environment is different in a number of ways from the business environment and these differences influence financial reporting objectives. Governmental environment components include organizational purpose, sources of revenue, potential for longevity, relationship with stakeholders, and role of budget.
5	Unique concepts in governmental accounting include MFBOA, fund accounting, and budgetary reporting.

# Practice questions

*Please note that the following practice questions are not required reading material.*

1. Which is a characteristic that distinguishes government from business enterprises?
  - a. Organizational purposes.
  - b. Sources of revenues.
  - c. Role of the budget.
  - d. All the above.
  
2. Which is **not** a financial reporting objective of state and local government?
  - a. Comparing actual results to budget.
  - b. Assessing cash flows.
  - c. Assessing results of operations.
  - d. Assisting in the evaluation of efficiency and effectiveness.
  
3. Who is a primary user of government financial reports?
  - a. The citizenry.
  - b. Legislative and oversight bodies.
  - c. Investors and creditors.
  - d. All the above.
  
4. What is a key accounting difference for state and local governments?
  - a. Budget reporting.
  - b. MFBOA.
  - c. Fund accounting.
  - d. All the above.
  
5. Which characteristic used to determine whether an organization is a government can be rebutted with compelling, relevant evidence?
  - a. The majority of governing board members are appointed by governmental entities.
  - b. An entity that has the power to enact and enforce a property tax levy.
  - c. An entity has the ability to directly issue federally tax-exempt debt.
  - d. The potential for unilateral dissolution with the net assets reverting to a government upon dissolution.
  
6. Which organization currently sets the primary accounting standards for state and local governments?
  - a. FASB.
  - b. GASB.
  - c. AICPA.
  - d. NCGA.

7. In the left column are four sources of GAAP for state and local governments. Draw a line from the respective source of GAAP to the appropriate category of GAAP to which it belongs in the right column.

AICPA Audit Guide content cleared by GASB
GASB Statement No. 54, <i>Fund Balance Reporting and Governmental Fund Type Definitions</i>
GASB Interpretation No. 6, <i>Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements</i>
The GASB Guide to <i>Implementation of GASB Statement 53 on Accounting and Financial Reporting for Derivative Instruments</i>

