Second Edition

Governmental Accounting Made Easy

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Preface

When I first began discussing the concept of a book on governmental accounting for nonaccountants for the first edition of this book, the publisher, John Wiley & Sons, Inc., asked a good question: "Who would be interested in a book on governmental accounting who is not an accountant?" The quick answers were obvious—bond underwriters and investors, lawyers, elected officials, financial and other managers working in government, labor unions, and so forth. On second thought, anyone who is impacted by a state or local government (this includes virtually everyone in the United States) might have an interest in understanding what at times seems like the overly complex and confusing world of governmental accounting. Being able to more intelligently read and understand the financial statements prepared by governments and understanding some of the key accounting concepts that underlie those financial statements can help nonaccountants better understand the financial affairs of governments.

The goal of this book is to provide a broad range of information about governmental accounting and financial reporting that will be useful to people who either have no (or very little) accounting background or have some accounting knowledge in the commercial or not-for-profit accounting areas, but do not understand governmental accounting. Governments have recently implemented a new financial reporting model that has resulted in a radical change in the way that governmental financial statements are presented. Frankly, even after several years of experience with the new model, there are very few people who actually understand what these financial statements are trying to communicate. This tries to make sense of these financial statements for the casual reader.

The information in this book is presented in as simple and as understandable a format as possible. This book will not make a governmental accountant out of you, nor will it give you all of the information that you would need to prepare a set of financial statements for a government. If you want to be a governmental accountant or prepare financial statements for a government, you might be interested in the current year's edition of *GAAP for Governments*, also published by John Wiley & Sons, Inc. and written by me.

The sequence of chapters in the book is designed to gradually build an understanding of governmental accounting and financial statements. Chapter 1 describes what is meant by governmental accounting and to what types of entities it applies. Chapter 2 discusses some basic accounting concepts underlying all governmental accounting and financial reporting, while Chapter 3 discusses fund accounting. Chapter 4 describes the basic financial statements prepared by governments under the recently implemented financial reporting model mentioned above, including the government-wide financial statements and the fund financial statements. Chapters 5 through 9 examine some of the more specific and complicated accounting issues often found in governmental financial statements such as defining the reporting entity and accounting for revenues, capital assets, and pensions. Finally, Chapter 10 discusses some of the upcoming changes that are expected to impact governmental accounting and financial reporting in the near future as a result of the issuance of new accounting standards and pronouncements.

I would like to thank John DeRemigis of John Wiley & Sons, Inc. for his steady direction of the project, as well as Judy Howarth for her editorial assistance. As always, I am truly lucky to have a supportive family—my wife, Marie, and sons Christopher and Gregory.

Warren Ruppel
Woodcliff Lake, New Jersey
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About the Author

Warren Ruppel, CPA, is a Partner at Marks Paneth & Shron LLP, New York, where he serves in the firm's nonprofit and Government Services Group and also is a leader in its Professional Practices Group. 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 thirty-five 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 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 four other books, *OMB Circular A-133 Audits, Not-for-Profit Organization Audits, Not-for-Profit Accounting Made Easy,* and *Not-for-Profit Audit Committee Best Practices.*

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 Governmental Accounting and Auditing and Not-for-Profit Organizations Technical Committees and is a trustee of the Foundation for Accounting Education. He has also served as the Chair of the Society's Audit Committee. He is also a past president of the New York Chapter of the Institute of Management Accountants. Mr. Ruppel is a member of the Government Finance Officers Association and serves on its Special Review Committee.

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CHAPTER 1

Introduction and Background

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-