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## Nonbusiness Organizations: Authoritative Sources For Governmental Accounting Principles

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# Authoritative Sources For Governmental Accounting Principles

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Accountants and auditors who wish to research an issue to determine the accounting and reporting of transactions and economic events that affect a business enterprise have a wealth of authoritative literature and accounting publications to assist them. On the other hand, an accountant or auditor who faces a similar issue related to accounting and financial reporting by a state or local governmental unit is not so fortunate. The purpose of this article is to identify the current status of authoritative literature available to an accountant or auditor on governmental accounting issues.

### Authoritative Bodies

For many years, it was informally accepted that the National Council on Governmental Accounting (NCGA) had the authority to establish financial accounting and reporting standards for state and local governments. The NCGA functioned for the most part as a standing committee of the Government Finance Officers Association (GFOA) in much the same manner that the Committee on Accounting Procedure and the Accounting Principles Board functioned in relationship to the AICPA. With the creation of the Financial Accounting Foundation (FAF) in 1973, the Financial Accounting Standards Board (FASB), an organization independent of the AICPA, was given the authority to establish generally accepted accounting principles. During the following ten years, there was much debate as to whether the FASB had the authority to issue standards that were applicable to nonprofit organizations, including state and local governments, as well as to business enterprises.

After a protracted battle over turf, all interested parties agreed to create

the Governmental Accounting Standards Board (GASB), which the FAF would oversee and finance in much the same manner as the FASB. The roles of the GASB and FASB were addressed in the FAF Agreement, which concluded that the GASB would have the authority to issue accounting and reporting standards applicable to state and local governments. The FASB would have the authority to issue standards applicable to all other entities (business enterprises and not-for-profit organizations, other than state and local governments).

Even with its creation and relationship with the FAF, the GASB was missing a key element to establish firmly its authoritative status. Much of the power of the FASB comes from the AICPA's Rule 203 (Accounting Principle) of the Code of Professional Conduct, which reads in part as follows:

*A member shall not (1) express an opinion or state affirmatively that the financial statements or other financial data of any entity are presented in conformity with generally accepted accounting principles or (2) state that he or she is not aware of any material*

### CALL FOR PAPERS

As editor of the Nonbusiness Department, I am interested in printing an article on the progress of women in local and state government accounting positions over the last 50 years. If you have done any research in this area and want to submit an article, I would like to review it for possible publication in the October 1988 50th Anniversary issue.



*modifications that should be made to such statements or data in order for them to be in conformity with generally accepted accounting principles, if such statements or data contain any departure from an accounting principle promulgated by bodies designated by Council to establish such principles that has a material effect on the statements or data taken as a whole . . . [AICPA, 1987].*

In 1973, the AICPA's Council designated the FASB as the body to establish accounting principles. But it was not until 1986 that the Council recognized the GASB as the body to establish accounting principles for state and local governments.

### Hierarchy of GAAP for State and Local Governments

The FAF Agreement lists the following categories in the hierarchy of generally accepted accounting principles for state and local governments:

- I Pronouncements of the Governmental Accounting Standards Board
- II Pronouncements of the Financial Accounting Standards Board
- III Pronouncements of bodies composed of expert accountants that follow a due process procedure, including broad distribution of proposed accounting principles for public comment, for the intended purpose of establishing accounting principles or describing existing practices that are generally accepted
- IV Practices or pronouncements that are widely recognized as being generally accepted because they represent prevalent practice in a particular industry or the knowledgeable application to specific circumstances of pronouncements that are generally accepted
- V Other accounting literature [AICPA, 1984]

Categories are based on degrees of authoritative support. For example, if authoritative support for one accounting principle can be found in Category I and support for an alternative accounting principle can be found in Category III, the accounting principle supported by Category I must be used to account for the transaction or economic event. Thus, when an ac-

countant or auditor is researching an accounting issue, the literature in Category I should be reviewed; if the issue is not addressed in Category I, then literature in Category II should be explored and so on.

The authoritative literature that comprises each of the five categories in the accounting hierarchy is described below.

**Category I — GASB Pronouncements.** The first category, which is the highest level of authoritative support, consists of pronouncements issued by the GASB. The GASB issues Statements and Interpretations.

When the GASB was created, there was some discussion as to whether pronouncements by the NCGA would constitute generally accepted accounting principles for governmental entities. As part of the FAF Agreement, it was concluded that accounting and reporting standards contained in all NCGA Statements and Interpretations would be designated as generally accepted. The NCGA pronouncements are in force until the GASB amends or supersedes them with new pronouncements.

*The NCGA pronouncements are in force until the GASB amends or supersedes them with new pronouncements.*

At the present time, the most authoritative accounting literature for state and local governments consists of the pronouncements displayed in the bookcase on this page.

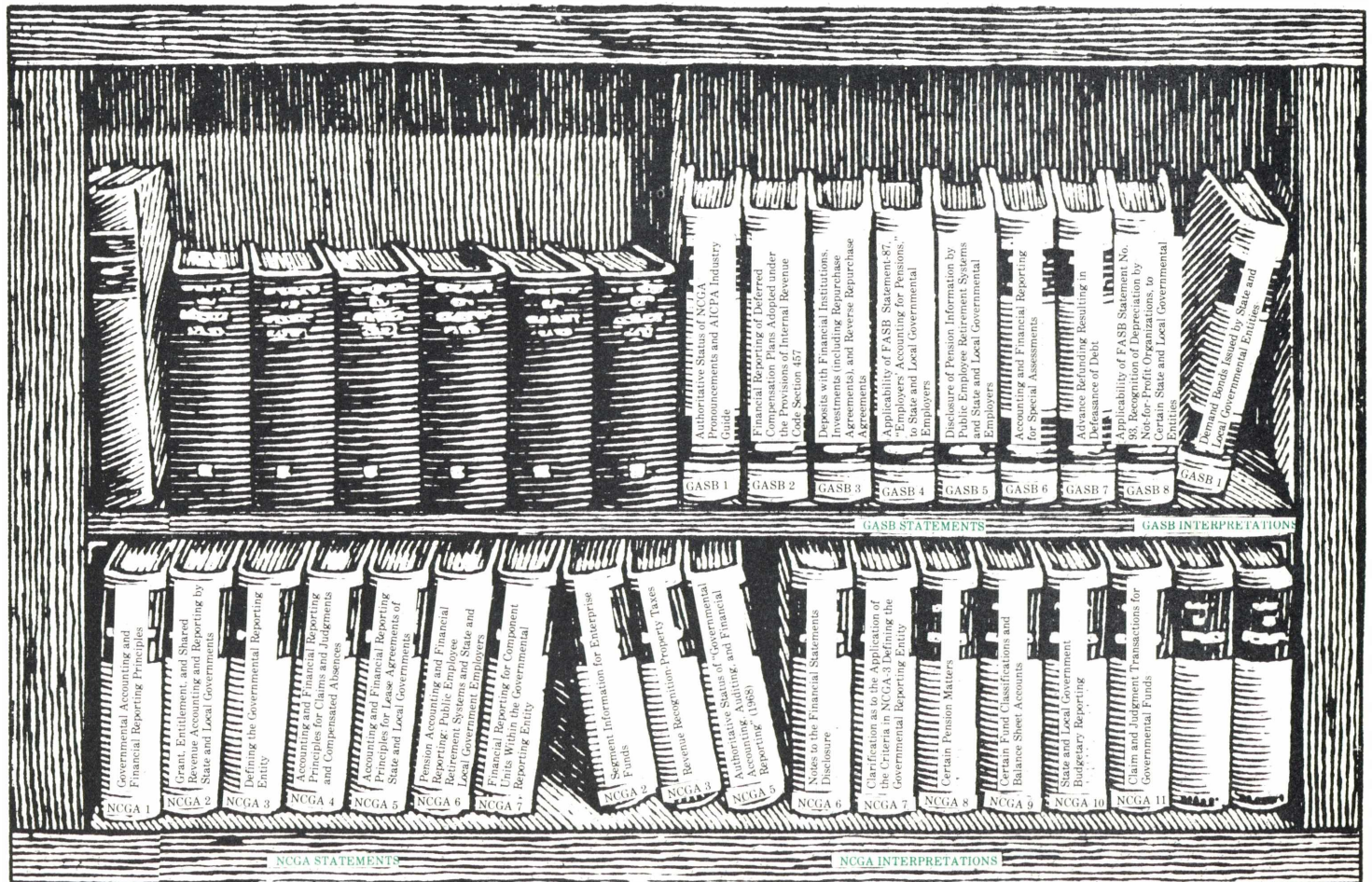
**Category II — FASB Pronouncements.** When an accounting issue has been addressed by an FASB pronouncement (Statement or Interpretation) but not by a GASB or NCGA pronouncement, it is accepted that the FASB pronouncement should be followed in the preparation of a governmental unit's financial statements. When a relevant FASB pronouncement exists, it is seldom possible to apply the FASB guidelines

without some modifications. Modifications are needed because the basis of accounting (accrual basis) and measurement focus (all economic resources) of a business enterprise are different from the basis of accounting (modified accrual basis) and measurement focus (current financial resources) of a state or local government.

The NCGA took explicit action in three instances in order to incorporate FASB standards as part of generally accepted accounting principles for state and local governments:

- NCGA Statement-4 restates FASB-5 (Accounting for Contingencies)
- NCGA Statement-5 restates FASB-13 (Accounting for Leases, as amended)
- NCGA Interpretation-8 restates FASB-74 (Accounting for Special Termination Benefits Paid to Employees)

NCGA Interpretation-8 requires that the accounting and reporting standards established by FASB-74 be observed in the preparation of



governmental financial statements. In 1985, the FASB superseded FASB-74 with the issuance of FASB-88, **Employers' Accounting for Settlement and Curtailments of Defined Benefit Pension Plans and for Termination Benefits**; however, FASB-74 must be followed by governmental units because NCGA Interpretation-8 has not been rescinded.

It is important to recognize that FASB pronouncements must be followed, with appropriate modification, even though neither the NCGA nor GASB has issued a pronouncement that requires that a specific FASB promulgation must be followed. For example, the accounting and reporting standards established by FASB-16, **Prior Period Adjustments**, must be followed by a governmental entity to account for a correction of an error even though FASB-16 is not explicitly incorporated into the governmental accounting standards. Therefore, accountants or auditors must be aware of the accounting standards for business enterprises and be capable of applying them with appropriate modification to a governmental entity.

**Category III — Expert Accountants/Due Process.** The third category in the accounting hierarchy of governmental accounting principles includes accounting publications that are issued by "bodies composed of expert accountants that follow a due process procedure." Generally, this category would include Statements of Position issued by the AICPA's Accounting Standards Division and Accounting and Audit Guides issued by special committees of the AICPA.

GASB-1 identified the following pronouncements as containing generally accepted accounting principles for state and local governments.

- Industry Audit Guide, **Audits of State and Local Governmental Units** (1974)
- SOP 75-3, **Accrual of Revenues and Expenditures by State and Local Governmental Units**
- SOP 77-2, **Accounting for Interfund Transfers of State and Local Governmental Units**
- SOP 78-7, **Financial Accounting and Reporting by Hospitals Operated by a Governmental Unit**

- SOP 80-2, **Accounting and Financial Reporting by Governmental Units**

Portions of two of the pronouncements listed above have been superseded by subsequent pronouncements or revisions. The portion of SOP 75-3 that discusses vacation and sick pay has been superseded by NCGA-4, and the AICPA revised its Industry Audit Guide in 1986. The revised audit guide did not address governmental accounting principles but rather was devoted to audit issues. The revised audit guide superseded the auditing sections of the previous audit guide but did not supersede the accounting sections. Therefore, the following sections from the 1974 Industry Audit Guide continue in force since they address governmental accounting principles.

- Interfund transactions — pp. 10-12
- Budgets and budgetary accounting — pp. 12, 22 and 23
- Legal compliance — pp. 12 and 13
- Basis of accounting — pp. 13-16

In addition to the AICPA's **Audits of State and Local Governmental Units** and the SOPs identified in GASB-1 as sources of generally accepted accounting principles for governmental units, some SOPs and Audit and Accounting Guides have been designated as establishing preferable accounting practices. APB-20, **Accounting Changes**, concludes that an entity can change from one acceptable principle to another acceptable principle only when the newly adopted principle is preferable. FASB-32, **Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters**, and FASB-56, **Designation of AICPA Guide and Statement of Position (SOP) 81-1 on Contractor Accounting and SOP 81-2 Concerning Hospital-Related Organizations as Preferable for Purposes of Applying APB Opinion 20**, identify the following governmental-related accounting pronouncements as establishing preferable accounting principles:

- Statements of Position
  - SOP 74-8, **Financial Accounting and Reporting by Colleges and Universities**
  - SOP 78-1, **Accounting by Hos-**

**pitals for Certain Marketable Equity Securities**

- SOP 78-10, **Accounting Principles and Reporting Practices for Certain Nonprofit Organizations**
- SOP 81-2, **Reporting Practices Concerning Hospital-Related Organizations**
- Industry Audit Guides
  - **Audits of Colleges and Universities**
  - **Hospital Audit Guide**

The pronouncements related to colleges and universities and hospitals are relevant because educational or medical institutions may be included in a governmental unit's reporting entity.

It should be noted that when the FASB identifies a preferable accounting principle, a governmental entity can change to that preferable accounting principle; nevertheless, it cannot change from a preferable accounting principle to another accounting principle that may be generally acceptable but has not been designated as preferable.

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*When a relevant FASB pronouncement exists, it is seldom possible to apply the FASB guidelines without some modifications.*

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**Category IV — Prevalent Practice.** An accounting principle may become generally accepted if it is considered to be a prevalent accounting principle. Prevalent accounting principles may be based on pronouncements other than those listed in the first three categories of the accounting principles hierarchy or on practices that are widely used in the preparation of governmental financial statements. There is no comprehensive list of pronouncements that may provide the basis for prevalent accounting principles; however, there are three publications that accountants and auditors should consider.

**1968 Governmental Accounting,**

**Auditing, and Financial Reporting** (GAAFR) was a codification of various NCGA publications. When NCGA-1 was issued, **1968 GAAFR** was superseded. Even so, NCGA Interpretation-5 concluded "to the extent that material contained in the **1968 GAAFR** is consistent with the principles of such Statements and Interpretations, such material may be considered illustrations of these principles."

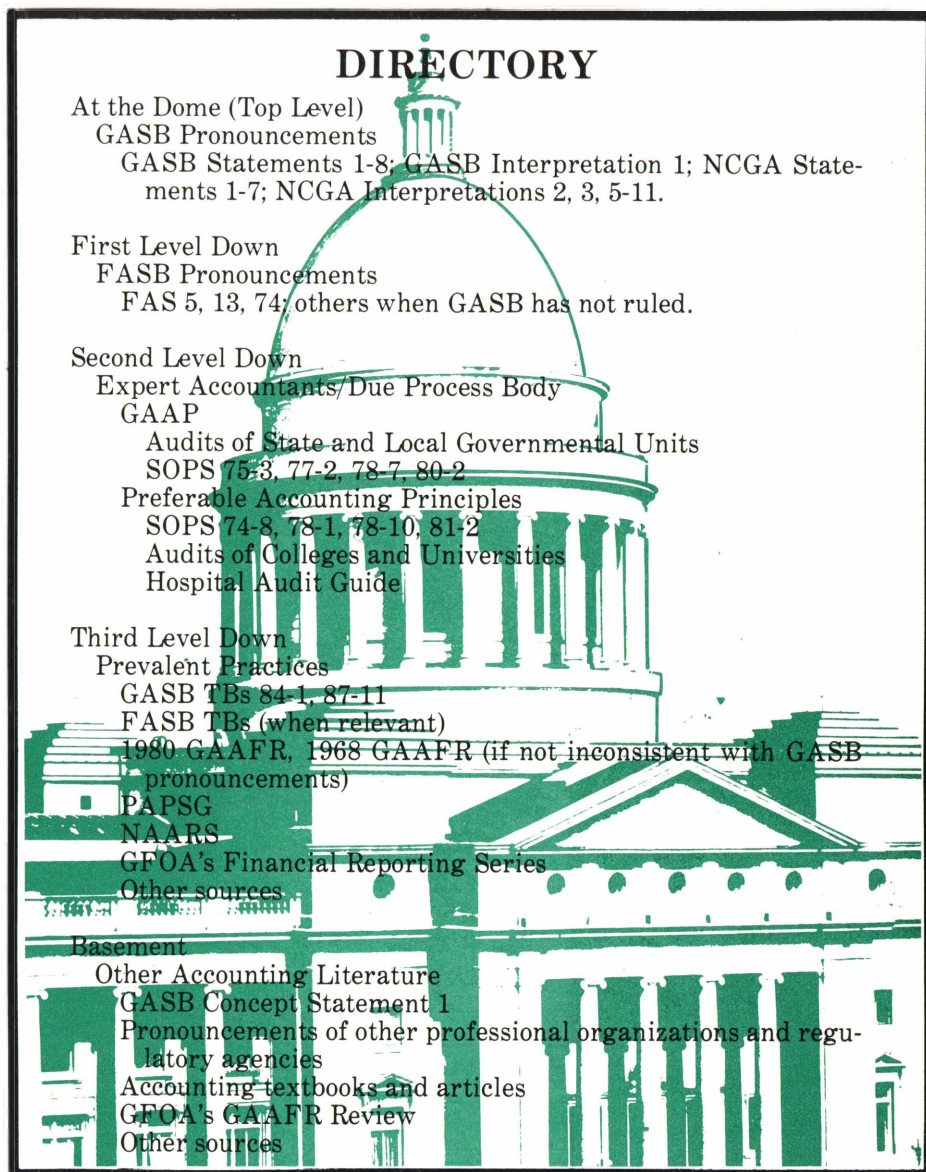
The **1980 GAAFR** was published by the GFOA as an illustration of NCGA-1 rather than as an authoritative pronouncement. Thus, while the **1980 GAAFR** does not establish generally accepted accounting principles, it may be a useful source for better understanding the application of NCGA pronouncements providing the illustrations are not inconsistent with subsequent pronouncements issued by the NCGA or the GASB.

A third document that accountants and auditors should be aware of is a research report entitled **Preferred Accounting Practices for State Governments (PAPSG)**, which was published in 1983 by the Council of State Governments. The purpose of the research project was to identify then current accounting practices of the 50 states. The project's completion coincided with the debate concerning the creation of the GASB, and for this reason the NCGA never formally incorporated its findings into a formal pronouncement. Nevertheless, the **PAPSG** can be used as a basis for identifying prevalent accounting principles for state governments.

In addition to the three sources listed above, prevalent accounting practices are established by GASB Technical Bulletins. To this date, the GASB has issued the following Technical Bulletins.

- **84-1 Purpose and Scope of GASB Technical Bulletins and Procedures for Issuance**
- **87-1 Applying Paragraph 68 of GASB Statement 3**

Also, prevalent practices that may be relevant to state and local governments are established in FASB Technical Bulletins. (GASB Technical Bulletins and FASB Technical Bulletins are not included in Category I and Category II respectively, because they are issued by the GASB staff and FASB staff and are not formally voted upon by the authoritative bodies.)



## DIRECTORY

At the Dome (Top Level)  
 GASB Pronouncements  
 GASB Statements 1-8; GASB Interpretation 1; NCGA Statements 1-7; NCGA Interpretations 2, 3, 5-11.

First Level Down  
 FASB Pronouncements  
 FAS 5, 13, 74; others when GASB has not ruled.

Second Level Down  
 Expert Accountants/Due Process Body  
 GAAP  
 Audits of State and Local Governmental Units  
 SOPS 75-3, 77-2, 78-7, 80-2  
 Preferable Accounting Principles  
 SOPS 74-8, 78-1, 78-10, 81-2  
 Audits of Colleges and Universities  
 Hospital Audit Guide

Third Level Down  
 Prevalent Practices  
 GASB TBs 84-1, 87-11  
 FASB TBs (when relevant)  
 1980 GAAFR, 1968 GAAFR (if not inconsistent with GASB pronouncements)  
 PAPSG  
 NAARS  
 GFOA's Financial Reporting Series  
 Other sources

Basement  
 Other Accounting Literature  
 GASB Concept Statement 1  
 Pronouncements of other professional organizations and regulatory agencies  
 Accounting textbooks and articles  
 GFOA's GAAFR Review  
 Other sources

Category IV also includes accounting practices that are widely recognized as acceptable even though they do not appear in a pronouncement or other publication. Generally, this means that the accountant or auditor must have access to numerous governmental financial statements or publications that summarize accounting practices used by governmental units. One source that may prove useful is the National Automated Accounting Research System (NAARS), which recently announced that certain governmental financial statement information would be included in its data base. Another useful source is the **Financial Reporting Series** published by the GFOA which presents illustrations of financial statements, notes, and other governmental financial statement information.

**Category V — Other Accounting Literature.** When authoritative support for an accounting principle cannot be found in the first four categories, other accounting literature should be reviewed. The FAF Agreement did not elaborate on what is meant by "other accounting literature." There is a similar accounting hierarchy for accounting principles for business enterprises (See SAS-5, **The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles" in the Independent Auditor's Report**), and the hierarchy refers to other accounting literature such as FASB Statements of Financial Accounting Concepts, APB Statements, AICPA Issues Papers, pronouncements of other professional associations or regulatory agencies, and accounting textbooks and articles. Care must be

taken when a publication primarily concerned with accounting for business enterprises is used as a basis for identifying an accounting principle for governmental accounting. As noted earlier, the basis of accounting and measurement focus of a state or local government is unique to governmental accounting. For example, many of the definitions in FASB Concepts Statement-6, **Elements of Financial Statement**, are not useful in the preparation of governmental financial statements.

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A publication that may be included in this fifth category is GASB Concept Statement-1, **Objectives of Financial Reporting**, which superseded NCGA Concept Statement-1. Also, another publication that may be considered is the GFOA's **GAAFR Review**, which is published monthly. Although the **GAAFR Review** is not authoritative, it often provides valuable insight into governmental accounting issues.

#### **Potential for Conflicting Standards**

Although both the GASB and the FASB are financed and somewhat directed by the FAF, there is a potential that different accounting standards issued by the two bodies may apply to the same transaction or economic event. To some degree, the FAF Agreement addressed the potential conflict with the establishment of the governmental accounting hierarchy discussed in this paper. The Agreement also notes that public sector entities such as utilities, authorities, hospitals, colleges and universities, and pension plans should observe FASB pronouncements unless the GASB has addressed the accounting issue through the issuance of a pronouncement. In addition, when a public sector entity's financial statements are included in the general purpose financial statements of a

governmental unit, GASB pronouncements should be observed.

The most recent conflict has been in the recognition of depreciation. FASB-93, **Recognition of Depreciation by Not-for-Profit Organizations** (August 1987), requires all not-for-profit organizations to recognize depreciation in general purpose financial statements issued for fiscal years beginning after May 15, 1988. GASB-8, **Applicability of FASB Statement No. 93, Recognition of Depreciation by Not-for-Profit Organizations, to Certain State and Local Governmental Entities**, was issued as a response in January 1988. GASB-8 states that governmental colleges and universities and other governmental entities should maintain the status quo until the GAB staff can complete the study of several projects. This means that specialized industry accounting and reporting practices may be continued rather than changed to meet the requirements of FASB-93.

Another area of conflict is in the accounting standards for pension plans. In the preparation of financial statements for pension plans, GASB-1 notes that Public Employee Retirement Systems and state and local government employers may follow any of the following pronouncements.

- NCGA Statement #1
- NCGA Statement #6
- FASB Statement #35

In addition to observing one of the three promulgations listed above, the pension disclosure requirements established by GASB-5 also must be observed.

Other areas of conflict between the GASB and the FASB are likely to arise in the future. For example, when the FASB placed accounting for colleges and universities on its agenda, the GASB became concerned that future FASB standards in this area might be inconsistent with the current governmental accounting model. Now the GASB has placed accounting for colleges and universities on its agenda and hopes to work closely with the FASB in formulating accounting standards acceptable to both bodies.

Accountants and auditors must be aware that conflicting accounting standards exist and must use the accounting hierarchy created by the FAF Agreement and their own professional judgment to determine

which standard results in the most informative financial statements for a governmental entity.

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*Accountants and auditors must be aware that conflicting accounting standards exist...*

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#### **Conclusion**

During the last two years, governmental accounting has taken a significant step toward parity with accounting for business enterprises. One implication of this progress is that governmental accounting will become an even more sophisticated discipline. An accountant or auditor must be aware of the authoritative sources of accounting principles that can be used in the preparation of governmental financial statements that purport to be in accordance with generally accepted accounting principles.  $\Omega$

#### **REFERENCES**

- American Institute of Certified Public Accountants, *Referendum* (AICPA, 1987), p. 7.
- \_\_\_\_\_, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles" in the Independent Auditor's Report: Auditing Interpretations of AU Section 411* (AICPA, 1984).



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