The Implications of GASB Statement No. 34 for Public Budgeting

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Statement No. 34 of the Government Accounting Standards Board (GASB) will likely have significant implications for the budgeting of state and local governments. This paper identifies six conceptual implications: need for a long-term perspective, emphasis on public accountability, consideration of the whole government, debate on accrual budgeting, financial position projection, and appraisal of budget practices. The implementation of Statement No. 34 will also necessitate greater support for accounting and reporting function and lead to closer cooperation between the budgeting and accounting staffs. Additional financial disclosure may result in greater public scrutiny of the budget and deferred costs.

INTRODUCTION

In June 1999 the Governmental Accounting Standards Board (GASB) issued Statement No. 34, requiring a new financial reporting model for state and local governments. The model inch des discussion and analysis by the administration of the government's financial affairs, followed by two sets of basic financial statements. The first set consists of a new statement of net assets and a new statement of activities for the entire government prepared following the full accrual basis of accounting. The current fund-based financial statements are essentially preserved, though major funds are singled out for greater attention. Although the GASB does not set budget principles for state and local governments, government accounting and financial reporting standards have implications for public budget concepts and practices. The purpose of this paper is to identify and elaborate some of the budgeting implications of Statement No. 34.

IMPLICATIONS FOR PUBLIC BUDGETING CONCEPTS

Statement No. 34 continues to call for the reporting of "budget and actual" comparisons for funds with a legally adopted budget, using whatever budgetary basis is adopted by the government. However, if original revenue estimates and appropriations are amended, both the original budget and the final budget have to be disclosed, rather than only the final budget. Statement No. 34 also retains the existing requirement for performing reconciliation when the budgetary basis differs from the Generally Accepted Accounting Principles (GAAP) basis.

Although the above provisions are the only direct reference to budgets in Statement No. 34, its overall thrust has a number of implications for budgeting at the state and local level:

1. emphasizing the long-term perspective in budgeting,
2. stressing budgets as a tool for demonstrating public accountability,
3. considering the government as a whole,
4. activating the debate about accrual budgeting,
5. raising the need to project financial position, and

6. critically appraising budget practices.

A brief discussion of each of these conceptual implications follows.

The Long-Term Perspective

Thirty-five years ago, Allen Schick identified three orientations of public budgeting: financial control, management improvement, and planning.[1] The prominent display of long-term liabilities in a basic financial statement, instead of the "general long-term debt account group," may increase public awareness of the magnitude of these obligations. Currently, governments prepare detailed projections of future debt service payments for outstanding bonds. Statement No. 34 conveys the message that operating debts are no less important. Operating debts are the deferred costs of past government services, such as employee pension and other postemployment benefits. These debts will require future cash payments. Although their amounts and timing may be more difficult to predict than debt service, the accounting process of recognizing and accruing these liabilities can improve the accuracy of multiyear projections. Accrual accounting and multiyear budgeting are complementary and mutually reinforcing.

Budgeting for Accountability

Demonstrating the government's accountability to the public is the underlying premise for requiring comprehensive financial statements that cover the whole government. Although skeptics argue that the public does not read government financial reports, a democratic government still has the obligation to report its financial affairs to the citizenry. The emphasis on public accountability through popular reporting is consistent with Irene Rubin's call for a type of budgeting that is also responsive to direct citizens' control.[2] Even though Rubin's message was aimed at municipal budgeting in the 1990s, its validity extends to the 21st century. In particular, governments are held accountable for the repayment of all their debts. Bonds and notes are visible debts, but the operating debts mentioned earlier are just as important. These debts appear obscure under the current financial reporting model because they are placed in an account group far removed from the general fund. Their inclusion in the government-wide balance sheet makes them virtually inescapable from the public view. Similarly, as an accountability document, the budget should disclose the accrual of operating debt due to the underfunding of the cost of services.

The budget can serve a greater role as an accountability document also by including more accounting information required by Statement No. 34. Whereas budgets declare intentions, accounting deals primarily with actual performance. Budgetary comparisons should be systematically incorporated in budget documents. Significant variances, such as revenue shortfalls or overspending, should be explained and remedial actions described. As functional specialists, budget preparers/analysts and accountants have a clear division of labor, but the general public may not clearly distinguish between the budget and financial reports. This creates a necessity for the budget office and the accounting office in government to harmonize their communications with the public.[3]

The Whole-Government Budget

Some state and local government budgets cover only parts of the government, typically the general fund and other governmental funds. Furthermore, at times, only expenditures financed by own-source revenues are appropriated by the legislature. The basic message of Statement No. 34 is that the public needs to see the "forest" before the "trees." A government should therefore show its whole fiscal picture ahead of those of the individual funds. For a government to have an integrated budgeting and accounting system, whole-government reporting should be based on a whole-government budget. Statement No. 34 has made whole-government financial statements an integral part of the basic financial statements of a government. This step hopefully will motivate state and local governments to reexamine the coverage of their budgets and to broaden it to encompass all of their units, functions, and activities.

Accrual-Based Budgeting

Statement No. 34 is being implemented at a time when the public budgeting community is revisiting the issues surrounding accrual budge ting.[4] The controversial issue of whether or not accrual accounting should lead to accrual budgeting cannot be adequately treated in this paper. The GASB does not have the authority to set budgeting standards, nor is it necessarily advocating accrual budgeting in Statement No. 34. Indeed, it has reserved the full accrual basis only for government-wide reporting, leaving the accounting for the different fund types to the status quo. This also allows individual jurisdictions to use their budgetary basis in making the required budgetary comparisons. Nevertheless, accrual accounting implies a long-term perspective, even though accrual is an elusive concept with multiple meanings.[5] Regardless of accrual budgeting, in order to prepare government-wide financial statements required by Statement No. 34, a government will collect a great deal of accrual data, such as capital assets, long-term receivables and long-term payables. This data will also be audited by external CPAs. These steps could facilitate the budget office's estimation of the amounts and timing of future funding requirements.

Projecting Financial Position

A strong message of Statement No. 34 is that so long as government extends and receives credit in its financial transactions, it has to account for and report different types of receivables and payables. The balance sheet is the medium for reporting these assets and liabilities. Under the accrual basis, a complete set of financial statements includes a balance sheet, an operating statement for revenues and expenses, and a cash flow statement. They place equal, if not greater, emphasis on the resources and financial burdens carried over from one period to the next. In contrast, government budgets tend to stress the financial resource flows within a fiscal year. The balance sheet emphasis of Statement No. 34 requires the complementary budgeting effort to balance a government's resources and responsibility in the short, medium, and long term.

Generally Accepted Budgeting Principles

So long as state and local governments desire an unqualified ("clean") audit opinion for their financial reports and favorable bond ratings, they have the incentive to comply with Statement No. 34. More generally, GASB standards are recognized by the auditing profession and the financial market as the benchmark for evaluating the accounting practices of individual jurisdictions. No such benchmark exists for evaluating budgeting practices.

Recently, Edward Lehan raised the intriguing idea of "budget appraisal."[6] Under budget appraisal, a government's budget practices would be evaluated on the basis of some agreed-upon benchmark. Leaving aside the issue of enforcement, there already exist some professional recommendations and a voluntary appraisal mechanism.[7] Even though the GASB lacks the authority to set government budgeting standards, accounting standards can be used as conceptual benchmarks to compare and evaluate budget practices. Indeed, in some countries, such as New Zealand, Australia, and the United Kingdom, accrual accounting standards have led to changes in government budgeting practices.[8] From Statement No. 34, one may be tempted to infer the following budgeting principles:

- A government should present a budget that encompasses all of its units, programs, and activities.
- A government should adopt a long-term perspective in budgeting.
- A government should balance its long-term resource availability and responsibilities.

Whether one agrees with these specific statements or not, the public budgeting community should consider formulating a set of budgeting principles to serve as the counterpart of GAAP.[9]

In short, there are many parallel conceptual issues in public budgeting and governmental accounting. Given the close relationship between the two fields. Statement No. 34 will hopefully trigger a far-reaching debate about some of the fundamental issues in public budgeting.

IMPLICATIONS FOR BUDGET OFFICES

Statement No. 34 can also be expected to have some practical implications for the budget offices in governments as well. The comptroller's office will likely request more budgetary resources to comply with Statement No. 34. The budget staff may be asked to contribute . to the Management's Discussion and Analysis (MD&A). Detailed budgetary disclosures may lead to inquiries. Funding operating debt will likely be an issue. Finally, in the new reporting environment created by Statement No. 34, even closer collaboration may be needed between the budget staff and the comptroller's office. These challenges and opportunities are discussed in this section.

More Resources for the Comptroller's Office

The comptroller's offices in many, if not most, governmental units will likely request additional resources in order to comply with the requirements of Statement No. 34. The amount will depend on the extent to which accrual data have been collected, the robustness of current systems, and the qualifications of current personnel. The largest single amount would likely be for the construction of infrastructure and fixed-asset accumulated depreciation records. Resources would be needed for system upgrades and performing analytical tasks, such as customizing reporting formats. Before software vendors redesign their packages to make data aggregation seamless, extensive manual operations may be required. In general, Statement No. 34 will require greater conceptual and analytical skills on the part of the finance staff. Finance departments will face the challenge of either upgrading the skills of the current staff or hiring broader-based financial or budget analysts. Initially, a larger training budget may be necessary.

Contribution to the Management's Discussion and Analysis

The MD&A is similar to the "budget message" commonly found in government budgets in many ways, with the main difference being their relative emphases. The budget message is more future-oriented, whereas the MD&A mostly reviews past performance relative to goals and policies. The budget director is usually responsible for drafting the budget message. The chief financial officer or comptroller will likely construct the MD&A. However, both of these documents are issued under the name of the government's chief executive officer. As such, they should be consistent, even though they may originate from two staff offices with two different time perspectives. As previously noted, the budget message should include more accounting information. Similarly, the MD&A will be more forward-looking if it is more closely related to a government's strategic plans. The collaboration of the budget director and the comptroller will likely increase the effectiveness of the government's financial communications to the public.

Justification for Within-Year Budget Revisions

Budget revisions made during the year will likely receive greater scrutiny under Statement No. 34. Previously, public attention had been directed to the differences ("variances") between actual results and the final or revised budget, but now both the original and revised budgets are required to be presented. The public will be able to know more about revisions of revenue estimates and supplementary appropriations or about the movement of budgetary resources from one department or function to another. In the spirit of full disclosure and public accountability, the budget office has to be prepared to explain such major changes.

Funding Operating Debt

Statement No. 34 will put the spotlight on operating debts. Operating debts differ from capital debt in one significant respect: they are not offset by any assets. Statement No. 34 requires the reporting of fixed assets on the balance sheet. These assets will therefore offset the related capital debt, hopefully resulting in a positive number in the net asset section of the balance sheet. Since there are no assets to offset operating debts, including these debts in the liability section will weaken the net financial position of the government.. It is possible that the government will even report a negative amount for the unrestricted net assets. Even if the general public does not notice this, alert finance or budget committee members and staff are likely to raise issues hi this regard. It would be wise for the budget director and comptroller to take the initiative to explain the impact first to the chief executive in order to prepare him/her for questions from the legislative body and the press. At the substantive level, it will take the cooperation of both the executive and legislative branches during the budget process to draw up a long-range plan to gradually fund this liability. Such a proposal may not be popular because it will compete with other spending priorities. One has to keep in mind that another implication of accrual accounting is the need to provide funding to cover the operating debt related to *current* services as well. This kind of "double jeopardy" may be too burdensome for one fiscal year. It is therefore preferable to draw up a multiyear financial plan to systematically fund the liability. In order to ensure this plan's consistent implementation and to insulate it from the uncertainty of the annual budgetary process, it may be necessary to enact legislation to require future annual payments, similar to creating a sinking fund for debt service.

Strengthening the Cooperation among Fiscal Offices

In smaller governments, the finance director may be responsible for the whole range of finance functions, including budgeting, accounting, purchasing, treasury management, and managing information systems. This makes the kind of collaboration suggested earlier easier to implement. In large jurisdictions, separate offices carry out these functions. Whereas the budget director is usually an appointed official, the comptroller can be an elected official with his or her own political base and prerogatives. Within the limits of separation of powers and checks and balances, there can still be room for cooperation. Indeed, such cooperation is essential for the entire financial management process to run efficiently and effectively.[10]

Some people may view the implementation of Statement No. 34 as a compliance issue to placate the independent auditors and bond rating agencies. However, if viewed positively, Statement No. 34 also, provides a major opportunity for the budget and accounting offices to jointly review the government's financial policies and procedures. It is only after the budget director and the comptroller can harmonize their viewpoints that they will have greater success in realizing the benefits of implementing Statement No. 34.

CONCLUSION

Through the new financial reporting model in Statement No. 34, the GASB has sought to simultaneously achieve two objectives of government accounting. The first is to ensure the government's compliance with finance-related laws and regulations, which are embodied directly or indirectly hi its budget. The second is to demonstrate financial accountability to the public through financial reports that are easy to understand. This has resulted in the requirement for two different sets of financial statements. In effect, the board has decided not to choose alternative approaches to external reporting. As a consequence, state and local governments' financial statements will likely become even more voluminous and complex, as well as more costly to prepare.

The budget offices in state and local governments will likely be asked to support the budget requests of their sister agencies, the comptroller's office or finance departments, for the implementation of Statement No. 34. More support will be needed for system upgrades, more sophisticated software, and personnel capable of handling accrual accounting. Unless the government already has a state-of-the-art fixed-asset management and accounting system, a significant investment will be required. When it comes to money, theoretical issues take on practical significance. Accrual accounting in government is not only complex and controversial, but also costly to implement.

Accrual accounting and financial reporting is a double-edged sword. On the one hand, it can make the government's fiscal picture look more positive than before. Under Statement No. 34, many governments will be able to add millions, perhaps even billions, of dollars of valuable fixed assets to their balance sheets, now renamed statements of net assets. The inclusion of depreciation expense provides a rationale for raising user fees.

In other ways, accruals may not improve the financial position of a government. Most government fixed assets were bought or built for use, not for sale, making them useless hi improving the government's ability to pay bills. Furthermore, the balance sheet will now be burdened with potentially large amounts of previously unrecognized liabilities for past services. Although there may be civic pride in refusing to burden future generations, such sentiments will probably evaporate quickly if higher taxes are needed to pay for past fiscal neglects and to avoid then- continuance by prepaying for deferred costs.

Although it is possible to project the direction of financial statistics as a consequence of implementing the accrual basis, the magnitude of change will depend on the extent to which a government has used the cash basis of accounting and operated on a "pay as you go" basis. Budget directors, along with their accounting colleagues, are advised to make such a fiscal impact analysis for their particular jurisdiction. At the same time, they need to prepare themselves to answer tough questions about their government's finances, because if the wish of the GASB becomes true, the public will be armed with numbers.

Although Statement No. 34 will add to the burdens and headaches of public finance practitioners, it may have the salutary effect of promoting a dialogue between scholars hi public budgeting and government accounting. The accounting policies underlying the government-wide financial statements may trigger another round of debate about budget principles. Should the budget be comprehensive in coverage? Should the budget be placed on the accrual basis? Even though sophisticated financial professionals can see the merits of different information for different purposes, multiple sets of books carry bad connotations to the general public. Harmonizing budgeting and accounting standards is essential for the credibility of government financial information.

1. Allen Schick. 'The Road to PBB: The Stages of Budget Reform," *Public Administration Review* 26 (December 1966): 243-58.
2. Irene Rubin, "Budgeting for Accountability: Municipal Budgeting for the 1990s," *Public Budgeting & Finance* 16 (Summer 1996): 112-32.
3. This is a neglected area of research that deserves greater attention. See Doris A. Grover, *Public Communication: How Organizations Manage Information* (Washington, DC: Congressional Quarterly, 1992); John A. Ferejohn and James H. Kuklinski, *Information and Democratic Processes* (Urbana, IL: University of Illinois Press, 1990).

4. U.S. General Accounting Office, *Accrual Budgeting: Experiences of Other Nations and Implications for the United States* (Washington, DC: USGAO, February 2000).
5. James Guthrie, “Application of Accrual Accounting in the Australian Public Sector—Rhetoric or Reality?” *Financial Accountability & Management* 14 (February 1998): 1-19; James L. Chan, “The Bases of Accounting for Budgeting and Financial Reporting,” in *Handbook of Government Budgeting*, ed. Roy T. Meyers (San Francisco: Jossey-Bass, 199S), 357-80.
6. Edward Anthony Lehan, “Budget Appraisal—The Next Step in the Quest for Better Budgeting,” *Public Budgeting & Finance* 16 (Winter 1996): 3-20; Philip G. Joyce, “Appraising Budgeting Appraisal: Can You Take Politics out of Budgeting?” *Public Budgeting & Finance* 16 (Winter 1996): 21-25.
7. Joseph T. Kelley, “The GFOA Budget Awards Criteria and Lehan’s ‘Budget Appraisal,’ *Public Budgeting & Finance* 16 (Winter 1996): 26-30. The recommendations include the GFOA’s Recommended Practices for State and Local Governments and the National Advisory Council on State and Local Budgeting. See John Gross, “NACSLB Recommended Budget Practices: What They Are and How to Use Them,” *Government Finance Review* 14 (June 1998): 9-14. More complete and timely information is available on line at <*www.gfoa.org*>. Currently the GFOA’s appraisal is limited to budget presentation as described by Kelley.
8. Allen Schick, *Modern Budgeting* (Paris: Organisation for Economic Cooperation and Development, 1997).
9. Budget documents sometimes do not state the budget rules being followed, making it difficult to evaluate the numbers. The inconsistencies between budget rules and accounting principles are revealed in the reconciliation between budget numbers and accounting numbers in financial statements. For example, the budgets of the City of Chicago apparently used the following rules: Federal and state grants are not included in the budget. Proceeds and long-term debt are treated as revenue; so are operating transfers in. Encumbrances are recorded as expenditures.
10. James L. Chan and Rowan A. Miranda, “Principles for Designing the Finance Organization: A Guide for Reform Efforts and Leadership Transition,” *Government Finance Review* 14 (June 1998): 15-19.

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