

Lectures in American Government Accounting

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Lecture 2. American Government Financial Statements

How to think about govt. acctg.

Making sense of financial statements

“5P Model”

For thinking about govt. accounting

5 Ps

- Purpose: Why?
- Preparer: Who?
- Policy: What?
- Process: How?
- Products: What?

Purpose of a Full-service Government Accounting System

- Basic Level: Help government (departments and officials) comply with finance-related laws and regulations.
- Intermediate Level: Support budgeting and financial management.
- Advanced Level: Help government (departments and as a whole) demonstrate and discharge financial accountability to stakeholders.

Preparer: Who's Who

Setting GAAP

- Applicable to business and nonprofit organizations in private and public sectors: Financial Acctg. Standards Board (FASB).
- Applicable to state and local govts: Govt. Acctg. Standards Board (GASB)
- Applicable to Fed. Govt.: Federal Acctg. Standards Advisory Board (FASAB)

Making Rules & Regulations

- Fiscal officers of the Fed. Govt. and each State
- Budget director
- Finance director or comptroller
- Auditor

Who's Behind Whom in Setting GAAP

State and Local Govt.

- American Institute of Certified Public Accountants (AICPA) recognizes GASB standards as GAAP.
- A broad coalition of stakeholders reinforcing GASB.
- Competent authorities adopt GASB standards.
- Private-sector CPAs enforce compliance with GAAP.
- Bond ratings requires audited financial statements based on GAAP.

Federal Govt.

- AICPA recognizes FASAB standards as GAAP.
- Office of Management and Budget (OMB) requires admin. compliance.
- Department of Treasury Financial Management Service uses FASAB standards in preparing financial statements.
- Govt. Accountability Office uses FASAB standards to audit financial statements.

Government Accounting Policies

Generally Accepted Accounting Principles (GAAP)

- GASB standards promote nation-wide uniformity and high quality in govt. financial reporting nation-wide.
- GASB and FASAB standards focus on general purpose external financial reports for external users.

Government Rules and Regulations

- Government rules and regulations are valid only within each jurisdiction
- Laws
 - State statutes
 - Local ordinances
- Regulations issued by
 - State Comptrollers (chief accounting officer)
 - State Auditors
 - State budget directors

Process

- Due process of setting GAAP: deliberative, open, participatory, consensus-building.
- Adoption of GAAP: economic and political incentives, need for sustainable support.
- Building accounting system capability
 - Hardware and software for integrated system;
 - Human resources for research, development and operations;
 - Authority and ability to collect, classify and summarize data from diverse sources;
 - Preparation of financial statements and reports

Products of Accounting Systems

General Purpose Reports

- Comprehensive Annual Financial Reports (CAFR)
- Core of CAFR: financial statements, consisting of statements of
 - Financial Position
 - Financial Performance
 - Cash flows
 - Others

Special Purpose Reports

- Cash-based financial statements
- Reports of budget execution (receipts, spending)
- Reports required by
 - Managers
 - Higher administration
 - Legislators
 - Grantors, donors
 - Others

Review of Concepts Underlying Govt. Financial Statements

Relationship between Financial Position and Performance

- At the beginning of a period: cumulative amounts from past periods

$$\text{Net Assets} = \text{Assets} - \text{Liabilities}$$

- Effects of transactions and events during the period

Borrowing	0	+A	+L
Revenues:	+ NA	+A	
	+ NA		- L
Expenses:	- NA	- A	
	- NA		+ L

- Result in new balances at the end of the period

$$\text{Net Assets} = \text{Assets} - \text{Liabilities}$$

Relationship Between BA and MF

- Basis of accounting (BA) is the method of measuring financial performance during a period: revenue, expenses, income.
- Measurement focus (MF) is the method for measuring financial position at the end of a period: assets, liabilities, and net assets

Related Financial Statements

- Results of financial performance depends on assets and liabilities used to measure financial position.
- Three financial statements are needed:
 - Statement of Financial Position at beginning and the end of a period.
 - Statement of Financial Performance during the period.
 - Statement of Cash Flows during the period.

Accounting Process Leading to the Financial Statements (IRMeD)

1. **Identify** the financial consequences of transactions and events of the govt. being accounted for interest.
2. **Recognize** those consequences that change the govt. assets or liabilities?
3. **Measure** the changes in assets, liabilities and net assets.
4. **Disclose** the financial position and performance in financial statements or elsewhere in the financial report.

U.S. Government Consolidated Fin. Statements (CFS)

Departmental CFS
Not discussed

U.S. Government Cash Deficit

Amounts in Billions of US\$	FY 2009	FY 2008
Receipts	2,105	2,523
Outlays	3,522	2,978
Deficit (-)	-1,417	-455

U.S. Government Accrual Deficit

Amounts in Billions of US\$	FY 2009	FY 2008
Revenues	2,499	2,912
Expenses	-3,736	-3,892
Deficit	-1,237	-980

U.S. Government Adjusted Accrual vs. Cash Deficit

Amounts in Billions of US\$	FY 2009	FY 2008
Accrual Def.	-1,253	-1,009
Cash Def.	-1,417	-455
Difference	164	-554

U.S. Government Financial Position

Amounts in Billions of US\$	End of FY 2009	End of FY 2008
Assets	2,668	1,975
Liabilities	14,124	12,178
Net Assets	-11,456	-10,203

U.S. Government Future Deficit, Debt and GDP

Amounts in Billions of US\$	FY 2010	FY 2011
Cash Def.(-)	-1,253	-1,009
Debt (-)	-9,298	-10,498
GDP	14,624	15,299

What is the U.S. Govt.?

- U.S. Govt. financial reporting entities includes
 - All three branches of govt.
 - All entities owned or controlled by U.S. Govt., including:
 - Public nonprofit organizations,
 - U.S. Govt. corporations.
- Consolidation eliminates the effects of all internal transactions, e.g. transfers and borrowings between the general fund and the social security trust fund.

Selected Financial Statements for the Whole U.S. Government

Generic Titles

- Statement of financial position
- Statement of Financial Performance
- Reconciliation between the cash deficit and accrual deficit

Actual Titles

- Balance Sheet
- Statement of Net Cost
- Statement of Operations and Changes in Net Position
- Reconciliation of Net Operating Cost [accrual deficit] and Unified Budget Deficit [cash deficit]

Accrual-based Statement of Financial Performance

- $\text{Gross cost} - \text{earned revenue} = \text{Net cost}$
- $\text{Revenue} - \text{net cost} = \text{net operating revenue}$
[accrual-based surplus] or cost [accrual-based deficit]
- $\text{Beginning net position} +/- \text{net operating revenue or cost [surplus or deficit]} = \text{ending net position}$

Technical Terms Made Easy

- Gross cost [of service] = expense.
- Earned revenue = user charges.
- Net cost = expenses offset by user charges; cost financed by taxes and debt.
- Revenue = mostly tax revenues.
- Net position = net assets = assets - liabilities

From Accrual Deficit to Cash Deficit

Accrual deficit (negative number)

+ Increases in liabilities

+ Depreciation expense

- Capitalized fixed assets

+/- other accrual adjustments

= Cash deficit (negative number)

From Cash Deficit to Accrual Deficit

Cash deficit (negative number)
+ Capitalized fixed assets
- Depreciation expense
- Increase in liabilities
+/- other accrual adjustments
= Accrual deficit (negative number)

Assets

- Fin. resources (at net realizable value)
 - Cash and other monetary assets.
 - Receivables: accounts, loans and taxes.
 - Financial investments
- Resources for use:
 - Consumables: inventories (historical cost, net realizable value)
 - Capital: property, plant and equipment (historical cost, net of accumulated depreciation)

Off-Balance Sheet Stewardship Assets

- Stewardship assets include:
 - Federal land for public and military use.
 - Heritage assets, including natural resources, museum collections and other cultural resources.
- Due to difficulties of financial measurement, these assets are described or measured by physical units.
- When they are purchased, their acquisition costs may be treated as expense.

Liabilities

- Current liabilities.
- Federal securities held by public
- Federal employee & veteran benefits payable (actuarial value).
- Environmental and disposal liabilities (cost of clean-up required by law)
- Social insurance benefits due and payable soon
- Loan guarantee (estimated cost due to defaults)

Off-balance Sheet Obligations

- Eligible Americans are promised “entitlement” benefits under Social Security and Medicare programs.
- Question: Are these obligations liabilities?
- In the absence of consensus, these obligations are reported “off balance sheet” in a Statement of Social Insurance as present value of (expenditures – revenues) over 75 years.

Net Position

- By definition, net position = assets minus liabilities.
- The amount of net position is greatly affected by:
 - The measurement focus of the balance sheet;
 - The criteria used to recognize assets and liabilities; and
 - The measurement methods used to express assets and liabilities in financial terms.

State/Local Financial Reporting: Government-wide Statements

Fund Financial Statements

Not discussed

New Features Since 1999

- Basic financial statements include both:
 - Government-wide financial statements, and
 - Fund Financial Statements
- Some component units to be discretely presented
- Separate presentation of governmental and business activities
- Original and final budgets for comparison with actual performance

Basic Financial Statements

New Reporting Model
(GASB Statement No. 34)

Structure of Disclosure

- Management's Discussion and Analysis (MD&A)
- Government-wide financial statements
- Fund financial statements
- Notes to the financial statements
- Required supplementary information (RSI)

Management's Discussion and Analysis

- Govt-wide comparison of the current and previous fiscal years.
- Govt's overall financial position and results of operations.
- Major changes in the govt's funds and significant budget variances.
- Capital asset and long-term debt activities.
- Currently known facts, decisions and conditions affecting the future.

Government-wide Financial Statements

- Entities: government and component units.
- Format: separate columns for governmental and business activities.
- Measurement focus: economic resources.
- Basis of accounting: strong accrual.
- Two financial statements:
 - Statement of Net Assets.
 - Statement of Activities.

Statement of Net Assets

- Excludes fiduciary resources unavailable to finance government operations.
- Assets include capital assets.
- Liabilities include general long-term debt: operating debts and bonds/notes payable.
- Net assets classified as:
 - Capital assets net of related debt.
 - Restricted net assets.
 - Unrestricted net assets.

Statement of Activities

- Format: expenses – revenues = net costs.
- Expenses classified by service function or activity.
- Program revenues, e.g. fees and restricted grants.
- Net costs to general taxpayers.
- Annual change in net assets.
- To answers the question: Is the government financially better off or worse off from one year to the next?

Interperiod Equity (IPE)

- Definition: In each fiscal year, government should collect enough revenues to cover the cost of services, so that financial burdens are not shifted to the future.
- Related to intergenerational equity.
- Rationale: selfishness or fairness.

Budgetary Actions

- Separate government into
 - Operate budget: financed by current revenues.
 - Capital budget: financed by borrowing.
- Balanced budget requirement
 - Applies to operating budget.
 - Revenues – expenditures = 0
 - Cash basis: receipts – disbursements = 0

IPE Requires that...

- For example:
- Public employee pension benefits be financed by the revenue of the period in which employees provide their services.
- The purchase of a public building should be financed by bonds with maturity to match the useful life of the building.

From Cash to Accruals

- *Cash basis commonly used in budgeting*

FB. Outlay (-FB)	xxx	
A. Cash (-)		xxx

- *Modified accrual basis used by funds controlled by annual budgets*

FB. Expenditure (-FB)	xxx	
A. Cash (-)		xxx
L. Current payables (+)		xxx

Cost of Services

- *Strong accrual basis used by govt.-wide financial statements:*

NA. Expense (-NA)	XXX	
A. Cash (-)		XXX
L. Short-term payables (+)		XXX
L. Long-term payables (+)		XXX
A. Capital assets (-)		XXX

Basis of Accounting and Measurement Focus

- Accrual basis requires broad measurement focus.
- Cost of service includes
 - Cost of using capital assets (depreciation).
 - Deferred compensation (pension benefits).
- Shift of emphasis to the balance sheet

Each Basis Serves a Different Purpose:

- Cash basis: cash management.
- Mild and moderate (“modified”) accrual basis: financial resources management.
- Strong accrual basis:
 - Fiscal analysis: amount of taxes to levy...
 - Assessment of IPE.

GASB's Decision

- Cash basis: Not acceptable.
- Modified (= mild) accrual basis: current operations governed by annual budgets.
- Accrual basis: government as a whole.

Reporting Entity in the New Model

- GASB 34 requires new government-wide financial statements.
- Decision: which government units to include in the financial statements?
- State and local government units:
 - Primary governments (PG)
 - Component units (CU)
- Distinguish between component units and related and affiliated organizations

Reporting Principle

- Financial reporting entity:
 - Primary government (PG)
 - CU's for which PG is financially accountable
 - Others so that financial statements will not be misleading

Primary Government (PG)

- Basic criterion: political and economic autonomy.
- All state governments are PG.
- All general-purpose local governments are PG.
- Certain special-purpose governments are PG if
 - Elected governing board
 - Independent legal entity
 - Fiscal autonomy

Component Units (CU)

- Must be legally separate entities
- Must meet any one of three tests:
 - Decision-making autonomy
 - PG appoints voting majority
 - PG able to impose its will or is financially interdependent with CU
 - Fiscal autonomy
 - Non-misleading presentation

What's Financial Accountability?

- PG appoints voting majority of CU's governing board, and
- [either one of the following conditions]
 - PG can impose its will on CU, or
 - PG enjoys CU's financial benefits (e.g. access to resources) or assumes CU's financial burdens (e.g. debt guarantee).

Some “Relatives” Are Closer Than Others

- Departments/agencies of the PG.
- Blended CUs same as PGs departments.
- Discretely presented CUs.
- Joint venture – part ownership.
- Related organizations – PG appoints voting majority of governing board only.
- Affiliated organizations – PG does not appointing majority of governing board.

Presenting CUs

- Blending presentation
 - Identified in Note on significant accounting policies.
 - Result of blending: loss of separate identity.
 - Further disclosures in other Notes.
- Discrete presentation
 - All CUs in a separate column in the financial statements of the PG.
 - CUs often issue their own financial reports.

American State and Local Governments Use “Funds”

For budgeting, financial management
and accounting purposes
(not discussed)

Funds as Fiscal and Accounting Entities

- Pools of resources segregated for carrying out specific objectives and activities
- Physical segregation as fiscal entities containing financial/economic resources, and responsible for own debt.
- “Virtual segregation” as accounting entities:
fund assets = fund liabilities + fund balance.

Reasons for Setting Up Funds

- Required by law to monitor the executive departments.
- Required by contracts to protect “property rights”:
 - Bond covenants.
 - Agreements with grantors.
 - Collective bargaining agreements.
- Sound financial administration
- Enforces financial accountability

Fund Classification Based on Nature of Operations

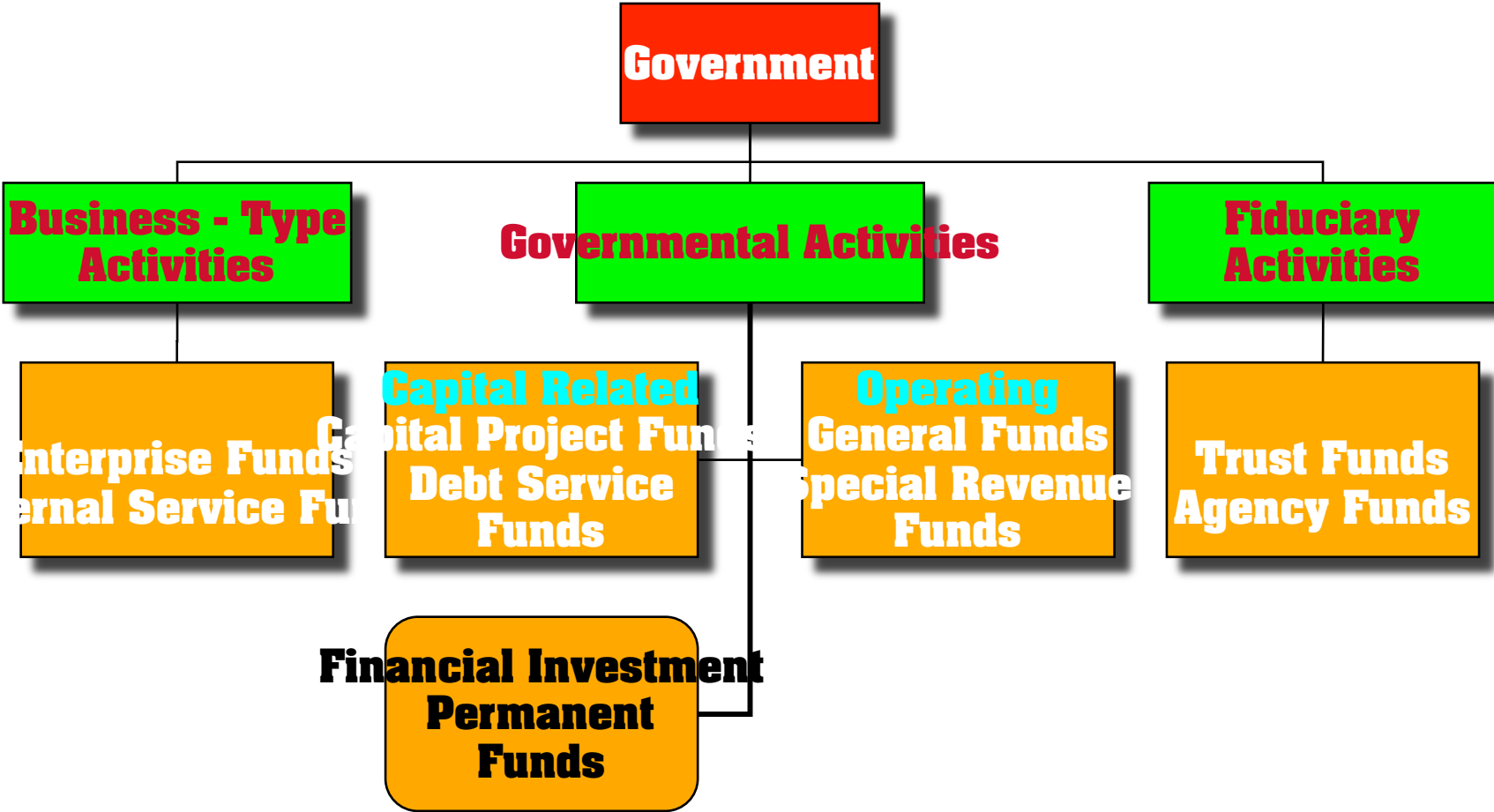
Operations

- Governmental Activities
- Business-type Activities
- Fiduciary Responsibilities

Fund Categories

- Governmental Funds
- Enterprise Funds
- Fiduciary Funds

Government Activities and Fund Types



Governmental Fund Types

- **General Fund** – resources whose use is not restricted by external parties.
- **Special Revenue Funds** – revenues for restricted operating purposes.
- **Capital Project Funds** - resources for acquisition or construction of capital facilities.
- **Debt Service Funds** - resources for payment of long-term debt principal and interest.
- **“Permanent Funds”** – endowments whose income is for governmental purposes.

Proprietary Fund Types

- **Enterprise Funds** – government business operations selling goods/services to the public.
- **Internal Service Funds** – same as enterprise funds except customers are other departments in the same government.

Fiduciary Fund Types

- **Trust Funds** - assets held in a trustee capacity for others.
- **Agency Funds** - assets held as an agent for others.

Fund Expendability

Expendable Funds

- Period oriented
- Resources may be expended
- Measurement focus: current financial resources
- Subject to appropriation process

Non-Expendable Funds

- Operate on ongoing basis
- Reuse resources indefinitely
- Measurement focus: all economic resources
- Often not subject to appropriation process

Summary

Financial Statements

- American govts. are required to prepare a statement of financial position with an economic resource measurement focus, and a statement of financial performance on a strong (full, if possible) accrual basis in order to assess inter-period equity.
- Additional disclosures include: comparison of budget vs. actual performance, and reconciliation between accrual deficit and cash deficit numbers.

Financial Reporting Entity

- The concept of “whole govt. financial statements” is interpreted by the federal govt. to mean consolidated financial statements, and by state and local govts. to mean multi-column govt. –wide financial statements, with disclosure about entities for which the govt. is financial accountable.

Statements within Reports

- Audited financial statements prepared using generally accepted accounting principles (GAAP) constitute the core of a govt. comprehensive annual financial report (CAFR).
- A CAFR contains budget information, financial trends and other disclosures to put one-year historical financial data in context.
- The validity of numbers in financial reports depend in the accounting standards used.

Further Readings

- “Structure of Govt. Acctg. Standards” (2010)
- “Form and Contents of American State and Local Governments’ Government-wide Financial Statements” (to be written)
- “Form and Contents of U.S. Government’s Consolidated Financial Statements” (to be written)
- Visit www.JamesLChan.com

Next Lecture: A Closer Look at Financial Accounting Principles