

Lectures in American Government Accounting

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Lecture 3. American Government Financial Accounting Principles

Policy Options and Choices Made

Accrual Accounting

Budget Comparisons

Financial Accounting Policy Options

A Review

Issue Area 1. Objectives and System Capability

- Relative weight of the following:
 - For determining and demonstrating compliance with finance-related legal and contractual provisions – Yes.
 - For supporting financial management, including budget execution – Yes.
 - For fair presentation in accordance with generally accepted accounting principles -- Yes.

Issue Area 2: Relationship with Budgets

- Range of relationships:
 - Reconciliation of actual results with budgeted results on the budgetary basis -- Yes.
 - Comparison of actual results with budgeted results on the budgetary basis -- Yes.
 - Comparison of actual results with budgeted results on a GAAP (accrual) basis -- No.
 - Budgeting on a GAAP (accrual) basis -- No.

Issue 3: Accounting and Reporting Entity

- One column for whole government only – Fed. Govt.
- One column for whole govt., and another column for legally separate but financially accountable entities – State and Local Govt.
- One column each for governmental activities, another column for business-type activities, and total column for whole government – State and Local Govt.
- Whole govt. statements complemented by financial statements for departments and funds – All Govt.

Issue Area 4.

Accounting System Architecture

- Should the asset accounting system be based on

- A single-entry recording system? No

Beginning balance of any account		xxx
Addition	+	
Deduction	-	
Ending balance		xxx

- A double-entry recording system? Yes

	Assets = Liabilities + Net Assets	
Building and Equipment	+ 1,000	
Bonds Payable	+1,000	
Net Assets		+ 0

Issue Area 5: Financial Statements

- Yes: A package of related financial statements should include at least:
 - A statement of assets and liabilities at the end of a period, and
 - A statement of revenues and expenses for the period.
- Issues:
 - To require a cash flow statement? -- Only for businesses
 - To require budget comparison statement/schedule? -- Yes
 - To require schedules that reconcile numbers? -- Yes
 - How many supplemental disclosures to require? -- Many

Issue Area 6: Time Orientation and Realization

- Financial accounting is fundamentally historical in nature. However, it is possible to consider:
- Realized distant future consequences of past transactions and events; and
- Unrealized consequences of transactions and events that have not occurred
 - Very few items (e.g. financial investments) – Yes.
 - Some items – Maybe.
 - Many items – No.

Issue Area 7: Accounting Recognition

- Accounting recognition stipulates the criteria for considering certain economic resources as assets, and certain responsibilities as liabilities of an entity.
- Issue: What should those criteria be?
 - Assets: future benefit, ownership, control – Yes, all.
 - Liability: future sacrifice due to reciprocal benefit, certainty -- Yes, all.

Issue Area 8: Measurement Focus of the Balance Sheet

Assets: Yes, all

- Current financial resources
- Long-term financial resources
- Capital resources

Liabilities: Yes, all

- Purpose
 - Operating debt/liability
 - Capital debt/liability
- Timing
 - Current financial liabilities
 - Long-term financial liabilities

Issue Area 9: Basis of Accounting

- Full accrual – for sales revenue on the basis of service delivery and matching related expenses.
- Alternatively, accruals in govt. measure the availability and use of resources – Yes, in several degrees.
- The issue boils down to the timing of availability and use of resources, and the kind of resources being measured -- Sure.

Which Degree of Accrual?

– Gradual and Symmetrical

- Mild accrual: short-term receivables as revenue and short-term liabilities as expenditure.
- Moderate accrual: long-term receivables also as revenue, and long-term liabilities also expense
- Strong accrual: receipt of non-financial resources also considered as revenue, and use of non-financial resources as expense.

Issue Area 10: Unit of Measurement

- The elements of a government's financial statements are usually stated in the units of its national currency -- Yes.
- Two valuation issues exist:
 - Whether to adjust for general or specific price level changes – No.
 - Fair market values – for financial resources; adjusted historical cost – for capital assets. Current liabilities are stated in in contract price, and long-term liabilities in present value of future cash outflows.

American Government Accounting Policies

Summary

Dual Purposes of Govt. Acctg.

- Government accounting systems serve the dual purpose of
 - Enforcing budgetary control as required by laws and regulations of a particular jurisdiction, and
 - Fair presentation of financial conditions as required by GAAP for uniformity and comparability.
 - Therein lies the potential for conflicts and the need for reconciliation and harmonization.

Financial Acctg. Principles for Fair Presentation

- Accountants defer to competent legal authorities in preparing budgets and enforcing budgetary compliance, and are willingness to use budgetary basis for making budgetary comparisons.
- However, American govt. acctg. standards boards have gained a high degree of independence in defining financial acctg. measurement rules and the form and contents of financial statements subject to external audit.

Financial Accounting and Reporting Entity

- A financial accounting entity is a fiscal entity, and may even be a legal entity, that is competent to own property, incur obligations and enter into transactions with others in the economic system.
- Financial statements are prepared for a financial reporting entity, which may be a group consisting of a primary government and the other entities for which it is financially accountable by virtue of funding, ownership or control.

Accounting Equation and Financial Position

- By virtue of the norm of reciprocity, an entity's resources are either owed or owned, as reflected in
- The accounting equation: $\text{assets} = \text{liabilities} + \text{net assets}$ (e.g. owners' equity), a representation of financial position at the beginning or end of a period.

Transactions and Events, and Realized Financial Consequences

- In contrast to budgeting, the role of financial acctg. is to identify, recognize, measure and report some financial consequences of transactions and events, after they have occurred, on the accounting entity's financial position,
- although, in the interest of being useful, financial acctg. also attempt to deal with unrealizable but realizable consequences as well.

Recognition of Assets and Liabilities

- By means of the double-entry recording method, financial consequences are expressed in terms of their dual effects on financial position, specifically on the entity's assets, liabilities, and net assets.
- An entity's assets are the economic resources it owns or controls through past transactions or events; liabilities are obligations that will require future cash payments or service also by virtue of past transactions or events.
- The range of assets and liabilities included determines the measurement focus of a statement of financial position.

Basis of Accounting Measures

Revenues and Expenses

- An entity's financial performance during a period is measured in terms of changes in net financial position: specifically revenues results from increases in assets or decreases in liabilities, and expenses from decreases in assets and increases in liabilities. The way revenues and expenses are measured is called an acctg. basis.

Cash Basis and Accrual Basis

- The cash basis measures revenues in terms of cash receipts and cash outlays as expenses.
- However, the full accrual basis, used in business activities, measures sales revenues to the extent of services rendered and then matches expenses against the revenues.
- When full accrual basis cannot be used, the accrual basis is modified in varying degrees to reflect the assets generated and liabilities incurred in a transaction or events.

Financial Measurement

- Finally, financial consequences are, by definition, measured in terms of money. While the nominal value of the domestic currency is used and historical cost is the starting point, economic reality may require the consideration of the purchasing power of money, market value and the time value of money.

Cash Deficit and Accrual Deficit

A Closer Look

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

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:	+	+A	
	+		- L
Expenses:	-	- A	
	-		+ L

- Result in new balances at the end of the period

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

Major Differences Between Cash and Accrual Deficits in Billions (FY 2008)

Liabilities for military employee benefits	110
Liabilities for veteran's compensation	339
Liabilities for civilian employee benefits	101
Depreciation expense	55
Capital expenditures	106

Accounting for Federal Bailouts in the 2008/09 Financial Crisis

Estimates inferred from financial
statements; not actual transactions

Accounting Recognition (?) of U.S. Government Actions

- The administration announces rescue plans.
- Congress passes legislation authorizing rescue actions.
- The government borrows cash to increase its own liquidity (ability to pay cash on demand).
- The administration enters into transactions with specific entities:
 - Lending, investing
 - Providing insurance coverage and guarantees

Cash Deficit Deteriorated Much More Than Accrual Deficit. Why?

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

Borrowing, Lending and Investing Had No Impact on Accrual Deficit

Amounts in Billions of US Dollars	Assets	- Liabilities	= Net Assets
Borrowing cash by issuing debt securities:			
Cash	+\$1,746		
Bonds or Notes Payable		+\$1,746	
Using borrowed cash to make loans or buy shares of failing banks and companies:			
Loans receivable & mortgage backed securities	+\$285		
Direct loans and equity investments	+240		
Investments in mortgage fin. institutions	+57		
Ownership interest in rescued companies	+24		
Cash	-606		

Increase in Accrual Deficit Results from Increased Liabilities in FY 2009

Amounts in Billions of US Dollars	Assets	- Liabilities	= Net Assets
Providing insurance and guarantee: Liabilities for providing insurance & guarantees Expense (estimated loss)		+81	-81
Providing liquidity guarantees: Liability for making guarantees Expense (estimated loss)		+78	-78

Distinguishing...

- Liquidity: the ability to pay cash as needed or on schedule
- Solvency: having enough financial resources (investments and claims against others) to cover financial obligations (claims by others) in
 - The short term
 - The long-term
- Viability: having enough economic resources to provide goods and services and have normal operations.

Artful Terms and Terms of Art

- Paper gains (losses) = unrealized gains (loss); unrealized means not yet confirmed by actual transactions.
- A house under water = current market value of the house < historical cost (i.e. actual amount paid for the house).
- Toxic assets = owned resources (assets) whose value is less than original cost, or is likely to give rise to risks.
- Legacy cost = liabilities; cost of past services deferred to the present or future for payment.

Degrees of Accrual

Differentiating the Shades of Grey

Some Economic and Political Realities

- Governments make decisions and take actions with financial consequences beyond the current period.
- Governments receive and extend credit.
- Governments have non-cash resources.
- There is a disconnect between taxes and government services in the short-term at the individual level.
- Politicians have the incentive to defer or obscure costs.

To Accrue Means...

- To grow – dictionary definition.
- No revenue until goods are sold or services are rendered – business GAAP.
- Modify the (full) accrual basis.
- Modify the cash-basis.
- Needed: distinguish the shades of gray in the spectrum in the meaning of accrual.

A New Perspective: Focus on Rights and Obligations

- Conventional view focuses on revenues and expenditures or expenses.
- Question: What rights and obligations lie behind these constructs?
- Assets are property rights (claims against others) and useful resources; liabilities are obligations (others' claims) and responsibilities.
- Revenue: Increase assets or decrease in liabilities.
- Expenditure or expense: Decrease in assets or increase in liabilities.

Financial Position in Terms of Assets and Liabilities, But

Are these Assets?

- Cash
- Current financial resources
- Long-term financial resources
- Capital assets
- Anticipated future revenue streams

Are these Liabilities?

- Current obligations
- Long-term obligations
- Contingent obligations
- Promise of service implicit in taxation
- Legislated social benefits (entitlements)

Answer: It Depends... on the Degree of Accrual

- That is, what assets *and* liabilities to recognize, measure and report in the balance sheet.
- Five degrees of accrual:
 1. Mild accrual
 2. Moderate accrual
 3. Strong accrual
 4. Super-strong accrual
 5. Radical accrual

Default Option: No accrual

- Cash
 - Level of cash at the end of day, month, quarter, year.
 - Cash receipt – cash disbursement during a period.
- Distinguishing
 - Cash basis for recognizing revenues upon receipt of cash regardless of completion of sales or delivery of services, and
 - Cash flow analysis to find out the sources and uses of cash.

1st Degree: Mild Accrual

- ***Current financial resources***

- Taxes receivable
- Accounts receivable
- Grants receivable
- ...

In general, government claims against others, convertible to cash within one year, net of allowance for uncollectible amounts.

- ***Current liabilities***

- Benefits payable
- Accounts payable
- Grants payable
- ...

In general, others' claims against government, requiring cash payments due within one year.

2nd Degree: Moderate Accrual

- Current financial resources
- ***Non-current financial resources*** - Claims against others but not convertible to cash within 1 year.
- Current liabilities
- ***2a. Long-term liabilities***
 - Others' claims against government but not due within 1 year.
- ***2b. Contingent liabilities*** – probable long-term claims

3rd Degree: Strong Accrual

- Current financial resources
- Non-current financial resources
- ***Capital assets, net of depreciation***
 - 3a. Operating assets
 - 3b. Special govt. assets
 - 3c. Infrastructure
 - 3d. Heritage assets
- Current liabilities
- Long-term liabilities
- Contingent liabilities

Degrees of Accrual and Cost of Service: An Illustration

- A small American village govt. has only one policeman. Last year, the policeman:
 - Was paid \$43,000 in salary, overtime pay, and fringe benefits (mainly health insurance);
 - Was owed \$1,000 in fringe benefits by year-end;
 - Earned \$8,000 in pension benefits due in 25 years
 - Used up \$10,000 worth of his police car.
- Question: How much was the cost of police service? How much should taxpayers have paid for police service last year?
- Answer: It depends on the degree of accrual!

Escalating Cost of Service Due to Higher Degrees of Accrual

Cash	Payment of salary and fringe benefits	\$43,000
	+ short-term payable for benefits earned	+1,000
Mild	Expenditure as measure of cost of service	=44,000
	+ long-term payable for pension benefits earned	+8,000
Moderate	Expense as measure of cost of service	=52,000
	+ depreciation expense of equipment used in service delivery	+10,000
Strong	Expense as measure of cost of service	=\$62,000

4th Degree: Super-strong Accrual

- Current financial resources
- Non-current financial resources
- Capital assets
- Current liabilities
- Long-term liabilities
- Contingent liabilities
- ***Tax collections regarded as liability; no revenue recognized until services are rendered***

5th Degree: Radical Accrual

- Current financial resources
- Non-current financial resources
- Capital assets
- *Anticipated future revenue streams*
- Current liabilities
- Long-term liabilities
- Contingent liabilities
- Unearned revenue
- *Legislative social benefits (entitlements)*

Problems of Higher Accruals

- The higher the degree of accrual:
 - The more dubious the recognition of assets and liabilities;
 - The more estimates and judgments required;
 - The less reliable and less possible the monetary measures;
 - The less meaningful the disclosure.

How Far to Accrue?

- “To accrue, or not to accrue?” – That’s not the question.
- “How far to accrue?” is the real issue.
- Accrue as far as benefits > costs.
- Maximize useful information subject to constraints.
- Recommendation: “moderate accrual” plus non-financial and supplemental disclosures.

Accrual Accounting for Management

- The prevailing view:
 - “Fair presentation” or “true and fair view”.
 - To compensate for cash-based budgeting.
- A management emphasis:
 - To safeguard cash.
 - To match payables with receivables.
 - To pay bills on time.
 - To efficiently use all economic resources.
 - To protect all public resources, including capital assets.

Even Moderate Accrual Accounting Can Produce Useful Information

- For predicting the amount and timing of future cash requirements.
- For predicting the amount and timing of future cash availability.
- For short, medium and long-term financial planning.
- For improving the accuracy of revenue & expenditure forecasts in cash budgets.

Main Points

- Accrual accounting reveals the long-term consequences of govt's decisions and actions.
- The balance sheet captures those consequences in terms of assets and liabilities.
- There are five degrees of accrual corresponding to the kinds of assets and liabilities reported.
- Governments should escalate the degree of accrual until costs exceed benefits.
- Balancing assets and liabilities is essential for balancing the budget and a secure financial future.

Budgeted and Actual Performance

A Closer Look at
“Budgetary Basis”

A Primer on Budgeting in American State and Local Governments

- Most governments prepare annual capital budgets and operating budgets based on “funds”.
- Operating budgets are usually required to be balanced, and capital budgets are financed by bonds, capital grants and taxes and fees.
- Revenue projections and budget (spending) proposals are usually prepared by the chief executive and approved by the legislature.
- Individual states have own budget laws that define budget terms and reporting requirements.

Basic Structure of Schedule of Budget Comparison

	Original Budget	Final Budget	Actual	Variance
Resource (Inflows)	\$	\$	\$	\$
Charges to appropriations (Outflows)	\$	\$	\$	\$

Terms Used in Budgeting Often Do Not Have Standard Definitions

- Resources (inflows) might include:
 - Revenues from sales and taxation,
 - transfers from other parts of same government,
 - even debt proceeds (“debt revenue”)
- Charges to appropriations (outflows) might include:
 - Expenditures: cash outlays, use of current financial resources for goods/services received,
 - Purchase orders and other contractual obligations for goods/services not yet received,
 - Transfers to other parts of same govt., and
 - Even repayment of debt (“debt service expenditure”)

Budgetary Basis and GAAP Basis

Budgetary Accounting

- For financial control to prevent over-spending appropriations
- Follows budget practices and is constrained by laws and regulations
- Key concepts: financing sources, financing uses, surplus, deficit

Financial Accounting

- Fair presentation of financial position and performance
- A high degree of independence in defining concepts and setting standards
- Key concepts: assets, liabilities, revenues, expenditures / expenses,

Budgetary Comparison

- Uses the budgetary basis in order to avoid mixing “apples and oranges”, and
- Necessitates explanation of differences of financial performance due to differences in measurement rules.
- Variance = (actual amounts under the budgetary basis) – (final budgeted amounts also under the budgetary basis).
- Unfavorable or unfavorable variances depends on actual amounts but also accuracy of revenue projections and tightness of spending benchmarks in appropriations.

Usefulness and Limitations of Annual Budgetary Comparisons

- Better late than never for general public accountability, but managers and legislators in dynamic economic environment require interim reports during the year.
- Original budgets are amended to reflect effects of changing environment to arrive at final budget used in making annual budget comparisons.
- Managers care most about available balance of appropriations: purchase orders count as use of appropriation.

Summary

Purposes, Financial Conditions

- American govt. accounting systems are designed to serve the purpose of budgetary control as well as fair presentation of financial conditions.
- Financial conditions are described in terms of levels and flows by the statement of financial position and statement of financial performance, respectively.

Accrual Acctg. for Inter-period Equity

- Unlike cash accounting, accrual accounting presents a broad range of assets and liabilities and measures revenues and expenses in terms of changes in those assets and liabilities.
- Stronger degrees of accrual are intended to promote inter-period equity in financing govt. services.

Relevancy, Performance Evaluation

- Subject to its historical nature, financial accounting strives to be relevant by recognizing realizable consequences of past transactions and events.
- Accountants are not allowed to set budgeting rules; however, budgetary comparisons are made at least a year-end to evaluate financial performance relative to the final budget.

Further Readings

- “Structure of Govt. Acctg. Standards” (2010).
- “Basis of Accounting for Budgeting and Financial Reporting” (1998).
- Excerpts from GASB (1987) Concepts Statement No. 1 regarding “Accountability and Inter-period Equity”.

Next Lecture: Fair Presentation and Informing the People