

# MAKING SENSE OF AMERICAN GOVERNMENT FINANCIAL STATEMENTS

# Issues to Address

- \*\* What is “fair presentation” in accordance with GAAP?
- \*\*\* How are whole-government financial statements under an accrual basis useful? To whom?
- \*\* How could the current financial model be improved?

# Federal Government

See Exh. 7.2 for  
Organization chart

# Multiple Financial Reporting Systems

Budgetary, Cash  
and Accrual

# Accountability Requirement of the U.S. Constitution

“No **money** shall be drawn from the Treasury, but in consequence of **Appropriations made by Law**, and a regular **Statement and Account** of the **Receipts and Expenditures** of all **public Money** shall be **published** from time to time.” (Article I, Section IX, Clause 7)

# Budgeting Ends and Accounting Begins

- Annually, the President requests new budget authority and estimates future revenues under current laws and proposed new revenue measures and programs.
- After setting budget totals, Congress approves, changes or disapproves specific spending and revenue proposals, subject to presidential veto.
- The President implements appropriations and other fiscal measures.

# Multiple Objectives of Accounting and Reporting

- A basic objective is to follow the money in terms of cash and **authority to spend**.
- An intermediate objective is to support **financial management** functions.
- An advanced objective is to provide **information overlooked** in the budget and cash-based financial statements.

# Budget and Entity

- Relation to budget
- Accounting entity
- Dual track accounting
  - Budgetary resources
  - Financial accounting
- Budgetary accounts
- Whole U.S. Govt.
- Individual agencies [departments] or funds



# Multiple Tracks in the Federal Accounting System

- During the budget preparation and approval process, **budget scoring** keeps track of budget authority, including appropriations.
- During the budget execution process:
  - **Budgetary accounting** keeps track of use (e.g. commitment) of appropriations.
  - **Financial accounting on the cash basis** keeps track of cash balances, receipts and outlays.
  - **Financial accounting on an accrual basis** keeps track of non-cash assets, liabilities, revenues and expenses.

# Multiple Reporting Systems

	Budget Account	Agency, Fund	Govt. as a whole
Budgetary Basis	Yes	Yes	Yes
Cash Basis	Yes	Yes	Yes
Accrual Basis	No	Yes	Yes

# Budgetary Accounting and Reporting

- Basic relationship:

Unspent appropriation at the beginning

-) contractual commitments/obligations

-) liabilities for goods/services received [?]

-) cash outlays

= Available balance of appropriation at  
any point in time during the period

# Budgetary Accounting for Receipt of Appropriation

	Dr.	Cr.
• <u>Agency/budget account</u>		
+A. Fund balance with Treasury	xxx	
+NP. Unexpended appropriations		xxx

A = assets, NP = net position = A - L

- Treasury

Memorandum entry in a single-entry system to record the congressional grant of appropriation (a type of budget authority).

# Budgetary Accounting for Use of Appropriation

	Dr.	Cr.
• <u>Agency/budget account</u>		
- NP. Unexpended appropriations	xxx	
- A. Fund balance with Treasury		xxx

- Treasury

Memorandum entry in a single-entry system to record the use of appropriation.

# Treasury Cash Accounting and Reporting (Exh. 7.10)

- The Financial Management Services of the U.S. Treasury keeps track of **cash balances**, receipts and outlays for the whole government.
- **Receipts** are further classified by source, department, and budget account
- **Outlay** are further classified by function, department, and budget account.

# Treasury Cash Accounting In Relation to Appropriation

- Basic relationship:  
Unspent appropriation at the beginning of the  
fiscal year  
- ) cash outlays during the fiscal year  
= Available balance of appropriation at any  
point in time during the period, and at year-  
end
- Data are organized by department, fund and  
budget account.

# Budgetary Basis and the Need for Reconciliation

- Budgetary basis includes cash outlays and contractual obligations or commitment. (The recognition of liability for services received is unclear.)
- **Reconciliation** is required to explain the differences between financial performance results measured in different ways.



# Financial Reporting

## Using Data from the Financial Accounting System

# The Financial Statements In Context...

- Preparation of consolidated financial statements on the accrual basis began in the 1970s; first audited fin. statements in 1998.
- 1990 Chief Financial Officers Act required **agency-wide financial statements** – building blocks of the government-wide statement.
- Auditor's opinion/report (**Govt. Accountability Office**): **disclaimer** due to **internal control** problems and unresolved accounting and reporting issues.

# Financial Statements for the Whole U.S. Government

## Generic Titles

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

## Actual Titles

- Balance Sheet
- Statement of Net Cost
- Statement of Operations and Changes in Net Position
- Reconciliation of [cash and accrued deficits]
- Reconciliation of [cash deficits and cash positions]

# Departmental Financial Statements

- Departmental financial statements are presented in annual Performance and Accountability Report.
- Departmental consolidated financial statements consist of
  - Balance sheet
  - Statement of Net Cost
  - Statement of Changes in Net Position
  - Statement of Budgetary Resources
  - Statement of Financing

# Accounting Process Leading to the Financial Statements

- **Identify** the financial consequences of transactions and events of entity of interest.
- Whether whether to **recognize** those consequences by asking: do what change the entity's assets or liabilities?
- If yes, record the financial **measures** in the financial accounts and later report in financial statements.
- If no, decide whether to **report** information in notes to financial statements or elsewhere.

# Focus: Govt.-level Financial (Accrual) Accounting

- Fin. and economic consequences of
  - Transactions (bilateral exchanges)
    - Exchange transactions (equal exchanges)
    - Non-exchange transactions (unequal exchanges)
  - Events (happenings)
    - Fed. govt. is responsible: “related events”
    - Fed. govt. is not responsible but choose to assume responsibility: “acknowledged events”

# The Added Value of Financial Accounting

- Financial accounting deals with the financial consequences of both transactions between the Federal Government and non-Fed. Govt. entities, and events affecting the Fed. Govt.
- Financial accounting emphasizes **cumulative financial consequences** in terms of assets and liabilities.
- Financial accounting is governed by **GAAP** developed through a participative due process.

# Transactions and Events As the Origins of Financial Data

- Transactions involve the exchange of economic benefits between two parties.
  - Market transactions: reciprocal and voluntary
  - Governmental transactions: non-reciprocal and involuntary at the individual level
- Events are happenings of significance that may evolve into transactions.
  - Events for which the govt. is responsible
  - Events for which the govt. agrees to be responsible.



# The Balance Sheet Emphasis

- Budgeting and budgetary accounting emphasize revenues (receipts) and expenditures (outlays) during a period.
- The emphasis of financial accounting is reflected in the accounting equation: assets = liabilities + net assets, or  $A = L + NA$ , at the end of a period (e.g. a fiscal year).
- Therefore:
  - Revenues are +NA (or +A or –L)
  - Expenses are – NA (or –A or +L)

# Relationship between Financial Position & Performance (Exh 7.3)

- At the beginning of a period:

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

- During the period

Revenues:                    +A                    -L

Expenses:                    - A                    +L

- At the end of the period: new balances

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

# 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

# Consolidated Financial Statements

# Related Financial Statements (see Exh. 7.3)

- 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.

# Terminology

- **Gross cost**: expenses.
- **Earned revenue**: user charges.
- **Net cost**: expenses offset by user charges; cost to taxpayers.
- **Revenue**: mostly tax revenues.
- **Net position (assets)**: assets - liabilities
- **Stewardship information**: off-balance sheet resources and responsibilities.

# Assets

(see Exh. 7.4)

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

# Off-balance sheet Resources (“Stewardship Assets”)

- Disclosures: narrative, physical measures, few financial measures
- Fed. land for public & military use
- Heritage assets
  - Collection-type heritage assets
  - Natural heritage assets
  - Cultural heritage assets



# Liabilities

(see Exh. 7.4)

- 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
- Loan guarantee (estimated cost due to defaults)

# Events

- Government-related: govt. is responsible.
- Recognition points:
  - *Occurrence of event.*
  - Payment due.
  - Payment made.
- Govt.-acknowledged: govt. volunteers to be responsible.
- Recognition points:
  - *Acknowledgment.*
  - Payment due.
  - Payment made.

# “Stewardship” Responsibilities

- Financial in nature, at issue
    - Extent of government obligation
    - Amount, time and uncertainty
  - Social security (\$4.6 trillion)\*
    - Old-age and survivors insurance
    - Disability insurance
  - Hospital insurance (\$5.1 trillion)\*
- \* PV of resources needed over 75 years.

# Net Position

(see Exh. 7.4)

- 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.

# Terminology on Financial Performance

- Gross cost [of service] = expense.
- Earned revenue = user charges.
- Net cost = expenses offset by user charges; cost to taxpayers.
- Revenue = mostly tax revenues

# Statement of Financial Performance (Exh. 7.6, 7.7)

- Gross cost - earned revenue = Net cost
- Revenue – net cost = net operating cost, when negative, same as **accrual-based deficit**
- Beginning net position - net operating cost = ending net position

# From Accrual Deficit to Cash Deficit (Exh. 7.13)

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

# From Cash Deficit to Accrual Deficit

Cash-based deficit (negative number)

+ Capitalized fixed assets

- Depreciation expense

- Increase in liabilities

+/- other accrual adjustments

= Accrual-based deficit



# Additional Information (Not Discussed)

- Audit report and “disclaimer”
- Management Discussion and Analysis
- Statement of Social Insurance
- Reconciliation of accrual deficit to cash position
- Stewardship assets
- Stewardship Responsibilities

# Value of Consolidated Financial Statements on the Accrual Basis

- Factual vs. projections in the budget
- Information about assets and liabilities shows long-term cumulative effects
- Whole govt. financial statements corresponds to unified budget
- Objective, detailed measurement rules

# Limitations of Consolidated Financial Statements

- Effects of internal borrowings and transfers are eliminated in consolidation (e.g. Social Security cash surplus used to offset General Fund cash deficit)
- Inability to include major resources and responsibilities on balance sheet
- Internal control problems undermine credibility of reported numbers

# Major Challenges in Federal Accounting and Reporting

- The Federal Government has to give a persuasive reason for excluding the cost of entitlement programs from its balance sheet.
- The Federal Government has to find a way to meaningful measure stewardship assets.
- The Federal Government has to reduce the instances of inconsistent accounting of transactions among Federal departments.

# Major Challenges (cont'd)

- The Federal Government has to practice the principle of accruing “enforceable legal claims” as tax revenues and receivables.
- The Federal Government has to substantially improve its internal control so that the GAO can at least issue an audit opinion, because a long series of disclaimers have undermined the credibility of Federal financial reporting.

# State/Local Government-wide Statements

GASB Statement No. 34 (1999)

# Comprehensive Annual Financial Report (CAFR)

- All state & local govts. are required to issue a CAFR
- A CAFR includes
  - Financial section
  - Statistical section with financial trend data and socioeconomic statistics.

# Financial Section in a CAFR

- Management's discussion and analysis (MD&A) of financial policy and reports.
- Government-wide financial statements.
- Financial statements of major funds.
- Notes to the financial statements.
- Required supplementary information.
- Financial statements of individual funds and component units.



# Government-wide Financial Statements

- Reporting entity: **primary government** and its **component units**.
- Two financial statements:
  - **Statement of Net Assets**.
  - Statement of Activities.
- Format: separate columns for governmental and business activities; no fiduciary activities.
- Measurement focus: **capital assets and long-term liabilities are included**.
- Basis of accounting: **full/strong** accrual basis.

# Primary Government and Component Units

- Primary governments (PG) have a high degree of political and economic autonomy
- All state governments and general-purpose local governments are PG
- A component unit (CU) is a legally separate unit that is subject to the control by or is financially interdependent with the PG.

# Statement of Net Assets

## (see Exhibit 11.1)

- Content: assets minus liabilities = net assets.
- Net assets are classified as:
  - Capital assets net of related debt.
  - Net financial assets
    - Restricted net financial assets.
    - Unrestricted net financial assets.
- Fiduciary resources are excluded
- Assets include infrastructure capital assets.
- Liabilities include operating debt and capital debt

# Statement of Activities

## (Exh. 11.2)

- Basic format: (expenses classified by service function) – (program revenues + general revenues)
- Program revenues are fees and grants.
- Total expenses – program revenues = Net expense (or revenue)
- Net expense (or revenue) minus general revenues = change in net assets

# New Features

- Basic financial statements include both government-wide and fund financial statements
- Some component units are included to show financial accountability
- Governmental and business activities are separately reported

# New Features (continued)

- Financial performance [of governmental activities] is measured by revenue and expense on a “strong” degree of accrual
- Actual financial performance compared with revised and original budgets
- General fixed assets and general long-term debts reported on a balance sheet with broad measurement focus

# Additional Information (Not Discussed)

- Management's Discussion and Analysis (MD&A)
- Fund financial statements
- Notes to the financial statements
- Required supplementary information, including budget comparison

# Conceptual Basis of the New Reporting Model



# 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.

# Common Budget Practices

- 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 Is Consistent with the “Golden Rule” in Public Finance

- Golden Rule would require:
- Public employee pension benefits be financed by the revenue of the period in which employees provide their services.
- The acquisition of a public building be financed by bonds with maturity to match the useful life of the building.

# From Cash to Mild Accrual

## Fund Balance = Fund A – Fund L

- *Cash basis often used in budgeting*

FB. Expenditure (-Fund Balance) xxx  
A. Cash (-) xxx

- *Mild degree of accrual*

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

# From Mild to Moderate Accrual

- *Moderate accrual basis*

NA. Expense (-NA)	xxx	
A. Cash (-)		xxx
L. Short-term payables (+)		xxx
L. Long-term payables (+)		xxx

# From Moderate to Strong Accrual

- *Strong accrual basis*

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

# GASB's Decision

- Cash basis: Not acceptable.
- Modified (equivalent to weak) accrual basis: current operations financed by annual budgets.
- Strong accrual basis [for governmental activities]: government as a whole for fair presentation.

# General Conclusion

- All American governments are required to prepare and publish budgets and annual reports.
- American government GAAP requires fair presentation to include government-wide financial statements: a balance sheet with a broad measurement focus, and a financial performance report on a strong accrual basis.