MAKING SENSE OF AMERICAN GOVERNEMNT FINANCIAL STATEMENTS

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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

Criteria for reporting entity: accountability due to financing, ownership and control

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	Mostly 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

- <u>Agency/budget account</u> Dr. Cr.

	Dr.	Cr.
+A. Fund balance with Treasury	xxx	
+NP. Unexpended appropriations		xxx

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

- <u>Treasury</u>

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

• Agency/budget account	Dr.	Cr.
- 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

- The Financial Management Service 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 of spending includes:
  - cash outlays
  - liabilities (not previously obligated), and
  - obligations
- Reconciliation is required to explain the differences between financial performance results measured under different basis.

Consolidated Financial Statements (CFS)

Prepared by combining accounts and eliminating the effects of internal transactions in the reporting entity

The Consolidated Financial Statements (CFS)

- 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 CFS.
- Auditor’s opinion/report (Govt. Accountability Office): disclaimer to date 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 accrual 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 the acctg. entity.
- Decide whether to recognize those consequences by asking: do they change the entity's assets or liabilities?
  - If yes, measure the amount of change in the financial accounts and later report in financial statements.
  - If no, decide whether to report information in notes to financial statements or elsewhere.

Transactions and Events as the Origin of Financial Data

- Financial consequences of
  - Transactions (bilateral exchanges)
    - Exchange transactions (reciprocal exchanges)
    - Non-exchange transactions (non-reciprocal exchanges)
  - Events (significant happenings)
    - Fed. govt. is responsible: "related events"
    - Fed. govt. is not responsible but has chosen to assume responsibility: "acknowledged events"

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.

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.

The Balance Sheet Emphasis

- Budgeting and budgetary accounting emphasize revenues (receipts) and expenditures (outlays) during a period.
- The emphasis of financial accounting is on 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

- At the beginning of a period:

  Net Assets = Assets – Liabilities
- During the period

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

- At the end of the period: new balances

  Net Assets = Assets - Liabilities

Relationship Between BA and MF

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

Consolidated Financial Statements

Articulated (Related) Financial Statements

- Results of financial performance depends on assets and liabilities used to measure financial position.
- Three articulated financial statements:
  - 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.

Federal Accounting 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 - liabilities
- Stewardship information: off-balance sheet resources and responsibilities.

Assets

- Financial Resources (for eventual payment, stated at net realizable value)
  - Cash and other monetary assets.
  - Receivables: accounts, loans and taxes.
  - Financial investments
- Economic resources (for use, at adjusted cost)
  - Consumables: inventories
  - Capital: property, plant and equipment

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

- Current liabilities (contract price).
- Social insurance benefits due and payable
- Federal securities held by public (contract price)
- Federal employee & veteran benefits payable (actuarial value).
- Environmental and disposal liabilities (estimated cost)
- Insurance and guarantee (estimated cost)

“Stewardship” Responsibilities

- Financial in nature, at issue is
  - Extent of government obligation
  - Amount, time and uncertainty
- Social Security (public pensions)
  - Old-age and survivors insurance
  - Disability insurance
- Hospital and medical insurance

Net Position

- Net position = assets minus liabilities.
- Net position is affected by:
  - Recognition criteria of A and L: yes or no;
  - Measurement method: asset "valuation" basis.
- Net position is NOT affected by the disclosure of
  - Stewardship assets, and
  - Stewardship responsibilities.

Statement of Financial Performance

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

Advanced Topics

- Effects of federal interventions in the 2008/2009 financial crisis
- Earmarked and non-earmarked funds (resources)
- Intra-governmental transfers
- Unmatched transactions and balances
- Prior period adjustments due to changes in accounting principles

From Accrual Deficit to Cash Deficit

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 (negative number)

Additional Information

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

Value of Consolidated Financial Statements on the Accrual Basis

- Facts 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 comprehensive annual financial report (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

- 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

- (Expenses by service function) – (program revenues + general revenues).
- Program revenues are fees and grants for specific functions/activities.
- 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
- Component units are included to show financial accountability
- Governmental and business activities are separately reported

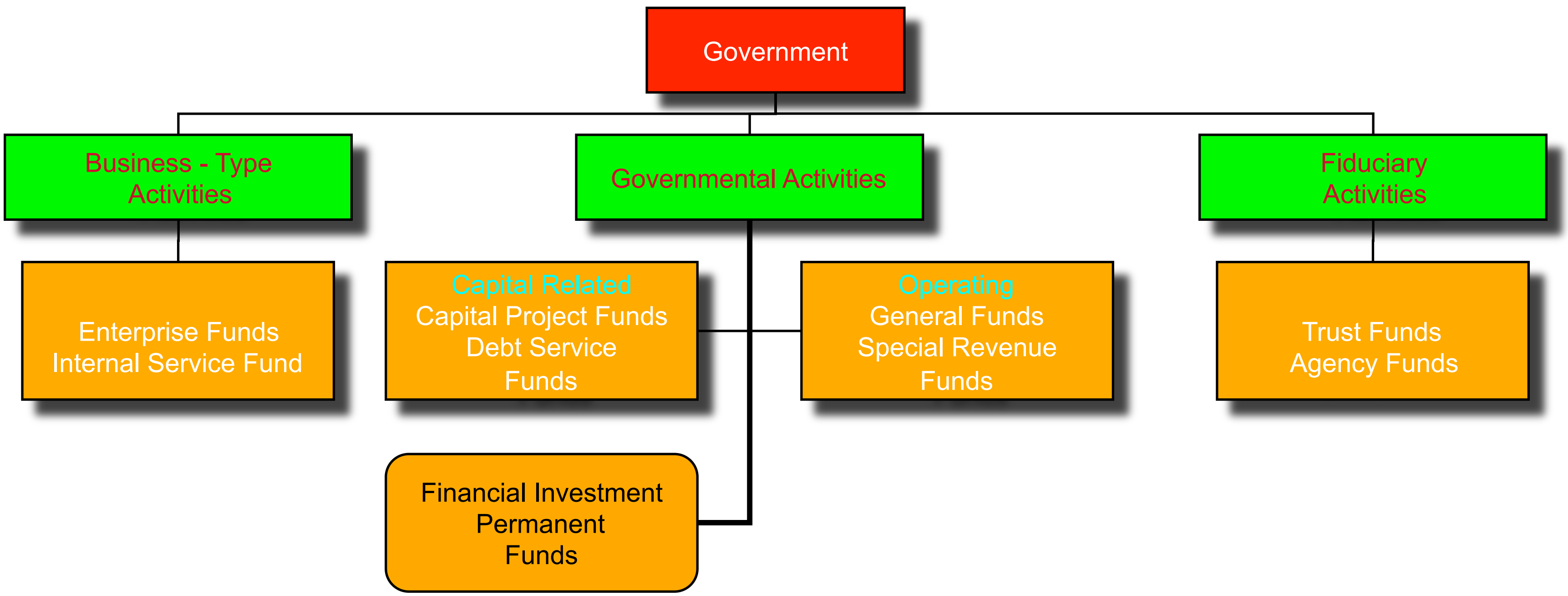
New Features (continued)

- 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

Government Activities and Fund Types



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.