Better Living Through Budgetary Reporting

by Richard Grove

Some jokes teach us important truths. Here is one: A corporate executive who is retiring is seeking a replacement. The executive interviews possible successors individually and asks, "What is 1 + 1?" Each answers, "Two." When it's the finance director's turn, the director replies, "What do you want it to be?"

The director's answer pokes fun at a deeper but similar question that every government should ask itself periodically. This article presents a case study of how one Pennsylvania community realized impressive financial advancements by applying its answer to budgetary reporting.

One term in the field of accounting is used to categorize possible answers to the executive's question: basis of accounting. Basis of accounting determines when an event is recorded in the books; hence it shapes financial reporting goals. Four bases of accounting are applicable to governments. They are summarized here and in Figure 1 on page 28:

Full accrual basis. The goal of full accrual is to measure the degree to which current year revenue is sufficient to cover current year expenses, in other words, to tell whether costs were deferred to future taxpayers and ratepayers.

This basis is used by the private sector and is mandated by accounting principles for some statements in governmental annual reports. These include

Figure 1. Bases of Accounting Applicable to Governments.

Basis	Measures	Goals	Future orientation	Annual report mandate
Full accrual	Economic resources flow	Revenue sufficiency	Long	All funds
Modified accrual	Current resources flow	Short-term solvency	Short	Governmental funds only
Cash	Cash flow	Certain financial analysis	None	Proprietary funds only
Budgetary	Defined by government	Planning, reporting, policy setting	Varies	Governmental funds with budgets

the government-wide statements and statements reporting individual proprietary funds (such as utility operations). Under full accrual, for example, fixed asset purchases are capitalized as assets, depreciation is expensed, and bond issues represent liabilities.

Modified accrual basis. The goal here is to measure the sufficiency of current assets in meeting current liabilities, in other words, to tell whether commitments due in the next month or so can be met. This basis is mandated by accounting principles for annual report statements showing individual governmental funds (such as the general fund) except statements reporting the budget. Under modified accrual, for example, fixed asset purchases represent expenditures, depreciation is not recorded, and bond proceeds show as a financing source much like a revenue.

Cash basis. The goal of this basis is to produce a cashflow statement useful in conducting various kinds of financial analyses. Accounting principles require cashflow statements in the annual report for proprietary funds.

Budgetary basis. Goals for this basis are delegated to the reporting government. A budget could be prepared on any of the above bases, or a government could invent its own unique set of rules. Most governments use this basis as their main tool of financial planning and in their most crucial communications to the press and public. Accounting principles mandate that a budget-to-actual statement appears in the annual report for governmental funds that have budgets.

A FINANCIAL REVIEW

Middletown Borough, Pennsylvania, with a budget nearing $20 million, in 2004 took the uncommon step of reexamining its budgetary basis of accounting. Both elected officials and staff valued clarity and therefore shied away from inventing their own set of accounting rules. Instead, they preferred a basis backed by generally accepted accounting principles.

Full accrual budgeting creates psychological motives to carefully weigh every decision because of the immediate cause-and-effect impact on expenses.

It was anticipated that pressure to modify the basis to suit an immediate political purpose would thereby be eliminated, debate would be minimized when recording a newly experienced event, and public confidence would thus be enhanced. A few individuals even took comfort in the potential to point a finger at the accounting industry when accounting principles appear to force a budget increase.

Middletown had been using modified accrual for its budgetary basis. Although generally satisfactory, the borough experienced a few problems. Because it routinely used excess fund equity to balance its budget, cash reserves did not grow sufficiently to take advantage of unforeseen opportunities or to replace fixed assets as needed. Opportunities were missed, and bond issues became the norm for capital asset replacement.

Deliberation by the elected officials, however, did not center on these problems. The die was cast to move to full accrual budgeting after officials realized that full accrual statements in the annual report would shape their financial legacy, as future taxpayers and ratepayers would surely look back to see whether costs had been deferred. Basically, the elected officials wanted the budget to guide them to an exemplary financial record.

Staff had different reasons to travel the same path. They saw full accrual as a means of enhancing cash reserves and as an aid in shifting budgetary discussions away from line items and toward service levels. So, for the 2005 budget, Middletown Borough became what its officials suspect is the first full-service local government to adopt full accrual as its budgetary basis of accounting.

The differences among the bases are shown in the following example. Assume that a community government has just signed a labor agreement that provides employer-paid retirement health care benefits. Economically speaking, this benefit is earned by an employee as the employee continues to work for the employer.

Under full accrual, the cost of this benefit matches the period in which it is earned regardless of when it will be paid. An expense is recorded annually to represent that portion actuarially earned by all the employees in that year. Because there is no cash outlay at this time, the expense is offset by a liability. When an employee retirees and begins to draw this benefit, the liability is reduced and no more expenses are recorded for that individual.

Cash reserves are built during the years that expense is recorded (assuming revenue always equals expenses) to meet the eventual payment of benefits. Because this cash reserve is offset by a liability instead of fund equity, there is no temptation to siphon it off to balance the budget.

Under the modified accrual basis and cash basis, no expenditure is recorded during employees' careers. Expenditures are only recorded at or near the time of cash outlay, so cash reserves do not automatically build to meet these expenditures.

FULL ACCRUAL

The same concept applies to fixed asset replacement where depreciation expense is essentially offset with increased cash reserves under full accrual (again, assuming that revenue always equals expenses), but no impact is felt under the modified accrual basis or cash basis until at or near the

Figure 2. 2007 Budget Summary, Middletown Borough, Pennsylvania.

	General fund	Special revenue funds	Capital fund	Total governmental activity	Water/ Sewer fund	Electric fund	Total business activity
Allocation between current and future residents							
Revenue as budgeted	$5,211,680	$183,710	$1,259,820	$6,655,210	$3,733,139	$8,522,060	$12,255,199
Expense as budgeted	5,208,360	183,710	551,700	$5,943,770	4,335,230	8,474,720	$12,809,950
Net budgeted change in net assets	$3,320	$0	$708,120		($602,091)	$47,340	
Costs saved (deferred) for future taxpayers				$711,440			
Costs saved (deferred) for future ratepayers							($554,751)
Minimum cash requirements							
Net (from above)	$3,320	$0	$708,120		($602,091)	$47,340	
Cash adjustments:							
Remove depreciation	-	-	479,500		726,110	84,080	
Remove amortization	-	-	-		26,230	-	
Include capital outlay	-	-	(1,719,180)		-	-	
Include debt service principal	(3,320)	-	(114,360)		-	-	
Subtotal	$0	$0	($645,920)		$150,249	$131,420	
Include use of existing bond proceeds			883,180				
Cash reserve decrease (increase)	-	-	(237,260)		(150,249)	(131,420)	
Minimum cash need	$0	$0	$0		$0	$0	

Note: This is the summary page from the Middletown budget. The full accrual basis is shown at the top with a conversion to cash basis at the bottom. The budget is not considered balanced until both the full accrual and cash basis needs are met. If the spending down of existing bond proceeds is ignored, there is no anticipated cash drain. There is no budgeted accounting deficit except the water/sewer fund. Middletown plans to systematically eliminate this deficit over several years.

time that payment is made for replacement assets.

Governments using modified accrual basis and cash basis budgeting sometimes apply complicated or encumbering alternatives, such as irrevocable trusts and internal service funds, to accumulate the same levels of cash reserves that are systemically derived from full accrual.

Of course, the converse could occur: a government could have a cash drain under full accrual while fund equity remains constant. For example, this would be seen when a government converts to full accrual late in the game, as large numbers of employees retire and begin to draw paid health care benefits. It would also be commonly seen in governments that are at or near financial crisis. This was not the case for Middletown.

Middletown encountered two problems during its basis conversion

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process. First, it took time for the public and elected officials to adopt a new thought process. Many continued to think in terms of capital asset expenditures rather than depreciation. The time spent in education proved worthy, however, as discussions eventually did focus on concepts such as depreciation.

Second, it was important that adequate cashflow be assured because key journal entries would no longer be in step with related cash transactions. The borough decided to use a dual-basis approach in its official budget. Line items are prepared in full accrual, but there is a reconciliation of the bottom-line total to cash basis (see Figure 2). The budget would not be considered balanced unless both accounting and cash needs were met. A cashflow statement for governmental activities was also added to the annual report so report users could compare actual results with that part of the budget.

IN THE BLACK

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Figure 3. Maneuvering Through Governmental Annual Reports.

All governmental annual financial reports adhering to generally accepted accounting principles follow the same format. Many reports are available for viewing on the Web. A consistently good example is posted by Downers Grove, Illinois (www.downers.us/page/view/209).

Annual reports are divided into three general sections. The middle one, called the financial section, is where all the relevant financial statements are found. The basic financial statements contained in the financial section begin with government-wide statements using the full accrual basis of accounting. (These are shown on pages 3–5 of the 2006 Downers Grove report.) It is here, in the Statement of Activities, that the bottom-line total (Change in Net Assets) concisely discloses the extent to which current year costs were deferred or saved for future tax and ratepayers (pages 4–5 for Downers Grove).

Following the government-wide statements are those showing governmental fund information using modified accrual (pages 9–13 for Downers Grove). A cash basis cashflow statement is also presented in the basic financial statements section if the government has proprietary funds (pages 16–17 for Downers Grove).

The budgetary basis statements begin on page 64 of the 2006 Downers Grove annual report. Downers Grove uses modified accrual as its budgetary basis of accounting, so the column labeled Actual on the budgetary statements will match the individual fund statements in the basic financial statements section.

geous than anticipated. The budgetary goal of establishing an unassailable financial legacy has eclipsed elected officials' fear of enhancing revenue. Legacy is easily measured by a single line in governmental annual reports titled "Changes in Net Assets" that appears in the statement of activities. In Middletown, this line has stayed in the black. A positive governmental activity cashflow was also achieved every year, and it appears that the borough is slowly weaning itself from bond issues.

Future benefits are expected to stem from organic improvements to long-term financial practices. Full accrual budgeting creates psychological motives to carefully weigh every decision because of the immediate cause-and-effect impact on expenses. The management staff and the elected officials who negotiate with employee labor unions, for example, are no longer quick to grant such delayed benefits as paid postemployment health care because expenses appear immediately.

Also, the use of depreciation expense instead of capital outlay expenditures makes it easier to replace existing assets than to add new ones. This is because new assets add much to depreciation, while replacements add little. These kinds of financial benefits make it easier for staff to shift budgetary discussions away from line items and toward service levels and other policy issues.

Modified accrual employs complicated deferrals, reserves, and omissions to negate the effect of long-term assets and liabilities, so certain financial condition indicators are thereby masked. Because the entire town now thinks in terms of a combination of full accrual and cash basis, modified accrual statements add confusion without benefit.

Governments are not yet in the habit of reevaluating the budgetary basis of their accounting. As the idea spreads, it is likely that full accrual budgeting will become more common. It will work best where there is a future orientation and good financial condition; it will probably not be as welcome in governments with a short-term focus and where the ability to manipulate budgetary results is desired. **PM**

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