



ACCOUNTING

ABCD: ACFRs, Budgets, Civics, and Democracy

Or, why we need both budgetary- and GAAP-basis reporting—an opinion

BY MICHELE MARK LEVINE

Government financial reporting is different. It's different because democracy demands transparency and accountability for public resources of a whole different order of magnitude than in any other sphere of financial reporting.

This essential truth arises from the power of governments¹ to levy and enforce taxes.² It is also the foundational supposition of financial reporting in accordance with generally accepted accounting principles (GAAP) state and local governments in the United States.³

The power to tax is vested in legislators, who are the direct representatives of voters. That power goes hand-in-hand with legislators' responsibility to *permit, direct, and limit* the spending

of those public resources, generally through the enactment of legally binding budgets. Together, these powers provide our democracy with the *taxation with representation* that our forebearers demanded when forming this nation. (Of course, budgets are also essential policy, planning, and management tools, but that's a discussion for a different article.)

Accountability for the collection and use of those public resources in accordance with legally adopted budgets is demonstrated through budget-to-actual comparison reporting, which is included in GAAP financial reporting by governments through required and other supplementary information in annual comprehensive financial reports (ACFRs).⁴

Now, some governments use GAAP-based modified accrual (for

governmental funds) or full accrual (for enterprise funds and internal service funds) as their bases for budgeting, but many do not. What budgetary bases governments use are dependent on applicable state and local laws and regulations, as well as a government's own policies.

While measurement and reporting of actual results of operations on a budgetary basis is essential for legal compliance and those stated principles of democracy just discussed, the bespoke nature of each government's budgetary basis means they are inherently noncomparable between governments. Moreover, they require detailed knowledge of the specific set of laws, regulations, and policies that are applicable to the budget practices of each government to be fully understood.

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In contrast, GAAP amounts are [1] generally comparable across governments, as they are based on well documented and widely known⁵ guidelines for recognition, measurement and disclosure,⁶ and [2] can be independently audited and are capable of receiving an unmodified ["clean"] audit opinion, and therefore are more likely to be trusted by those outside of the government's management. (Public trust in government is no small issue, although it too is a topic for a different article.)

As readers of the articles in this space well know, I am very much part of, and steeped in, the language and customs of the GAAP-governmental-accounting-and-financial-reporting "tribe." Less well known is that the largest portion of my professional career was spent among the members of the neighboring governmental-budgeting "tribe."⁷ Questions about the value of GAAP and budgetary bases of financial reporting are regularly raised between the two, sometimes giving rise to "broader disputes." Let's address head-on some of those territorial issues, in my opinion.

Other than being more comparable across governments, what makes GAAP financial reporting inherently "better" than a cash or other non-GAAP budgetary bases for general purpose financial reporting?

The largest and most obvious difference between the two can be seen in a comparison of cash basis information to a full-accrual GAAP basis presentation of the same transactions and events. Full-accrual GAAP represents,⁸ to the greatest extent possible, the *underlying economic substance* of transactions and other events affecting a government's financial position.

A cash basis report recognizes only those inflows [revenues] that have been realized [collected in cash] and only those outflows [expenditures/expenses] that have been liquidated in cash. While this might seem like a "balanced" recognition—both unrealized inflows and unliquidated outflows are excluded—it is not. The delay in realizing revenue is significantly shorter, in almost all cases, than the delay in liquidating liabilities. (The comparison of cash basis and full-accrual-GAAP basis recognition of long-lived assets and of long-term debt is excluded here and will be addressed shortly.)

The overwhelming majority of property, sales, and income taxes, for example, will be collected within a year of becoming due. The overwhelming majority of pension and other postemployment benefits (OPEB), compensated absences, asset retirement obligations, and claims and judgments, for example, will not be liquidated until many years, decades, or even generations after they are incurred. Therefore, the financial position of a government reported on a cash basis—in the great majority of cases—is going to paint an inaccurately rosy picture.

One major exception is acquiring long-term assets. The full acquisition price will be recognized immediately as an outflow on a cash basis, rather than being treated as assets that are gradually expensed [depreciated] over their useful life, as under full-accrual GAAP. But the proceeds of long-term debt, which are often issued to acquire long-term assets, are recognized as cash-basis inflows when received, rather than as liabilities, as under full-accrual GAAP. These two sizable

flows might largely offset each other in the year debt is issued to acquire capital assets. Similarly, in the years during which those assets are used, the GAAP-basis outflows for depreciation might be similar to the cash-basis outflows for debt service payments.

Importantly, any mismatch of asset lives and debt duration, or the use of pay-as-you-go capital acquisitions [larger cash than economic outflows] or the use of any debt proceeds for purposes other than acquiring long-term assets [larger cash inflows than economic inflows], will cause timing differences between cash basis and full-accrual GAAP basis information, and may be significant. But this just illustrates yet another way in which GAAP is better: The long-term effects of these policies are only observable when reported on a GAAP basis.

The modified-accrual GAAP basis, which is used for governmental funds, has a lot in common with the cash basis; so why is it inherently better?

First, remember that while governmental funds are reported on a modified accrual basis, all of the activities accounted for on this basis are also reported on a full accrual basis in the government-side financial statements that are part of a GAAP presentation. So all of the benefits of full accrual GAAP reporting discussed above are still relevant.

Moreover, even the modified accrual GAAP-basis defaults to full accrual for transactions and other events *except those for which GAAP specifically permits and requires a modification* [hence the name]. Unlike cash basis, which permits essentially unlimited movement of inflows and outflows between periods *simply by moving the*

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timing of cash collections and payments, modified accrual GAAP is based on a defined system of rules. Those rules yield financial reports that, like full accrual GAAP, represent the economic substance of transactions and other events *in most situations*, with only those specific (albeit generally significant) exception items recognized in different periods.

Those modifications result in only partial recognition of the specified outflows and long-term liabilities in governmental funds, generally limiting their recognition to the periods in which they *are due and payable* rather than when they are initially incurred. These exceptions are made for:

- Long-term debt, such as bonds (this is akin to recognizing only the mortgage payment that is due, rather than the entirety of the mortgage balance);
- Claims and judgements;
- Certain specified environmental obligations (landfill closure, pollution remediation, and asset retirement); and
- Certain specified deferred employee compensation:
- Pension and other postemployment benefits (when benefits are administered through formal plans, outflows are generally recognized when contributions are payable to those plans rather than when benefits are ultimately payable to retirees);
- Compensated absences; and
- Termination benefits.

The resulting balances reported using the modified accrual basis are very

similar to measures of working capital (current assets – current liabilities), a measurement that is seen as an important measure of liquidity and the ability to meet obligations as they come due in the private sector, and are useful as such.

With limited exceptions, capital assets and long-term debt are treated similarly in both cash basis and modified-accrual-GAAP basis reporting.


So, in summary:

GAAP:

- Is based on a widely recognized body of literature, facilitating understandability, comparability, and consistency.
- Reflects economic substance, including all long-term obligations, in government-wide financial statements.
- Reflects balances and flows of “working-capital-like” (current financial) resources in governmental funds.

Cash basis:

- Is subject to easy manipulation of results for any given period by speeding up or delaying collections or disbursements.
- Nearly always delays recognition of substantial incurred costs (pensions, OPEB, environmental obligations) far more than delaying recognition of inflows (tax and other receivables).
- Makes borrowing look beneficial, and capital investment look harmful (when compared to government-wide financial statements).

Like the democracy that shapes it, GAAP is an imperfect system that is nonetheless better than any other available option. 

¹ The ability to set rates and levy taxes is only one criterion for an entity to be considered a government under GAAP, and there are governments, especially special-purpose governments, that do not have taxing authority.

² For this purpose only, “taxes” include all charges for goods and services as well as fines and forfeitures.

³ The financial reporting entity, analogous to a consolidated corporate entity, includes all those legally separate entities for which the elected officials of a primary government are financially accountable.

⁴ This need to demonstrate accountability to legally adopted budgets as an essential element of ensuring taxation with representation is the reason that GFOA opposed the demotion, based on changes to GAAP, of budget-to-actual reporting from basic financial statements to RSI.

⁵ This, of course, is a relative condition. GAAP, while not well understood by the general public, is more widely understood than the individual intricacies of each government’s own budgetary basis.

⁶ In fairness, though, it must be said that the differences between governments’ scopes of activities, as well as decisions they make about their fund structures and between options under GAAP, do often hinder comparisons among governments reporting in accordance with GAAP.

⁷ Michele worked for the Mayor’s Office of Management and Budget of the City of New York (City) for more than 18 years. Throughout her tenure in that role, much of her responsibility was to interpret GAAP to operationalize the city’s legal requirements to balance (1) its operating budget in accordance with GAAP, and (2) work with legal counsel to ensure that the city complied with legal constraints limiting the use of debt proceeds to capital purposes.

⁸ The two approaches to recognition and measurement reporting in GAAP for US state and local governments are referred to herein exclusively by basis of accounting, but technically are two combinations of measurement focuses and bases of accounting. Thus, “full accrual” refers to the combination of an economic resources measurement focus and an accrual basis of accounting, and “modified accrual” refers to the combination of a current financial resources measurement focus and a modified accrual basis of accounting. The former pair is used in reporting government-wide financial statements, proprietary fund financial statements, and fiduciary fund financial statements, while the latter is used exclusively in governmental fund financial statements.



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