GOVERNMENT ACCOUNTING
A Conceptual Approach

Government accounting presents several challenges to the newcomer more used to for-profit accounting. First, there are two reporting systems. These might be likened to a company having to produce reports based on both its managerial and its financial reporting system. Governments are required to do their internal accounting using *fund* accounting. They are required to publish reports that reflect the use of fund accounting. In addition, they are required to publish so-called *government-wide* reports that look much more like for-profit statements. It is very important, therefore, to know at which set of statements one is looking.

Second, governments are *legally* responsible for the flow of *financial* resources through the system. They levy and collect taxes, which are then spent in accordance with a budget established by the legislature, be it City Council, of House of Representatives. They must report back to taxpayers how that money was collected and how it was spent. They are much less concerned with measuring the flow of *economic* resources i.e., with recognizing revenue and matching it with expenses for the simple reason that they are not-for-profit entities and, therefore, have no mandate to measure the profit they make.

Third, governments do not have a capital account -- or a retained earnings account. They have asset and liability accounts that are virtually identical to for-profits. (One change is that the familiar accounts payable becomes vouchers payable!) The difference between the two is known as the *fund balance*. Some of this balance might have been earmarked or *encumbered* in previous years for spending in this year. If so, it is labeled encumbered fund as distinct from unencumbered or unreserved.

Fourth, like all other nonprofits but unlike for-profits, governments have a wide variety of revenue sources such as income taxes, property taxes, grants and so on. Apart from the multiple revenue sources, the *statement of changes in the fund balance* is virtually identical to an income statement with excess (or deficit) of revenues over expenditures replacing net income and net change in fund balance replacing change in retained earnings.

This short summary of government accounting begins with fund accounting and describes how it makes use of *modified accrual basis* for accounting. That is followed by a discussion of the government-wide reporting requirements of *GASB 34*.

FUND ACCOUNTING

The primary unit of analysis is the *reporting entity*, which may be a city, a parks board, a state government. Within that entity, there might be a number of components. The reporting entity is defined by the political structure. For instance, a city might be responsible for the water supply, the police department, and the fire department. These components are a part of the reporting entity if the entity (a) is able to impose its will on the component by legislation or election of its

members and (b) the entity derives financial benefit from that component. If neither of those holds, the the component will produce its own financials. In many cases, for instance, water boards are independent of the city they supply. They will then be separate reporting entities.

Within that reporting entity there are a number of activities that are accounted for in separate ledgers, almost like separate little businesses. These include:

Governmental Funds

1. General fund	This is often called the operating fund and is where all the regular business of the entity is recorded.
2. Special revenue fund	In the private non-profit world, this is where *temporarily restricted* revenues would be recorded.
3. Capital projects fund	Used for capital projects such as new roads and new buildings.
4. Debt service funds	Accounts for monies set aside to repay loans that have been taken out to finance capital projects.
5. Permanent funds	Accounts for endowment funds given to the entity where capital must be preserved and only the earnings used.

Proprietary Funds (These essentially use for-profit accounting.)

6. Enterprise funds	City operations that charge customers such as refuse collection, sports arenas, and municipal bus companies.
7. Internal service funds	Accounts that track services that one unit in the government provides another such as a car pool for the use of employees, computer services and the like.

Fiduciary Funds (These use the same accounting as used by for-profit businesses.)

8. Pensions

9. Investment trust funds

10. Private-purpose trust funds

11. Agency funds

Governmental funds such as the general fund, the special revenue fund, the capital projects fund, and the debt service fund are often called *expendable* funds because long-term assets are treated as expenditures. Contrast this with the proprietary funds, namely the enterprise fund and the internal service funds, which are often called *non-expendable.* Our focus in the next sections is entirely on expendable funds since the non-expendable funds follow the normal GAAP requirements with which everyone is familiar.

Account group entities

Under the modified accrual basis of accounting used for fund accounting in goverments all long-term assets are treated as expenditures and all long-term liabilities are treated as income. To keep a record of these long-term assets and liabilities a set of accounts known as the *General Fixed Assets Account Group* and the *General Long-Term Obligations Account Group* are used. This is essentially just a listing of long-term assets and liabilities.

Under the new rules of *GASB 34*, many government entities are expected to discontinue the use of these account groups and to maintain long-term assets and liabilities in a balance sheet setting similar to a for-profit business.

Old CPA questions and maybe new ones too ask whether the acquisition or construction of property is accounted for in the general fund, the capital projects fund, or in the GFAAG. The answer is the last. Similary unmatured bonds are not accounted for in the Debt Service Fund, which only records debt *when due*, but in GLOAG.

General Fund Statements

All the accounting for day-to-day events takes place in the general fund statement. This statement is set up to track the flow of financial funds through the entity, not to track the flow of economic resources. The acquisition of fixed assets, therefore, is treated in the general fund as an outflow of financial resources – to all intents and purposes as an expense. Funds that come in from borrowing are treated as an inflow of financial resources[1] – to all intents and purposes as income – not quite revenue but pretty close to it and more like a "gain" in an income statement.

The statement of position for the general fund (the balance sheet), therefore, shows only working capital. There are no long-term assets and no long-term liabilities. The accumulated surplus or deficit is the difference between current assets and current liabilities. It is not, as one used to business accounting might think, the difference between total assets and total liabilities.

The statement of change in financial position (in effect the income statement) shows revenues

[1] This is why the new governor of California is able to "balance the budget" by borrowing.

and borrowings as "income" and expenditures on goods and services as well as acquisitions of property, plant and equipment as "outgo." There is no depreciation expense because the balance sheet has no long-term assets. The deficit or surplus for the year is, therefore, very different from net income. Newspaper reports of the federal government's deficit are often misunderstood.

Revenue recognition

Most of us come to government accounting after long exposure to for-profit accounting where we learned that revenue is recognized only when it is (a) earned and (b) realizable. In the context of government, this would mean that the government would not recognize taxes as revenues until it had delivered the services for which it was taxing us. In a for-profit business, there would be no record when the government announced the tax. At the time of collecting the tax, the business enterprise would debit cash and credit unearned revenue. Later as it delivered the services, it would debit unearned revenue and credit earned (regular) revenue. This follows what is known as the *accrual* basis of accounting.

Governments do not, in their internal accounting system, follow accrual accounting. Instead they use a *modified accrual* system. The rule under this system is that revenue is recognized when it is (a) measurable and (b) available to finance expenditures in the current fiscal period. Under this system taxes are recognized when levied because (a) they can be measured and (b) because they will be collected (that's the law) and they will be used in the current period. Governments are given 60 days after the end of the year to collect their taxes. If they can't collect within that period then the revenue cannot be recognized in that period. If the government does collect taxes in 2002 that will be used in 2003 then it does use an unearned revenue account.

The argument for using the modified accrual system is partly that taxes are always "realizable." We go to jail if we don't pay our taxes. The argument, though, rests largely on the the financial resources view of accounting – how was money collected and where was it spent – rather than the economic resources view of accounting – matching revenues and expenses to determine profit.

Cities are often dependent on a share of the sales tax that is collected by the state. This suffers from the problem of measurability. We know it will be collected, we know the percentage that is being charged, but we don't know how much consumers will be spending. As a result, sales tax is difficult to measure. Typically an estimate is used based on previous years but for many entities this estimate has proved very unreliable in recent years as spending has dropped. The result can be a huge shortfall as government entities spend sales taxes that they never collect.

Expenditures

Like revenues, expenditures are handled on a modified accrual basis, and recognized when there

is a legal obligation. There is no intent to match expenses with revenue. Essentially, one has an expenditure when the bill arrives. As noted earlier, the bill generates a vouchers payable instead of an accounts payable.

One major difference between for-profit and governmental accounting is that bad debt expense is required to be treated as an offset to revenue. This is the treatment that most textbooks recommend for businesses, but that few, if any, ever apply. One sees the method in use in the governmental sector.

Another major difference between for-profit and governmental accounting is that acquisitions of long-term assets are treated as expenses in the *general* fund. Records are made of long-term assets, but not in the general fund which is concerned with the flow of financial resources.

Inventory

Inventory accounting is not too dissimilar from business accounting. The so-called *consumption* method tracks the actual use of inventory through the accounts debiting inventory with its purchase and crediting it out to expense as it gets used. The so-called *purchase* method expenses all inventory as purchased. Then at the year end it computes how much inventory is left over. It debits the inventory account with that amount and credits the fund balance with the same amount. The expense account is overstated in this method but the fund balance corrects that overstatement at the end of the year. Clearly, the consumption method is theoretically preferable and the purchase method is just convenient. An example follows in which we assume that $2,000 of inventory was purchased in 2002 and was used up in the amounts of $600 and $900 in 2002 and 2003 respectively.

Consumption method:

	Cash	Inventory	Fund balance	Expense
1/1/2002	(2,000)	2,000		
12/31/2002		(600)		600
Closing entry			600	(600)
Balance sheet	(2,000)	1,400	600	
12/31/2003		(900)		900
Closing entry			(900)	(900)
Balance sheet	(2,000)	500	(1,500)	

Purchase method:

	Cash	Inventory	Fund balance	Expense
1/1/2002	(2,000)	2,000		
12/31/2002		(2,000)		(2,000)
Adjusting entry		1,400	(1,400)	
Closing entry			(2,000)	2,000
Balance sheet	(2,000)	1,400	600	
Adjusting entry		(900)	900	
12/31/2003	(2,000)	500	1,500	

The key to notice here is that both methods yield the same balance sheet, but very different statements of changes.

Budgetary Control

When it comes to bookkeeping, the major difference between governmental and all other forms of accounting is that the budget is entered directly into the accounts. A variety of account headings are employed in practice to make this work. In our more conceptual approach, we will reduce the account headings to a minimum to make the concept as visible as possible.

The idea is simple. The entity produces a legally-binding budget prior to the fiscal year. This budget is entered into the accounts in reverse. The difference between budgeted revenues (a debit) and budgeted expenditures (a credit) goes to the fund balance. If budgeted revenues exceed budgeted expenditures then the fund balance will be credited with the budgeted surplus for the year.

As the year proceeds, regular accounting entries are made in the accounts i.e., the revenue account is credited and expense accounts are debited. If actual equals budget then all temporary accounts will have zero balances. If actual differs from budget then the variances will be left in each account and are closed out to the fund balance at the end of the year.

When closing the temporary accounts in the general fund one has two choices: Combine budget and actual and close the difference to the fund account. This has the virtue of showing what the variances were between budget and actual and what the necessary adjustment to the fund balance is. The other alternative is to simply reverse the budget entries and to close only the actual entries to the fund account. This has the virtue of creating a statement of activities in the

process of closing much as one would create an income statement in for-profit accounting.

Encumbrance accounting

Another wrinkle is so-called *encumbrance* accounting. In this procedure, orders are recorded as expenses when placed. This is done to avoid overspending an account, which is illegal. When the item arrives the encumbrance is reversed and the expenditure entered.

Classification and reclassification

Given the legal underpinnings of government accounting, it is necessary to lay out very clearly the status of various accounts. One therefore sees a great deal of reclassification going on in the accounts.

Funds, for instance, as noted earlier will be classified into three or more subgroups such as Unreserved, Reserved for Encumbrances, Reserved for Inventories. Receivables, when delinquent, are moved into a separate account labeled Delinquent Receivables. Each might have its own Allowance account shown as a contra to the receivables account. These various subcategories are very necessary in practice, but they do tend to obscure the economics of what is occurring. This chapter, therefore, makes very little use of these sub-accounts as it seeks to develop the conceptual underpinnings of governmental accounting.

TO FOLLOW

TRANSFERS

REVENUE

Accrual basis accounting: When preparing *government-wide* statements, entities are required to adjust their modified accrual reports to configure more closely to accrual accounting -- still not quite what we would consider full accrual, though. *GASB 33* (1998) as modified by *GASB 36* (2000) lays out four categories of revenue.

1. *Derived tax revenues* such as income taxes and sales taxes are essentially recognized when levied despite the fact that they have not been earned.

2. *Imposed nonexchange revenue* such as property taxes and fines are also essentially recognized when levied.

3. *Government-mandated nonexchange transations* such as transfers from the federal government to help a local level with things like a school-feeding program are recognized when the terms of the transfer have been met but, typically, before cash has been transferred and before the cash has been earned.

4. *Voluntary nonexchange transactions* such as

Other revenue sources and their accounting include:

Interest on investments and delinquent taxes

Income taxes and sales taxes

Miscellaneous revenue

Grants, entitlements, and share revenue

GASB 34 requires that all assets be recorded on the books of the government-wide balance sheet. Many infrastructure assets such as roads and bridges were built many years ago when cities kept no record of their assets. All new infrastructure assets must be capitalized immediately; cities have 4 years in which to bring all their old infrastructure assets onto their books.

REVENUE RECOGNITION

GASB 33 (1998) deals with revenue recognition at the government level. It tries to separate

revenues in to four categories:

Derived revenue such as sales tax which is derived as a percentage of a sale transaction. Income tax is derived from the profit earned by a business or individual.

Imposed nonexchange revenues occur when there is no underlying transaction. The primary example is property tax.

Government-mandated nonexchange transactions in which a local authority, such as a city, receives monies from another authority, such as the state, to carry out a project mandated by that other authority such as the provision of shelters for the homeless.

Voluntary nonexchange transactions in which a business or individual gifts money to the city such as to fund a reading program in schools.

Derived revenues are recognized in both government-wide and government-fund accounting when the underlying event occurs -- or on a periodic basis thereafter. A sale generates a sales tax, which may be recognized before it is collected. Fund accounting adds that the tax must be available for spending either by the receipt of cash or by a tax-anticipation note for the tax to be recognized as revenue.

Imposed nonexchange revenues are typically accrued when levied with an allowance for bad debt if necessary. If they are to be used over multiple years, the revenue should be appropriately deferred.

Other nonexchange revenues are accrued when *eligibility requirements* have been met. These are typically written into the contract and so fairly obvious. For instance, one cannot recognize a government grant until one has met the stipulations of that grant. Any cash received is treated as Unearned Revenue. A grant intended for a specific program should be recognized in the period in which the program is run. Reimbursements should be matched with the relevant expenditures.