Current State of Government Budgets

By Michael H. Granof and Alan Mayper

The requirement of a balanced budget for governments is widely acclaimed as a means of achieving fiscal prudence and economy. But many users of government financial statements are baffled by the relationship of a budget, which is on a cash basis, and statements on a GAAP basis, and then by arcane devices used to achieve a required balanced budget. The authors believe that auditor involvement with the budget, and additional data to present actual results on a comparable basis will provide improved and more forthright reporting by government entities.

It's time for accountants to accept responsibility for government budgets, in addition to government financial statements! By doing so auditors will elevate the standards of both budgeting and financial reporting and enhance their professional contributions to efficient and effective governance.

According to GASB pronouncements, budgeting is an essential element of the financial planning, control, and evaluation processes of governments. GASB standards require that every government prepare an annual budget and that the annual financial report include a comparison of the budget to actual results. GASB has asserted that a foremost objective of financial reporting should be to demonstrate whether resources were obtained and used in accordance with an entity's legally adopted budget.

Despite the importance attached to budgeting, professional rules have permitted governments free rein in preparing budgets. There are no established standards for formulating these budgets nor requirements that budgets be audited. Except for mandating that budgets be prepared and compared with actual results, standard setting bodies apparently have considered budgets to be beyond their purview. The authors believe that the profession needs to establish standards for both the preparation and the audit of government budgets. Auditing standards for budgets will not only promote more prudent fiscal management, but will also lead to improved financial reporting.

WHY THE PROFESSION MUST BE CONCERNED WITH BUDGETS

First, budgets are the primary financial documents produced by governments. In the business sector, budgets are internal documents; the annual report is a company's main link with stockholders, creditors and other users. In government, by contrast, the budget occupies center stage; the annual report is a mere sideshow. For accountants to be concerned only with the annual report is to assure that they will never be more than bit players for governmental entities.

Second, current standards require that budget to actual comparisons be incorporated into the general purpose financial statements upon which independent auditors are required to report. Thus, auditors are presently associated with budgetary data, even though they have no responsibility for them other than to verify that when they appear in an annual report, they were drawn from the legally adopted budget. Insofar as budgets contain errors or are perceived as being misleading, the reputation of individual auditors as well as the accounting profession is certain to be tarnished. It is improbable that the public will disassociate an auditor from unaudited information when that information appears in the same set of statements as audited data.

Third, budgets have had a predominant influence upon accounting and reporting standards. As pointed out, GASB has asserted that a main objective of financial reporting is to demonstrate budgetary compliance. Budgets, however, are generally on a cash or near-cash basis. For that reason GASB has selected "financial resources" as the "measurement focus" in government funds. Another of the Board's reporting objectives, however, is that financial statements should reveal the extent to which interperiod equity was achieved, i.e., whether current revenues covered the cost of current services. To realize this objective, however, the measurement focus must be broader than financial resources. It must also encompass nonfinancial resources, such as long-lived assets. In addition, financial reporting must be on an accrual basis. Thus, because governments have prepared only cash or near-cash budgets, the two reporting objectives have been in conflict. Were the budget to be prepared on the accrual basis, which better reflects interperiod equity, the conflict would be reduced or eliminated.

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ROLE OF BUDGETS IN MUNICIPALITIES

The business sector is governed by the market mechanism; the public sector by the budget principle. As explained by a specialist in public finance:

> "The essence of the budget principle is that the services in this sphere are determined not by profit expectation and the willingness of individuals to spend their money for the purchase of such services, but by the decisions reached through political and administrative procedures and based on common social objectives."[1]

FASB as well as GASB and its predecessor, the National Council on Governmental Accounting, have recognized the unique role of the budget in the public sector. FASB points out that in government and other nonprofit entities budgets are central not only in allocating resources but in obtaining them. They are pivotal in establishing the level of dues, taxes or fees to be imposed; the level of services to be provided; the desired relation between the two.[2]

GASB standards require that every government prepare . . . a comparison of the budget to actual results.

GASB is more explicit. It maintains that many believe that the budget is the *most* significant financial document produced by a government entity. It contends that the legally adopted annual budget is:

- An expression of public policy;
- A financial plan, or an expression of financial intent;
- A form of control having the force of law; and
- A basis for evaluating performance.

DEFICIENCIES OF CURRENT BUDGETARY PRACTICES

Budgetary deficiencies fall into at least two categories. In the first are practices that thwart interperiod equity by measuring revenues and expenditures in ways that fail to capture their economic substance. They include "one shot" transactions such as the sale and leaseback of government assets. While not violating legal constraints, management can shift the current payment burden for services to taxpayers of other periods. In the second category are practices that diminish the reliability of the budget by producing material budget variations—differences between actual and predicted revenues and expenditures. These undermine the political process by causing a distribution of resources different from that contemplated in the budget.

Principles of Revenue and Expense Measurement

Specific rules of municipal budgeting are generally stipulated either in a state constitution or in state or local statutes. Because budgets are almost always prepared on a cash or near-cash basis, amounts budgeted for revenues and expenditures do not properly measure the resources received or consumed within a particular year.

Furthermore, budgets are prepared for each individual fund that is defined as a fiscal and accounting entity with a self-balancing set of accounts, rather than for the government entity as a whole. Consequently it is possible to balance the revenues and expenditures of the general fund, to which political attention is paid and to which balanced budget requirements apply, by making discrete transfers among funds or by budgeting selected activities in funds other than the general fund.

A recent budget of the State of Texas provides an example. The Texas legislature recently approved a "balanced budget" for the 1990-91 biennium. As promised by the Governor and other state officials, the budget increased spending for key services but held the line on taxes. Yet given the state's economy, this seemed well beyond the limits of fiscal possibility. A closer look revealed that the budget was balanced in part by the following:

- Transferring $733 million from 219 of the state's special revenue funds to the General Revenue Fund (the one fund that has to be balanced) on the last day of the 1990-91 biennium and then transferring the money back the first day of the next biennium. Per Texas law, this one-day borrowing maneuver made the special revenue funds that had already been designated for other purposes available for general appropriation in 1990-91.
- Changing the state's payments to the Teacher Retirement System from a monthly to a quarterly basis and postponing the payment for the last quarter of the 1990-91 biennium until the first day of the next biennium. This payment delay freed up three months of payments, estimated at $200 million.
- Prepaying anticipated bills of 1990-91 in 1988-89. The state benefited from a stronger than expected economy in that biennium and had higher than expected revenues. Under the law, if these extra funds had not been spent in the 1988-89 period they would have had to be transferred to the Economic Stabilization Fund, a rainy day reserve. By paying the bills in advance, the state was able to shift $150 million of 1990-91 costs to the 1988-89 fiscal period, thereby giving the appearance of planned savings.

These transactions were neither unusual nor were they carried out in secret. Other examples abound and have been widely reported in the press. They need not, however, be highlighted in the governments' financial statements, or in accompanying audit reports.

Significance of Budget Variances

The second category of budget deficiencies are budget variances—differences between budgeted and actual amounts. Their adverse consequences can be as severe as weaknesses in underlying budgetary principles. The greater the variances the less reliable and the less useful is the budget. Budget variances thwart the political process and may lead to a distribution of resources that misrepresent what was expressed in the budget itself. Moreover, insofar as budgets are used by investors and creditors, they may contribute to misallocation of resources among government entities.

> ***... in government ... budgets are central not only in allocating resources but in obtaining them.***

Budget variances can have several causes:

- Computational or other types of technical errors: misclassifying costs or revenue among programs or activities, or failing to make proper distinctions between fixed and variable costs.
- Incorrectly applying required budgetary procedures: the applicable budget law may require that encumbrances be accounted for as expenditures (i.e., as if goods and services had actually been received). The government may mistakenly budget as expenditures only goods or services expected to be received, not ordered.
- Incorrectly forecasting the variables to which specific revenues or expenditures are tied. This may result from failing to properly account for all factors relevant to a projection. For example, the budget department may incorrectly estimate the yield from sales taxes by incorrectly forecasting retail sales.
- Failure (however understandably) to anticipate unusual occurrences that could affect revenues or expenditures—e.g., championships by home town sports teams, snowstorms, or disasters.
- Intentionally overestimating expenditures to enhance the appearance of performance. If actual expenditures are less than those budgeted, the favorable variance may create an illusion of effective cost control.
- Intentionally overestimating revenues or underestimating expenditures to satisfy constitutional or statutory provisions that require that the approved budget be "balanced." These incorrect estimates may enable postponing a tax increase until after a forthcoming election.

Evidence that Budget Variances are Substantial

To assess the magnitude of budget variations, the authors calculated budget variances for general fund revenues and expenditures for a sample of major U.S. cities. The authors requested budgets and recent annual reports from all U.S. municipalities with populations over 100,000; they received usable information from 125 of 170 requested.

Results

The analysis indicated that municipal budgets are of questionable reliability. Thirty-nine percent of the sample cities incorrectly estimated revenues and 60% incorrectly estimated expenditures by more than 5%. Moreover, the budgets tend to be biased toward "conservatism," mainly because of overestimates of expenditures. This assessment is consistent with the proposition that the budget variances are the result of fiscal and political caution, or attributable to other rectifiable causes. Hence the variances might be reduced by improvements in budgetary practices, one of which might be enhanced monitoring. The results of this study are by no means conclusive as they are for a period of only one year. Nonetheless, they strongly suggest that budget variances seriously detract from budget reliability.

PROPOSED REFORMS

To eliminate inherent biases in budgetary practices and to reduce budget variances, intentional or accidental, the authors propose two reforms:

- GASB should prescribe that the budgets included in annual report comparisons be on the basis of GAAP; and
- AICPA and other authorities establish standards to require independent budget reviews.

GASB Should Mandate GAAP-Based Budgetary Comparisons

GASB has the authority to prescribe the form and content of annual reports. It also has the authority to specify the principles underlying the budget presented in the required budget to actual comparisons.

The authors propose that GASB exercise this authority by mandating that, prior to the period covered by the annual report, governments prepare a budget on the basis of GAAP—one in which all revenues and expenditures are measured in accordance with the same principles used in the end-of-period financial statements. This budget would be in addition to, not in place of, the legally mandated budget, over which GASB has no direct jurisdiction.

Budgetary comparisons included in the annual report would be based on the budget as prepared under GAAP rather than the legally adopted budget. This change will not, however, compromise the objective of demonstrating whether resources were obtained and used in accordance with the entity's legally adopted budget, relative to present practices.

Currently there can be differences of basis between the appropriated budget as presented in the annual report and the actual results. These differences result from timing, perspective, and entity definition. GASB standards require that they be reconciled either on the comparison statement itself or in accompanying notes. Only the net excess of revenues over expenditures must be reconciled; not the individual revenues and expenditures. The result is that the statement comparing budgetary to actual results does not provide information on whether actual individual revenues and expenditures were as budgeted. Hence the objective of reporting legal compliance is presently being achieved only as to the net surplus or deficit, not the budget components.

comparison . . . can best be achieved by . . . a statement comparing the legally adopted budget with actual results determined on a budget basis.

The objective of this comparison is important. It can best be achieved by including in the annual report a statement comparing the legally adopted budget with actual results determined on a *budget* basis. Such a statement would be in addition to the comparison of the budget with actual results, both on a GAAP basis, and would in no way detract from it.

The requirement that governments include in their annual reports a statement comparing the GAAP budget and the actual results will not, of course, have any direct effect on constitutional or statutory budget mandates. The legally adopted budgets of most governments will continue to be on a cash or near-cash basis. What the new requirement would do, however, is to draw more sharply the distinction between cash and other types of budgets. It would emphasize to public officials as well as the public-at-large that while a cash budget is essential for effective planning and management, it is not sufficient. It would highlight the differences between the cash and the GAAP bases and spotlight the type of budget-balancing practices described previously. Equally important, it would unshackle GASB from its ties to the legally mandated cash budget. It would allow GASB to establish accounting principles that are not compromised by an objective of having to demonstrate compliance with a legally mandated budget.

AICPA and Other Authorities Should Require Independent Budget Reviews

We further propose that the AICPA or other authorities (such as the General Accounting Office and the Office of Management and Budget), which prescribe auditing standards for state and local governments, require that the annual audit of a government include an independent review of its GAAP-based budget. The review would be similar to the auditor's examination of prospective financial statements, and it would involve, with appropriate modifications:

- Evaluating preparation of the budget;
- Evaluating the support underlying the assumptions;
- Evaluating the presentation of the budget for conformity with guidelines; and
- Issuing an examination report.

Advantages of such an independent budget review are that it would reduce technical and computational variances, assure that the underlying assumptions are reasonable, make certain that projections are consistent with assumptions and confirm that appropriate budgetary principles have been applied.

Questionable Incentives

Endorsement of the two proposals by government officials is important. First, government officials are a major constituency of GASB. Nevertheless, it has no enforcement authority and its own due-process rule virtually assures that it will not issue pronouncements unless they are endorsed by a sizable proportion of its constituents. Second, government officials will have to authorize funds for the auditor reviews. They are unlikely to do so in the absence of incontestable benefits to themselves or their communities.

BUDGETS CANNOT BE OVERLOOKED

Financial accounting in state and local government is budget-driven. Yet the accounting profession has maintained a hands-off approach to government budgeting. The profession has directed attention to the budget only to the extent of requiring budget to actual comparisons in annual reports. As a result, budgets have become subject to, at times, conflicting interests. Also, financial accounting has become the handmaiden to what is, in essence, a budgeting system based on flows of cash and near-cash.

The authors' two proposals are intended to improve both budgeting and financial reporting. The beneficiaries will be government, the public and, not incidentally, the accounting profession. Ω

[1] G. Colm. "Why Public Finance?" *Essays in Public Finance and Fiscal Policy*, (New York: Oxford University Press, 1955).

[2] FASB, *Objectives of Financial Reporting by Nonbusiness Organizations*, 1980.