
STUDY GOALS AND CONCERNS

TRUTHFUL ACCOUNTING IS ESSENTIAL TO GOVERNMENT ACCOUNTABILITY

The foundational principle of this Study is the idea that all governmental entities, including state governments, derive their just powers from the consent of the governed.ⁱ Since an informed electorate is the basis for a sound democracy, providing such information is an essential part of *accountability* in government. Government officials have a special responsibility to report on their actions and the results of those actions faithfully with timely and accurate reports.ⁱⁱ These reports must transmit truthful information to inform citizens and to guide decisions made by their representatives and other public officials. The Institute for Truth in Accounting defines truthful information as the complete set of facts needed to make knowledgeable decisions. This means information should be complete, understandable, reliable, consistent and comparable from one reporting period to the next. It also means that the information must be produced and transmitted to the users in time to be relevant to the ongoing processes of governing.

STUDY GOALS

The specific goal of this Study is to determine how well the states meet this standard of truthful reporting. To make that determination, we set out to:

- Ascertain if the public and governmental officials have the information needed to make knowledge decisions during states' budget processes and about state governments' accountability and sustainability;
- Review each state's balanced budget requirements;
- Investigate states' claims of balanced budgets to ascertain if the intent of their balanced budget requirements were achieved;
- Survey the availability and *timeliness* of the states' *annual reports*; and
- Investigate if preparing state budgets using *Generally Accepted Accounting Principles* would result in a true presentation of these annual plans and the related financial consequences.

As a part of this Study, we reviewed each state's budgeting and accounting practices. We also compared budgetary transactions to related amounts included in each state's financial reports for fiscal years 2005-2007. To evaluate the timeliness of state financial reports, we calculated the number of days that elapsed between the end of the state's fiscal year and the date on which they issued their annual report. We studied the accounting standards used to prepare state and local governments' annual financial reports. We examined a number of state financial reports, including related notes and required supplementary information, to determine if pension and *other post-employment benefits* were adequately disclosed.

STUDY CONCERNS

IMPORTANCE OF THE BUDGET PROCESS

A state budget is a financial representation of the goals and objectives of elected officials.ⁱⁱⁱ The budget process of a state government is the principal vehicle through which the state legislatures and governors annually allocate resources. It is a plan of financial operations which includes an estimate of the resources that will be available to the state and an estimate of proposed *expenditures* for a given period.

The budget should be presented in a way that facilitates policy analysis and promotes public accountability. The estimates of resources that will be available and the costs that will be expended should be calculated using the most accurate techniques available. Inferior econometric methods or accounting practices which are known to produce less accurate estimates can be used only disingenuously even if they produce a desired political result.

What's more, the budget process deals in the uncertainties of the future. Revenues are subject to changing economic conditions. There is always upward pressure on state resources. Therefore it is essential that the most truthful information be available during this critical decision making process.

TYPICAL STATE BUDGETING AND FINANCIAL REPORTING EVENTS

State governments undertake two major financial reporting events every fiscal year. The first is the preparation of a prospective budget which (i) estimates the revenues and other sources of funding that will be available to the state, and (ii) its plan to spend them. The budget is prepared before the fiscal year begins and approved by the each state's respective legislature and governor.

The second event occurs at the conclusion of the fiscal year when each state produces its annual report, a comprehensive document which retrospectively presents the results of the fiscal year's activities. The annual report is effectively a report card that illustrates how the actual revenues were collected and spent. The variations between the budget plan and the annual report are a major concern of this Study.

CASH BASIS BUDGETING

The root of current state government budget processes and accounting systems is called *cash basis* fund accounting. The antecedents of this accounting method can be traced back to the early twentieth century when governments had one bank account or "fund" for the government's general expenditures, and separate bank accounts or "funds" for each special project. The purpose of this segregation was to ensure that the taxes, i.e. cash, collected for specific projects, would be visible and available to fulfill the legislatures' intents. In addition, the amount of cash in the fund put a practical limit on spending.^{iv}

Under this cash basis method of accounting, revenue is recognized when cash is received rather than when earned. Revenues include taxes, charges for services, fees, fines and funds received from other governmental units. Taxes can be thought of as a state's "earnings" and these funds can be used at the state's discretion. Funds received from other governmental entities, like the federal

government, are essentially grants that may have requirements as to why, how and when the funds are spent.

State budgets use the term “expenditures” to replace both of the terms, costs and *expenses*, as they are used in accounting for profit-seeking entities. Expenditures are defined as decreases in fund financial resources.^v Under the cash basis system, expenditures are recognized when paid rather than when incurred. Expenditures include the checks written for items such as salaries, services, supplies, the costs of long term assets, debt service principle and interest.

The advantages of cash basis budgeting includes:

- The ease of understanding the system;
- Reliable information about cash flows;^{vi} and
- Cash fitting well with a budgeting system that focuses on controlling and ensuring compliance with the legal purpose of the spending and its limits.

One artifact of cash basis accounting is its treatment of capital asset purchases. In a pure cash accounting system for example, the entire cost of constructing a bridge or road would be budgeted in the year that the state actually paid the contractors. This ignores the fact that the bridge will have a 25-50 year useful life. But, allocating the cost over an asset’s useful life is impossible in a cash basis accounting system. The *accrual basis accounting*, described immediately following this section, remedies this and other shortcomings of the cash accounting systems.

Despite the existence and universal use of objectively better accounting systems in the private sector, the Institute’s research determined that state budget calculations are still dominated by cash basis fund accounting. With few exceptions, state budgets recognize only current cash inflows and outflows to the state “checkbook”. Therefore in this document we will use the term “cash basis” to describe the method used to calculate state budgets, even though governmental officials may use the term “*modified accrual basis*”.

ACCRUAL BASIS BUDGETING

The alternative to cash basis budgeting is accrual basis budgeting². Under this system, revenues are recognized when earned and costs are recognized when incurred rather than when they are paid. Accrual accounting generally provides a more accurate calculation of an entity’s financial performance and condition than does cash basis accounting. Interestingly, governments insist that businesses of nearly any scale use accrual accounting to calculate tax liabilities.^{vii}

The accrual system’s major goal is to properly define and match revenues with the actual costs and expenses incurred during the fiscal period. In addition to cash transactions, accrual accounting recognizes a host of non-cash transactions. These include amortization, depreciation, earned but not received revenues, and obligated but not yet paid expenses. In this, it is a more complicated, but a much more informative *basis of accounting*.

An example of a typical accrual accounting transaction would be the interest payment on a bond. If the bond paid interest on June 30 and December 31 of each year, a bond holder, using a cash basis

² Please note: Accrual budgeting is based on full accrual accounting. Full accrual accounting is not the same as accrual accounting under GASB GAAP. Full accrual accounting recognizes all expenses including the actuarially determined cost for post employment benefits.

accounting system, would book the interest received when a check came in the mail. In contrast, an accrual system would recognize one-twelfth of the total annual interest payments on every month's financial statements, regardless of the fact that no cash was actually received.

On the other side of that transaction the bond issuer, using a cash basis system, would only recognize the interest expense twice per year. The interest expenditure would be recorded only on the June and December statements, even though the interest to be paid had accumulated **every** month. Accrual accounting would recognize that the issuer had become **obligated** to pay the accumulating interest, even though a cash payment would not be required or made for several months.

Accrual *accounting principles* apply to any number of events that do not involve cash but do have financial consequences. These include:

- Allocating the cost of long-term assets over their service lives;
- Recognizing the costs of post-employment benefits even though they will not be paid in cash for many years; and
- Reporting the costs of goods and services when consumed even though the vendor will not be paid until some time in the future.

For many government transactions such as salaries, grant payments and other general expenditures, there would be no significant differences between cash and accrual based budgeting. In the case of employee pensions and post-employment health care benefits, an accrual budget would recognize costs earlier, when the commitment is made, and thus enhance the legislature's ability to understand and control these costs. For capital purchases, accrual budgeting would delay recognition of costs and may impair the legislature's ability to control and account for the expenditures related to these purchases.^{viii} By establishing compensating controls, the states would be able to address such control issues. Under accrual budgeting the depreciation of assets would be included in the annual budget, not the cost to purchase the assets. Funds would be appropriated for depreciation, even though this is a non-cash expenditure. Therefore governmental agencies would receive *appropriations* marked as depreciation that could be used to purchase assets or set aside for future asset acquisitions.

Besides illuminating the long term effects of current policy, accrual budgeting also provides:

- Increased financial transparency;
- Full costing information to determine accountability and performance measurements;
- Recognition of expenses when incurred, regardless of payment date; and
- Support for longer range policy and management perspectives.

While full accrual budgeting is not used by any state to prepare budgets, it is being used in various countries. In February 2000 the U.S. Government Accountability Office (GAO) issued a study titled, "Accrual Budgeting: Experiences of Other Nations and Implications for the United States".^{ix} As a part of this study, the GAO reviewed six countries, Australia, Canada, Iceland, the Netherlands, New Zealand and the United Kingdom who have adopted accrual budgeting.

FINANCIAL ACCOUNTING STANDARDS

While typical state budgets are often created without much regard to sound accounting practices state annual reports are subject to established accounting principles. These annual reports are

described in the section immediately following but it is important to touch on the organizations that create and prescribe accounting standards. Since its beginning, the accounting profession has continuously examined the techniques and methods it employs to present financial information in the most informative, comprehensive, and consistent manner. This collection of “best practices” is known as “Generally Accepted Accounting Principles” or “GAAP”.

The Financial Accounting Foundation (FAF), a private-sector, independent organization has ultimate responsibility for the creation of GAAP standards which it fulfills with this hierarchy:

General Accepted Accounting Principles (GAAP) Comes From:		
The Financial Accounting Foundation (FAF) Established 1972 Which oversees:		
Private Sector Principles via:	Governmental Principles via:	
For Corporations and Non-Profit Entities The Financial Accounting Standards Board (FASB) Established 1973	For State and Local Governments The Governmental Accounting Standards Board (GASB) Established 1984	For the Federal Government The Federal Accounting Standards Advisory Board (FASAB) Established 1990

As indicated above, the Financial Accounting Foundation has authorized three specialized bodies to ascertain the need for and to debate the creation of new accounting principles. In 1973, the FAF created the Financial Accounting Standards Board (FASB) and charged it with establishing accounting standards to be used by the private sector, including business and non-profit entities.^x In 1984, the *Governmental Accounting Standards Board (GASB)* was charged with establishing state and local government accounting principles. The GASB was created by FAF with the assistance of ten national associations of state and local government officials. The GASB serves a diverse constituency including preparers and auditors of governmental financial information, users of those statements, including rating agencies, academics and citizens-at-large. The GASB is governed by seven board members. It is funded by contributions, the sale of publications and a nominal fee voluntarily assessed on municipal bonds issued.^{xi} The Federal Accounting Standards Advisory Board was created by federal government officials to establish accounting principles for the federal government. As a consequence of three bodies governing their respective spheres, GAAP is different in each sector. In our view, private sector GAAP is more comprehensive and mature than the GAAP established for state and local governments and the GAAP established for the federal government.

FINANCIAL REPORTING: THE COMPREHENSIVE ANNUAL FINANCIAL REPORT

Each state budget is its annual blueprint for how the state resources **will** be spent, while the *Comprehensive Annual Financial Report (CAFR)* is the document that reports how the resources **were** employed. This report is issued by the state comptroller or treasurer after the fiscal year ends and is functionally equivalent to a corporation’s annual report. It is considerably longer than

the typical private sector annual report because of the multiple fund transactions and balances that must be reported.

The CAFR is prepared using state and local GAAP established by the GASB. *GASB GAAP* requires that the CAFR consists of two major sections: introductory and financial.

- The introductory section includes the letter of transmittal identifying the responsibility for the creation of the report; a list of government officers; an organizational chart and, if awarded, the Government Finance Officers' Association's "Certificate of Achievement for Excellence in Financial Reporting".
- The financial section includes the auditor's report; the management discussion and analysis of operations and financial position; and the basic financial statements including the government-wide, consolidated statements. These consolidated statements, which look much like those prepared by businesses or non-profits, include a *Statement of Net Assets* and a *Statement of Net Activities*. In the data section of this Study, each state's schedule includes a "GAAP Basis" column. This column is derived from the government-wide Statement of Net Activities.

Included in the financial section are the financial statements for eleven funds which are categorized as governmental, proprietary and fiduciary funds. Every major fund in each of these categories is presented separately. Six of the eleven funds fall into fiduciary and proprietary categories and are reported using accrual accounting. Pension Trust Funds and Investment Funds are examples of fiduciary funds. Unemployment Insurance and University Funds are examples of proprietary funds. The remaining five funds are reported as governmental funds and represent the most basic functions the state government provides. These are presented using the modified accrual method. The focus of this method of accounting is the receipt and expenditure of resources,^{xii} which is very similar to the cash base method. The General Fund and Road Fund are examples of governmental funds.

Another GASB GAAP requirement is the inclusion of a "Budgetary Comparison Schedule" in the CAFR. This schedule includes the original budget, the final appropriated budget and the actual results computed on the same basis as the budget. In the data section of this Study, each state's schedule includes a "Budgetary Basis" column. This column is derived from the amounts reported on the Budgetary Comparison Schedule in the budget columns. If the "original budget" is reported, then its amounts are used.

State governments are not required to, but may include a statistical section in their annual reports. This section, which is not audited, provides historical trend information and additional detail that may offer users of the annual report a better understanding and assessment of a government's economic condition. The information in the statistical section may include revenue capacity, debt capacity, demographic and economic data, and data such as the number of government employees, volume and usage of capital assets, and indicators of the demand for government services.^{xiii}

SPECIAL MENTION: PENSIONS AND PENSION ACCOUNTING

The obligation for pension benefits is a major factor in determining the financial conditions of states. By way of background, there are two types of pension plans: defined benefit plans and defined contribution plans. Defined benefit plans are designed to provide a designated series of payments to employees when they retire. These payments are usually defined by contracts or collective bargaining agreements between the state and their employees. These plans can be funded as a pay-as-you-go system or the employer and employees can contribute funds to the plan over the employees' working lives. Defined pension benefits are usually required to be paid

without consideration to the amount of assets that have accumulated in the plan. Therefore the employer takes on the risk of decreases in the market value of plan assets. A defined contribution plan provides a payout at retirement that is dependent upon the amount of money contributed and the performance of the investment vehicles utilized. Participants in a defined contribution plan typically have control over investment decisions and bear the investment risk.

Employers who offer defined benefit plans are obligated to pay the specified benefits when employees retire. Employers may or may not accumulate assets to fund these payments during the time workers are employed. As a result of the fluctuations in the market value of plan assets, defined benefit plans have all but disappeared from the private sector and have been replaced by 401(k) plans (or their equivalents). The risks associated with defined benefits plan were highlighted when FASB started to require corporations to report their total unfunded pension liabilities. Corporations are also required to report increases in their pension expense as plan assets decrease in value. When these disclosures were required, a massive switch to defined contribution plans commenced. This means that future pension obligations are not accumulating because the employee benefits are based upon what has been contributed to the plans, plus any earnings realized by investing those contributions.

The private sector pension disclosures have not been required in the public sector. Prior to June 15, 1997 state and local government-wide financial statements reported pension costs using cash basis accounting. Pension benefits were reported when paid, not when earned. Annual reports that were issued after June 15, 1998 were required to follow "GASB Statement No. 27 - Accounting for Pensions by State and Local Governmental Employers (GASB 27)". Statements of Net Activities issued after this date include an Annual Pension Cost, which can consists of four elements. The first element is the *actuarially determined amount* of normal pension cost based on the current period salaries of employees covered under the pension plan. The second element is the amortization of pension under-funding prior to the implementation of GASB 27. These previously incurred costs, that were not adequately funded, are being amortized over a 40 year period. The third element is the amortization of newly approved pension benefit increases. These increases can be amortized over a period of 30 years, with no liability being reported by the government in the year the increases are approved. The fourth element is interest on the government net pension obligation. This is the amount the state must pay to "make up" for the earnings it would have received had it actually contributed the amounts required by the first three elements.

If a state government makes a contribution to its pension plan which is less than the amount of the Annual Pension Cost, the contribution deficiency is a Net Pension Obligation, which is reported as a liability on the government's Statement of Net Assets. Conversely, if a government makes a contribution to its pension plan of more than the amount of the Annual Pension Cost, the contribution excess is reported as a Net Pension Asset. The cumulative difference, since the effective date of GASB 27, between annual pension cost and the employers' contributions to the plan is reported as the government's Net Pension Obligation or Asset on the state's Statement of Net Activities.

The notes to the financial statements include important information about each of the government pension systems including a description of the plan and the funding policy. Significant disclosures about each pension fund are also included as "Required Supplementary Information" in the financial section of the CAFR. The document titled "Schedule of Funding Progress" includes each pension funds' "Unfunded Actuarial Accrued Liability" for the last three fiscal years. This liability is calculated by the pension funds' actuaries based on the present value of the amount that will be needed to pay future benefits. Actuaries calculate the "actuarial accrued liabilities" based on an

actuarial cost method and a number of assumptions, including discount rates as well as worker and retiree mortality. Actuaries also estimate the “actuarial value of assets” that the pension plan has. The excess of actuarial accrued liabilities over the actuarial value of assets is referred to as the “unfunded actuarial accrued liability”. The Institute for Truth in Accounting considers this liability amount to be state and local governments’ a truer liability for pensions. We do not consider this amount the “true” liability, because of the actuarial assumptions that GASB allows states to use when valuing pension plan assets and liabilities. The accurate calculation of the “true” pension liability is a discussion outside the scope of this Study.

ACCOUNTING FOR OTHER POST-EMPLOYMENT BENEFITS

In addition to promising future pension benefits, states also provide for other needs of retired workers. The largest of these is medical care, but these non-pension benefits can also include ophthalmic, dental and hearing plans, long-term care, post-employment life and disability insurance and other benefits. Collectively, these non-pension benefits are known as “Other Post-Employment Benefits” and abbreviated with the acronym “OPEB”. Most state governments have funded and accounted for OPEB on a pay-as-you-go basis. Expenses have only been recorded and recognized when actually paid and in most cases these liabilities are unfunded because no assets have been accumulated to fund these benefits in the years that employees have earned them.

To date the GASB has not required state and local governments to disclose their OPEB obligations. This will change when GASB Statement Number 45 - “Accounting and Financial Reporting by Employers for Post-employment Benefits Other Than Pensions (GASB 45)” takes effect over the next couple of years. Governments with annual revenues of \$100 million or more are required to implement this Statement in their FYE 2008 financial statements. Governments with total annual revenues of \$10 million or more but less than \$100 million are required to implement this Statement in their FYE 2009 financial statements

By requiring these costs to be recognized on an accrual basis, GASB 45 will dramatically change the way states and municipalities account for these expenses and their associated liabilities. GASB 45 requires existing liabilities to be disclosed and to be amortized over a 30 year period. The truer representations of the OPEB liability must be disclosed in the CAFR Required Supplementary Information similarly to the disclosures required for pension liabilities. The IFTA believes that GASB 45 is an important and positive development because OPEB costs are material and may actually represent larger liabilities than pensions. Determination of the degree to which this may be true is a subject for a future study but at the federal level Medicare and Medicaid are larger net liabilities than is Social Security.

IMPORTANCE OF TIMELINESS

Timely production and release of financial information is one of the cardinal requirements of an effective system of financial reporting and control. Each state CAFR provides information that is essential to **future** financial decisions. For this information to be useful it must be understandable, reliable and relevant. To be relevant this information must be available on a timely basis.