PacificCPE

COURSE

21153A

Government Budgeting, Control, and GAAP Challenges

Budgeting in government is more than a planning exercise—it carries legal authority and real accountability. This course digs into the principles of governmental budgeting and internal control, while also examining real-world budget gimmicks states use to mask deficits, the cost of GAAP compliance, and creative tactics like selling assets to yourself. If you advise or audit government entities, understanding these issues helps you spot red flags and assess financial health more effectively.

CREDIT HOURS 2 | FIELD OF STUDY ACCOUNTING | EXAM QUESTIONS 10

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Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Identify different budgeting and control methods used by governmental entities.

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TABLE OF CONTENTS

CHAPTER 01

Issues Of Budgeting And Control 4

1.01 What Are The Key Purposes Of Budgets? 5

1.02 Table 3-1. City Of Houston Citywide Performance Measures—Excerpt From Fy 2023 Adopted Budget 10

1.03 On What Basis Of Accounting Are Budgets Prepared? 17

1.04 How Do Budgets Enhance Control? 26

1.05 An Alternative Method: Crediting Or Debiting The Difference Between Revenues And Expenditures To "Budgetary Control" 33

1.06 Are Budgetary And Encumbrance Entries Really Needed? 44

Test Your Knowledge 47

Final Exam Copy 54

Glossary 52

Index .....

Chapter 1: ISSUES OF BUDGETING AND CONTROL

Chapter Objective

After completing this chapter, you should be able to:

- Identify different budgeting and control methods used by governmental entities.

Budgets are to governments and not-for-profits what the Sun is to the solar system. Trying to understand government and not-for-profit accounting without recognizing the centricity of the budget would be like trying to comprehend the Earth's seasons while ignoring the Sun. As emphasized in Chapter 1 of course 21151F, and incorporated into generally accepted accounting principles, **budgets** are the key financial instruments.

Budgeting is an essential element of the financial planning, control, and evaluation processes of governments. Every governmental unit should prepare a comprehensive budget covering all governmental, *proprietary*, and *fiduciary* funds for each annual (or, in some states, biennial) fiscal period.[1]

Governments and not-for-profits are disciplined mainly by their budgets, not by the competitive marketplace. With few exceptions, governments reflect all significant decisions—whether political or managerial—in their budgets. As also pointed out in Chapter 1 of course 21151F, a key objective of accounting and financial reporting is ensuring that an entity obtains and uses its resources in accordance with its budget. Budgeting exerts a major influence on accounting and financial reporting principles and practices.

The main purpose of this chapter is to provide an overview of budgets and the budgeting process and thereby establish a basis for appreciating the relationship between budgeting and accounting. The first part of this chapter discusses functions of budgets, the different types of budgets, schemes of account classification, budgeting cycles, budgetary bases, and the significance of budget-to-actual comparisons. The second part shows how governments (and, to a lesser extent, not-for-profits) promote budgetary compliance by integrating the budget into their accounting systems. They do this primarily by preparing journal entries to record both the budget and the goods and services that have been ordered but not yet received.

Although this chapter describes budgetary procedures and related accounting practices mainly in the context of governments, most of the points can properly be extended to not-for-profits. For example, whereas the legislatures of governments *appropriate* (a term reserved for governments) funds for expenditure, the boards of directors or trustees of private-sector not-for-profits *authorize* or *approve* outlays—performing essentially the same function. However, the budgets of governments

often have the force of law, and officials may be subject to severe penalties for violating them. To prevent overspending, governments are required to institute certain accounting controls—such as integrating both the budget and purchase orders into their accounting systems—that are optional for not-for-profits.

WHAT ARE THE KEY PURPOSES OF BUDGETS?

Budgets are intended to carry out at least *three* broad functions:

- **Planning**. In a broad sense, planning comprises *programming* (determining the activities that the entity will undertake), resource acquisition, and resource allocation. Planning is concerned with specifying the type, quantity, and quality of services that will be provided to constituents, estimating service costs, and determining how to pay for the services.
- **Controlling and administering**. Budgets help ensure that resources are obtained and expended as planned. Managers use budgets to monitor resource flows and point to the need for operational adjustments. Legislative bodies—such as city councils or boards of trustees—use budgets to impose spending authority over executives (such as city managers or executive directors), who in turn use them to impose authority over their subordinates (such as department heads).
- **Reporting and evaluating**. Budgets lay the foundation for end-of-period reports and evaluations. Budget-to-actual comparisons reveal whether revenue and spending mandates were carried out. More important, when tied to an organization's objectives, budgets can facilitate assessments of efficiency and effectiveness.

WHY IS MORE THAN ONE TYPE OF BUDGET NECESSARY?

The benefits of the budgetary process cannot be fully achieved by a single budget or single type of budget. A well-managed government or not-for-profit—just like a well-managed business—should prepare budgets for varying lengths of time from multiple perspectives. These include:

- **Appropriation budgets**, which are concerned mainly with current operating revenues and expenditures
- **Capital budgets**, which focus on the acquisition and/or construction of long-term assets
- **Flexible budgets**, which relate costs to outputs and are thereby intended to help control costs, especially those of business-type activities

In addition, many governments and not-for-profits prepare **performance budgets** (discussed later in this chapter).

Appropriation Budgets

A government's *current* or *operating* budget covers its general fund and possibly some or all of its special revenue funds. The operating budget is almost always an **appropriation budget**—one incorporating the legislatively granted expenditure authority, along with the related estimates of revenue. In most state and local jurisdictions, the operating budget must, by law, be balanced. Public attention focuses on the appropriation budget because it determines the amount of taxes and other revenues that must be generated to cover expenditures. Owing to the importance of appropriation budgets and the influence they have had upon the establishment of accounting principles and practices, this chapter directs attention mainly to this type of budget.

Governments may require that separate appropriation budgets also be developed and approved for special revenue, debt service, or capital project funds, in addition to the general fund. However, such budgets may be unnecessary if a government has established adequate controls over spending by other means. For example, by accepting a federal grant and creating a special revenue fund to account for it, the government may implicitly approve expenditure of the grant resources. Similarly, by issuing bonds, it may authorize spending for specified capital projects. Still, principles of sound management dictate that a nonappropriation budget—a financial plan not subject to appropriation—be prepared each year for such funds and organizational units. Budgets of some type are almost always necessary if activities are to be effectively planned, controlled, and evaluated.

Capital Budgets

Although the accounting cycle is traditionally one year, the budgeting process commonly extends for a considerably longer period. The needs of an organization's constituents must be forecast and planned for years in advance.

A **capital budget**, in contrast to an appropriation budget, typically covers multiple years, often as many as five. It concentrates on the construction, acquisition, and major renovation of long-lived assets such as land, buildings, roads, bridges, and major items of equipment. These assets can be expected to last for many years. Therefore, in the interest of interperiod equity, they will generally be financed with long-term debt rather than taxes of a single year. The capital budget is, in essence, a plan setting forth when specific *capital assets* will be acquired and how they will be financed.

Legislators are sometimes more extravagant with capital than with operating resources. Capital projects, they reason, can be financed with debt rather than taxes and thus will not affect the surplus or deficit of the general fund, the budget of which must be balanced. Their error is in failing to take into account the additional operating costs associated with new long-term assets. Roads must be repaired, buildings maintained, and equipment tuned up. Further, in future years, the debt must be serviced with interest *and principal* payments made from operating resources.

Flexible Budgets

These are budgets that focus on expected revenues, expenses, and net income under different assumptions of volume. Governments use **flexible budgets** for enterprise funds, which account for business-type activities, even though enterprise funds are generally not subject to the same statutory budget requirements as governmental funds. Nevertheless, budgets are as important to enterprise funds as they are to businesses and governmental funds. As a rule, governments should prepare the same types of budgets for enterprise funds as would a private enterprise carrying out similar activities. For certain, they should prepare a series of flexible budgets, each of which contains alternative budget estimates based on varying levels of output. Unlike **fixed budgets**, flexible budgets capture the behavior of costs, distinguishing fixed and variable amounts. A flexible budget is a form of "what-if?" analysis. Fixed budgets may be appropriate for governmental funds in which the expenditures and level of activity are preestablished by legislative authorization. Flexible budgets are especially suited to enterprise funds in which the level of activity depends on customer demand.

HOW ARE EXPENDITURES AND REVENUES CLASSIFIED?

How financial data are presented affects how they are used. Therefore, accountants, public administrators, political scientists, and economists have directed considerable attention to the form and content of budgets. They are aware that the way the budget is prepared and presented can significantly affect the allocation of resources among organizations, programs, and activities.

Expenditures

Governmental accounting standards advise that "multiple classification of governmental expenditure data is important from both internal and external management control and accountability standpoints" as it "facilitates the aggregation and analysis of data in different ways for different purposes and in manners that cross fund and organizational lines." Suggested classifications include:

- By *fund*—such as the general fund, special revenue funds, and debt service funds
- By *organizational unit*—such as the police department, the fire department, the city council, and the finance office
- By *function* or *program* (a group of activities carried out with the same objective)—such as general government, public safety, sanitation, and recreation
- By *activity* (line of work contributing to a function or program)—such as highway patrol, burglary investigations, vice patrol
- By *character* (the fiscal period they are presumed to benefit)—such as "current expenditures," which benefit the current period; "capital outlays," which benefit the current and future periods; and "debt service," which benefits prior, current, and future periods

- By *object classification* (the types of items purchased or the services obtained)—such as salaries, fringe benefits, travel, and repairs[2]

Revenues

In contrast to expenditures, revenues present less significant issues of classification. Most revenues are not designated for specific purposes (or, if they are, they are reported in separate funds); therefore, their classification is relatively straightforward. Governmental accounting standards recommend that, in fund statements, revenues be classified first by fund (i.e., the columns on a statement of revenues and expenditures) and then by source (i.e., the rows). Suggested major revenue source classifications include:

- Taxes
- Licenses and permits
- Intergovernmental revenues
- Charges for services
- Fines and forfeits[3]

Most governments divide these classifications into numerous subclassifications—such as property taxes, sales taxes, and hotel taxes.

WHY ARE PERFORMANCE BUDGETS NECESSARY?

The traditional, and most commonly prepared, budget is referred to as an **object classification budget** because it is characterized by the expenditure classification that categorizes objects—such as the type of goods or services to be acquired. The primary virtue of an object classification budget is that it facilitates control. The managers who prepare the budget, and the legislators who pass it, establish rigid spending mandates and thereby direct, in detail, how every dollar should be spent. But this strength may also be a shortcoming:

- By expediting control, an object classification budget discourages planning. It encourages top-level decision makers to focus on specific line items rather than on *overall* entity objectives, strategies, and measurable performance targets. Thus, the officials of a school district may focus on the need for increased appropriations for salaries, fuel, supplies, and food while failing to consider how the additional outlays will affect the school's primary educational mission.
- It promotes bottom-up rather than top-down budgeting, with each unit presenting its fiscal requirements for approval in the absence of coordinated sets of goals and strategies.
- It overwhelms top-level decision makers with details. As a consequence, the decision makers are induced to take budgetary shortcuts—such as increasing all expenditures by a fixed percentage.

- By failing to relate specific *inputs* (factors used to provide goods and services) to outputs (units of service) or outcomes (accomplishments in terms of organizational objectives), it limits post-budget evaluation to whether spending mandates were observed.

Owing to these deficiencies, many governments and not-for-profits have adopted performance budgets in place of, or as a supplement to, object classification budgets. Performance budgets focus on measurable units of efforts, services, and accomplishments. They are formulated so that dollar expenditures are directly associated with anticipated units of outputs or outcomes. They enable managers to define goals, plan their resource needs, and measure the achievement of their various objectives. Table 3-1 illustrates an example of a government's performance metrics in its annual budget.

TABLE 3-1. CITY OF HOUSTON CITYWIDE PERFORMANCE MEASURES—EXCERPT FROM FY 2023 ADOPTED BUDGET

Public Safety	FY2021 Actual	FY2022 Target	FY2022 Estimate	FY2023 Target
911 Emergency Calls Answered within 15 Seconds	96%	90%	85%	90%
First Unit Fire NFIRS* 100 Series Call Type Response Time 90th percentile (minutes/seconds)	9.56	7.30	10.00	7.30
Dangerous Buildings Secured/Make Safe	549	950	427	436
Dangerous Buildings Demolished	147	300	134	179
Police Priority 1 Calls Responded to within 6 Minutes	61.70%	75.00%	55.00%	65.00%
Priority 2 Average Response Time (Minutes)	10.49	8–12	11.61	8–12
Traffic Fatalities	296	286	332	300
Services & Infrastructure	**FY2021 Actual**	**FY2022 Target**	**FY2022 Estimate**	**FY2023 Target**
Average Age of Fleet	9.3	10.3	9.6	10.0
Traffic Signal Repairs Completed (annually)	14,880	15,000	15,000	15,000
Flood Plain Area Inspections Completed (annually)	19,369	17,000	19,000	19,000
311 Average Speed of Answer (seconds)	163	120	120	120
Commercial Plans Reviewed within 13 Days	90%	100%	90%	90%
Traffic Signs Completed within 10 Business Days	96%	95%	95%	95%
Potholes Repaired within Next Business Day after 311 Request	99%	95%	95%	95%
Bridges Inspected (annually)	2,751	2,752	2,752	2.752
Complete Communities	**FY2021 Actual**	**FY2022 Target**	**FY2022 Estimate**	**FY2023 Target**
Bike/Hike Mowing Cycle (average number of days)	19.0	21.0	21.8	21.0
Percent of Anti-Gang Program Youth Who Reoffend	10%	7%	8%	8%
Clean Rivers Sites Monitored	556	798	600	600
Air Quality Inspections within 24 Hours of Complaint	98%	95%	95%	95%
Sound Financial Management	**FY2021 Actual**	**FY2022 Budget**	**FY2022 Estimate**	**FY2023 Budget**
General Fund Balance % of Expenditures	13.7%	10.5%	14.0%	13.2%
General Fund Surplus or (Deficit)	($1M)	($41M)	$36M	($7M)
General Fund Expenditures Budget vs. Actual Utilization	97.0%	98%	101.6%	98%
General Fund Revenues Budget vs. Actual Utilization	101%	100%	103%	100%
General Fund Expenditures Per Capita	$890	$967	$967	$1,009
General Fund Revenues Per Capita	$1,062	$1,129	$1,163	$1,196
Pension Payments as a % of Expenditures	8.2%	7.7%	7.6%	7.1%
Pension Payments Per Capita	$161	$175	$170	$177
Resilient Houston	**2021 Actual**	**2022 Target**	**2022 Estimate**	**2023 Target**
Houstonians that Participate in Preparedness Training or Receive Preparedness Materials	67,252	106,749	85,000	106,749
New Trees Planted	496,465	376,535	436,000	376,535
New Trails and Bike Lanes	92	16	16	16
New Green Stormwater Infrastructure Projects	40	10	12	10