PacificCPE

COURSE

21155A

Recognizing Expenditures and Expenses in Government Accounting

Understanding when and how governments recognize expenditures and expenses is critical for accurate financial reporting and compliance. This course covers the GASB standards that govern expenditure recognition across governmental funds, including topics like claims, judgments, compensated absences, and capital outlays. A practical example examining how California school funding policies affect financial reporting grounds the material in real-world context. Designed for accountants and auditors working with state, local, or educational government entities.

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

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LEARNING ASSIGNMENTS AND OBJECTIVES

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

- Recall how to properly recognize expenditures in governmental funds.

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Chapter 1: RECOGNIZING EXPENDITURES AND EXPENSES

Chapter Objective

After completing this chapter, you should be able to:

- Recall how to properly recognize expenditures in governmental funds.

HIERARCHICAL APPROACH TO TRANSACTION ANALYSIS

In the previous chapter, we addressed the question of when revenue should be recognized. We turn now to the other side of the ledger and consider how expenditures and expenses should be accounted for.

Like revenues, expenditures can be of two types: exchange and nonexchange. Our discussion of revenues centered mainly on nonexchange revenues, as most governmental funds revenues are of that type. By contrast, our discussion of expenditures focuses primarily on exchange expenditures. Most governmental funds expenditures result from exchanges—the acquisition of goods and services for cash or other assets. This is not to say that governments do not engage also in nonexchange expenditure transactions. Just as governments receive grants from other governments, they also provide them—to other governments, to private (mainly not-for-profit) organizations, and to individuals (e.g., assistance payments). GASB Codification Section N50—Nonexchange Transactions, applies to both nonexchange revenues and nonexchange expenditures. Nonexchange expenditures, per the standards, should be accounted for as the mirror Image of nonexchange grant revenues. Therefore, we need to direct only minimal attention to nonexchange expenditures.

Governmental funds expenditures, like revenues, are accounted for on a modified-accrual basis on the fund statements. For the most part, although there are several exceptions, exchange transactions are accounted for on a full-accrual basis, and the relevant GASB standards are similar to those of the FASB. This chapter, therefore, is devoted mainly to accounting for and reporting expenditures on a modified-accrual basis—the area in which governmental accounting is unique. As we did in the previous chapter with respect to revenues, however, we also note how the various expenditures would be accounted for differently on the full-accrual basis.

Resource Flows Statement versus Balance Sheet

In the previous chapter, we focused on revenues. In this chapter, we focus on expenses and expenditures. In both cases, the center of attention is the resource flows statements (e.g., a

statement of revenues and expenditures). We could just as plausibly concentrate on related liabilities and assets and thus on the balance sheet.

By the very nature of a double-entry accounting system, there are close ties between the balance sheet and resource flows statements. If a government incurs a cost, then it is reported as an expense (or expenditure), an asset, or a deferred outflow of resources. There are no other options. For example, if a government acquires an insurance policy, the cost must be apportioned (debited) among the three categories—expense (or expenditure), asset, or deferral. Conversely, if it receives a resource, then it must be assigned to a revenue, a liability, or a deferral inflow of resources.

- The GASB takes a hierarchical approach toward evaluating how events or transactions should be reported. It evaluates whether the item meets the definition of an asset or liability. If it does, it is recognized as such.
- If it does not meet the definition of an asset or liability, the GASB then questions whether it meets the definition of a deferred outflow or inflow of resources. If it does, it is recognized as such.
- If it does not meet the definition of a deferred outflow or inflow of resources, then the GASB asks whether it meets the definition of a current-period outflow or inflow of resources, for example, an expense (or expenditure) or a revenue[1]. If it does, it should be recognized as such.
- If it does not meet the definition of a current-period outflow or inflow of resources, then it should not be recognized in the financial statements.

This approach suggests that the recognition focus is on the balance sheet. Only what is not reported on the balance sheet as an asset, liability, or deferral can be reported on a statement of flows. Nevertheless, the analysis is not as straightforward as might be implied by the hierarchy. Specific types of transactions necessitate specific guidance and, hence, the last printed version of the GASB Codification was about 5,000 pages and weighed approximately eight pounds[2].

In considering whether recognition of specific revenue and expenses (expenditures) should be deferred until some future period, it is tempting to apply "the matching principle," a principle that historically has been associated with business accounting. The matching principle requires that expenses incurred during a period be recorded in the same period in which the related revenues are earned.

It is important to note, however, that a matching principle is nowhere to be found in the conceptual framework of governmental accounting as developed by the GASB. Instead, as set forth in GASB's Concept Statement 1, *Objectives of Financial Reporting*, governmental accounting is concerned with the extent to which interperiod equity has been achieved. Interperiod equity is the notion that current-year revenues were sufficient to pay for current-year services. Thus, in government-wide and other statements prepared on a full-accrual basis of accounting, expenses are recognized in the

period in which the services are provided and their cost incurred—and presumably in the period in which the taxpayers benefited from those services. Although this is most often the same period in which the resources that will pay for those services will be recognized as revenue, that is not always the case. Thus, for example, as was noted in the previous chapter, governments can recognize revenues from grants only after all eligibility requirements have been met. Yet, the government may satisfy all the eligibility requirements in a period before or after the services they are intended to support are performed.

HOW IS THE ACCRUAL CONCEPT MODIFIED FOR EXPENDITURES?

The Distinction Between Expenditures and Expenses

Under the modified-accrual basis of accounting, governmental funds are concerned with **expenditures**. By contrast, the government-wide statements and proprietary funds, like businesses, focus on **expenses**. Expenditures are narrower in scope than expenses. Whereas expenditures are decreases in net current financial resources, expenses are decreases in net economic resources. An expenditure is generally recognized when an asset is acquired, whereas an expense is generally recognized when an asset is consumed. Thus, funds that are accounted for on a modified-accrual basis would report equipment costs as "capital outlays"—expenditures to be recognized at the time of acquisition. By contrast, those that are accounted for on a full-accrual basis would report the equipment costs initially as an asset and then depreciate (expense) them over the life of the equipment.

The Virtues of Accrual Accounting and the Rationale for Modification

As pointed out in the previous chapter, the accrual basis of accounting is generally considered the superior method of accounting for organizations because it captures the economic substance of events and transactions, not merely the inflows and outflows of cash or near-cash items.

We have seen that the accrual concept is applied differently in governmental funds than in businesses or in proprietary funds, which are accounted for as if they were businesses, as well as in government-wide statements. Governmental funds accounting is heavily influenced by governmental budgeting. Owing to the importance of the budget, expenditures are closely tied to cash flows and near-cash flows rather than to flows of economic resources. In addition, governmental funds report only current, not long-term, liabilities. They focus on obligations that must be funded by current, not future, taxpayers.

Although the general principles of accrual accounting apply to governmental funds, there are key differences between how they are applied in governmental funds and how they are applied in businesses. In this chapter, we discuss seven key differences in how expenditures are accrued in governments versus businesses. They are compensated absences, pension and other postemployment benefits, claims and judgments, inventories, prepayments, capital assets, and

principal and interest payments on debt. The differences are consistent with the concept that under the modified-accrual basis of accounting, expenditures are decreases in net **current financial resources**—current assets less current liabilities. But unlike a business's current liabilities, defined as those that must be paid within a year, a government's liabilities are considered current only when they must be liquidated with expendable available financial resources.

In the context of governmental funds, **financial resources** refers to current financial resources—cash and other assets that are expected to be transformed into cash in the normal course of operations. "Net financial resources" refers then to financial resources less claims against them.

A government should recognize an expenditure when its net expendable available financial resources are reduced—that is, when it either pays cash for goods or services received or accrues a liability. But when should it accrue (i.e., give accounting recognition to) a liability? Under the modified-accrual basis, a government should, as a general rule, accrue a liability in the period in which it incurs (i.e., becomes obligated for) the liability. This general rule, however, does not by itself distinguish the modified-accrual basis from the full-accrual basis. What distinguishes the two bases are the several exceptions to this general rule set forth by the $GASB_3$. These exceptions permit governments to delay recording both a governmental fund liability and its associated expenditure until the period in which the liability must be paid—that is, when payment will reduce expendable available financial resources. Until that period, the government needs to report the liability only in its government-wide statements (as well as in its schedule of long-term obligations).

HOW SHOULD WAGES AND SALARIES BE ACCOUNTED FOR?

Wages and salaries may be earned in one fiscal year but paid in the next. Most governments pay their employees periodically—on a specified day of a week or month. Whenever the end of a pay period or the pay date does not coincide with the end of the fiscal year, the government must carry over wages earned in one year until the next. Therefore, the question arises of whether the wages and salaries should be reported as expenditures in the period earned or in the period paid.

EXAMPLE: WAGES AND SALARIES

A city with a December 31 fiscal year-end pays its employees for the two-week period ending January 8, 20X2, on January 11, 20X2. The portion of the payroll applicable to December 20X1 is $40 million, an amount included in the city's 20X1 budget.

GASB Standards

The GASB Codification does not specifically address wages and salaries. Hence, the general principles of modified accrual accounting apply. Wages and salaries should be recognized in the period in which the employees earn their wages and salaries, as long as the government's obligation will be liquidated with expendable available financial resources.

GASB Standards (continued)

In this example, the employees will be paid within days of year-end and with resources budgeted for 20X1 expenditures—resources that would generally be assumed to be available and expendable. Thus (ignoring the usual payroll-related taxes, withholdings, and benefits):

Payroll expenditures	$40	
Wages and salaries payable		$40

To record the December payroll (in 20X1)

In the following year, when the employees are paid, the entry to record the 20X1 portion of the payroll would be:

Wages and salaries payable	$40	
Cash		$40

To record the payment of wages and salaries recognized as 20X1 expenditures (in 20X2)

The entries in this chapter designate an **object** classification (such as payroll, insurance, supplies). Alternatively, they could designate an *organizational* unit (such as police department, fire department, sanitation department) or a *function or program* (such as public safety, general government, culture and recreation). Although the financial statements of most governments report expenditures by organizational unit, function, or program, the expenditures are typically charged initially to an object account.

Differences in Government-Wide Statements

Wages and salaries are already recognized on an accrual basis in the governmental funds; no change would be required by a shift to a full-accrual basis.

Changing the Pay Date by One Day

In Texas, as in many cities and states, state government employees receive their monthly paycheck on the first day of the month following that to which it is applicable. They used to receive it a day earlier, on the last day of the month. Why the change? In one year, the state needed additional funds to balance its budget. What better way than to move the pay date forward by one day, thereby shifting one complete payroll from the current fiscal year to the next? This scheme worked, of course, for budgeting purposes only because the state budgets on what is essentially a cash basis. For reporting purposes, however, most of the payroll accounted for in governmental funds is on a modified-accrual basis. Therefore, the expenditure must be reported in the fiscal year in which the employees earn their wages and salaries, irrespective of the date that the state actually makes the payment.

HOW SHOULD COMPENSATED ABSENCES BE ACCOUNTED FOR?

Governments compensate employees for time not worked for a variety of reasons: vacations, holidays, sick leave, sabbatical leave, jury duty, or military reserve. In concept, the accounting issues are similar to those of wages and salaries earned in one period but paid in another. But there are differences as well. Most significantly, compensated absences are earned in one period, but they are often not used or paid until several periods later. Hence, the liability cannot be considered current. In addition, the amount of compensation to be paid is not always certain. First, some employees may leave the organization before they take all the time off to which they are entitled. Second, the amount of compensation is almost always based on the employee's wage or salary rate in effect when the time off is taken, not when it is earned.

Accounting for Most Paid Leave

As in the private sector, government employees are almost always granted paid vacation after completing a specified period of service. Paid sick leave may be available even sooner. The number of vacation days generally varies with years of employment. While on vacation or sick leave, employees are paid at their current wage rate, irrespective of when they earned the leave. From their perspective, the pay they receive for vacation or sick days is usually indistinguishable from that received for working days. *Employers*, however, usually charge the expenditure to a vacation pay or sick leave pay account instead of their standard wages or salary account.

EXAMPLE: VACATION LEAVE

City employees earn $8 million in vacation leave. Of this amount, they are paid $6 million in 2018 and postpone the balance until future years. The leave vests (i.e., employees are legally entitled to it, even if they resign or are discharged) and can be taken any time up to retirement or as additional compensation at the time of retirement.

GASB Standards

The general approach of GASB Statement 101, *Compensated Absences*,[4] is to accrue a liability for compensated absences, which should be accrued (as a liability) as the benefits are earned by the employees if all of the following conditions are met:

- The employees' rights to receive compensation are attributable to services already rendered.
- The unused leave is carried forward to future periods (i.e., it accumulates).
- It is more likely than not (i.e., greater than 50 percent probability) that the employer will compensate the employees for the benefits through paid time off or some other means, such as cash payments at termination or retirement.

The compensation should be based on the wage or salary rates in effect at the balance sheet date, and employers should adjust for benefits that are expected to lapse.

Although this guidance may appear to support accrual of paid leave, there is a catch. GASB standardsexpla in that liabilities for compensatedabse ncearenormallyl iquidated with expendable available resources in the periods in which the payments to employees are made. Therefore, both the vacation pay expenditures and the related fund liabilities should be recognized intheperiodsin which the paymentsaredue. Until those periods, the liabilities should bereported only onthegovernment-widestatementof netposition and a schedule of long-term obligations, not on a governmental funds balance sheet.

The following entry, in the general fund or other appropriate governmental fund, would give effect to the GASB standards:

Expenditures—Vacation pay	$6	
Cash (or wages payable)		$6

To record vacation pay

The $2 million postponed until future periods should not be recognized as either an expenditure or a liability in the governmental fund. Instead, it should be reported only on the government-wide statement of net position and a schedule of long-term obligations.