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K. K. Raman

R. Michael Moore

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Current Problems in Governmental Revenue and Expenditure Recognition

By K. K. Raman and R. Michael Moore

The objective of this article is to discuss some conceptual and practical issues in current generally accepted accounting principles (GAAP) for governments. The article is restricted to a discussion of the Governmental Funds, which are unique in that the measurement focus is not net income but rather the sources and uses of financial resources.[1]

The rules for recognizing revenue and expenditure[2] (the inflow and outflow of financial resources) in the governmental context are just as important as the rules for recognizing revenue and expense in the corporate context. Just as the "bottom-line" of a corporate income statement is a significant measure of business performance, and as such may prompt so-called "management" of the income statement,[3] the bottom-line of a municipality's statement of revenues and expenditures signals the presence of an excess or deficit of revenues over expenditures. Municipal officials may be motivated to show an excess of revenues in order to demonstrate that the city is not in financial difficulty. However, a large excess of revenues over expenditures may invite criticism that the level of taxes is needlessly high, or it may encourage excessive demands from employee unions. Governmental organizations appear to be motivated to show that revenues at least equal expenditures (to satisfy creditors and rating agencies), as well as to demonstrate future need so that contributions and grants will continue to be forthcoming and to stem the tide of tax and expenditure limitation activities.

Revenue Recognition

It should be understood first that revenue in governmental accounting is not the same concept as revenue in corporate accounting. In the corporate context, a revenue is an increase in owners' equity resulting from the operations of the entity. Revenue is recognized upon the occurrence of a critical event, such as a sale, in the earnings cycle. If the receivable is a long-term receivable, revenue is recognized for the amount of its present value.

In governmental accounting, the measurement focus is *not* on the determination of net income, and most increases in financial resources resulting from the operations of the governmental unit are considered revenue. Prior to the National Council on Governmental Accounting (NCGA) Statement No. 1, all inflows of financial resources were labeled as revenues; Statement No. 1 now requires that the proceeds from borrowing and operating transfers between funds be reported separately as "other financing sources."

If governmental revenues were recognized on a cash basis, then the meaning of "financial resources" would be clear-cut and unambiguous, i.e., financial resources would mean cash. However, current technical literature requires that revenues be recognized on a modified accrual basis. Practical application of this principle means that some revenue items are recognized on a cash basis and others on an accrual basis. Thus, for example, miscellaneous revenues such as parking meter collections and fines are recognized only when cash is received. Other revenues, e.g., sales tax and revenue sharing, may be recorded when information (about the amount) is received from the higher governmental unit, even though actual receipt of the monies may be delayed for some months. This discussion suggests that financial resources may be the same thing as cash and receivables. In corporate accounting, as guided by Accounting Research Bulletin (ARB) 43, all receivables collectible within 12-months of the end of the fiscal period are classified as current. As we shall see, this 12-month concept does not always apply in governmental accounting.

NCGA Interpretation No. 3: Property taxes are an important revenue item and property tax receivables are to be recognized on an accrual basis. Interpretation No. 3 requires that property tax revenue for taxes due and uncollected at year end be recognized only to the extent that the receivables are collectible generally within 60 days of the end of the fiscal period. Thus in this case only 60-day (rather than 12-month) receivables qualify as financial resources.

Lease Purchase Agreements Where Government is the Lessor: Guidance on accounting for leases was provided recently in NCGA Statement No. 5. For situations where a government is the lessor and has financial resources in the form of lease payments *coming in*, the NCGA requires that on the signing of the lease a receivable be recorded in the general fund for the gross amount (not present value) of the lease payments. The

receivable being long-term is therefore not recognizable as revenue and is offset by a liability (deferred revenue). Lease payments are not to be accrued but recorded as revenue only when received in cash. Clearly, in this instance only cash and no portion of the receivables qualifies as a financial resource for revenue recognition purposes.

Joint Ventures: A governmental unit may enter into a joint venture with other governments or private parties. The discussion here is restricted to joint ventures where the investment is/was made from the Governmental Funds.

Use of the equity method (APB Opinion No. 18) by the participating government would not be consistent with the established financial resources concept of revenue recognition, since the joint venture may not necessarily distribute all of its earnings. On what basis, then, should the governmental unit recognize from joint ventures? In other words, should revenue be recognized when earned or only if the amount is expected to be collected either 1) within 12-months of the end of the fiscal period, or 2) within 60-days of the end of the fiscal period, or 3) only when received in cash?

NCGA rules to date do not provide explicit guidance on how revenues from governmental fund joint ventures are to be accounted for. Wide diversity is therefore to be found in current practice, reducing the comparability of the financial reports of different governmental units.

Safe Harbor Leases: The Economic Recovery Tax Act of 1981 (ERTA) introduced the safe harbor lease concept, under which an entity (such as a firm incurring a loss or a governmental unit) unable to take advantage of accelerated depreciation deductions and the investment tax credit may sell those benefits to another firm. In such a lease, the governmental unit (the lessee) enters into a sale-leaseback transaction with a firm with taxable income (the lessor-buyer). The sale of the property is recognized as sale for federal income tax purposes only.

While the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) curtailed safe harbor leasing in the private sector, governmental units may continue to use safe harbor leasing for mass transit vehicles until at least 1987. To take an example,[4] assume that a city sells and leases back buses worth $2 million to a private firm. The firm pays the city $300,000 (which is less than the present value of the ACRS depreciation benefits that the firm obtains on the buses). The firm (lessor-buyer) borrows the remaining money ($1.7 million) required to buy the buses from the city (lessee-seller) by giving the city a note for $1.7 million. "The note is actually a "phantom debt," for the lessor-buyer's debt service obligations under the note are set exactly equal to the lessee-seller's lease payment obligations under the lease. These two sets of obligations cancel each other out and, except for the down payment, no money or payments change hands between the lessor-buyer and the lessee-seller.[5]

> Ambiguities appear to be pervasive in the current authoritative literature.

The $300,000 payment in the above example can be made at the inception of the lease or at a mutually-agreed upon later point in time (in which case the amount would presumably be larger to compensate for the time value of money). The inflow of $300,000 is clearly an increase in financial resources, and revenue could be recognized if the amount were expected to be collected either 1) within 12-months of the end of the fiscal period, or 2) within 60-days of the end period of the fiscal period, or 3) only when received in cash. To date NCGA has not provided definitive guidelines on safe harbor leasing and the related revenue recognition issues.

An Ambiguous Situation: The primary problem facing governmental units and CPAs is deciding what "financial resources" means. As discussed above, financial resources can mean 12-month receivables, 60-day receivables, or cash, *depending on the source of revenue*. This problem is compounded by the fact that the recognition of *expenditure*, which is discussed in the next section, is sometimes contingent on the availability of financial resources. Accordingly, governmental units and CPAs can find themselves in an untenable position where existing revenue recognition ambiguities directly impact the accounting for certain significant expenditures.

Expenditure Recognition

An expenditure is an outflow of financial resources. The general rule is that expenditures should be recognized in the fiscal period in which the liability is incurred. NCGA Statement No. 1 does not place an explicit limit on the liability in terms of the number of days beyond the end of the fiscal period by which the liability must be paid-off, i.e., the NCGA has not defined a current liability in governmental accounting. In contrast, as discussed earlier, uncollected property tax revenues may generally be recognized only if cash is expected to be collected within 60 days of the end of the fiscal period.

Lease Purchase Agreements Where Government is the Lessee: In a lease purchase agreement, the lessee has a long term obligation which will be liquidated by periodic lease payments. NCGA Statement No. 5 requires the present value of the payments to be recognized as an expenditure when the lease is entered into, with the long term portion recorded as an "other financing source". (This is the only such NCGA requirement, and differs from other expenditure recognition criteria discussed later). In subsequent periods, Statement No. 5 requires that expenditure for lease payments (which represent both principal and appropriate interest) be recognized only in the period payment is actually made, i.e., that interest on lease obligation is *not* to be accrued. In this case, "financial resources" is clearly defined to mean cash — i.e., recognize the expenditure only when cash is actually paid out.

NCGA Statement No. 4: This Statement seeks to provide guidance on accounting for loss contingencies and compensated absences. With regard to contingencies, FASB Statement No. 5 criteria apply, i.e., a liability should be recognized when liability has been incurred and the amount of the loss can be estimated. However, at least a portion of this liability is likely to be of a long-term nature, since there is usually a significant time lag between

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the occurrence of the loss contingency, its adjudication, and finally its payment. For this reason, NCGA Statement No. 4 requires the expenditures from loss contingencies and compensated absences to be recorded in the current period only for the amount to be liquidated with "expendable available financial resources".

The phrase "expendable available financial resources" remains undefined by the NCGA. As we have seen, financial resources can mean either cash or varying portions of receivables, depending on the source of revenue. A second and more important concern in applying NCGA Statement No. 4 arises when a governmental unit has insufficient "expendable available financial resources," i.e., its cash and qualifying receivables are more than offset by short-term liabilities. In such an event, apparently no portion of the anticipated payment for loss contingencies and compensated absences should be recorded as expenditures. This appears to be a clear departure from the general rule that expenditures be recorded when incurred rather than be subject to the availability of financial resources. Statement No. 4 appears to reflect a reluctance on the part of the NCGA to compel cities to record an expenditure when the result might be a negative fund balance.

The ambiguity in NCGA Statement No. 4 has led one Big-8 firm to develop its own definition for expendable available financial resources to be "cash or near-cash assets adjusted for the amount of property taxes to be received within 60 days of year end to the extent that such amount does not exceed the total of the designated and undesignated fund balances." The point is that governmental units and CPAs are being compelled to develop their own understanding of an important concept. Without clear guidance on this issue, the present situation may result in considerable variation in practice — to the detriment of the comparability of financial reports of different governmental units.

NCGA Statement No. 6: This is the most recent Statement issued by the NCGA and relates to pension accounting. It requires governmental employers to record an expenditure only for the amount of the actuarially determined contribution requiring use of "expendable available financial

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resources." It appears, therefore, to be substantively similar to NCGA Statement No. 4.

NCGA Exposure Draft: Recently, the NCGA has issued an exposure draft[6] (ED) which recommends that all expenditures be recorded when incurred. However, the NCGA is still faced with the problem that certain expenditures (e.g., loss contingencies and pensions) result in long-term liabilities, and therefore do not require "current resources." "Current resources" is a new undefined phrase used in the ED and presumably means the same thing as expendable available financial resources. The ED recommends that while an expenditure should be recorded for the full amount incurred, any portion of that expenditure not requiring "current resources" should be shown as an "other financing source." This is the NCGA Statement No. 5 approach discussed above under "Lease Purchase Agreements Where Government is the Lessee" (pp. 7-8). This treatment is confusing if not strange; however, the net effect will be to reduce the Governmental Fund balance only for the amount requiring use of "current resources."

Conclusions and Suggestions

The "revenue-expenditure" statement in governmental accounting shares significant common elements with the *corporate* "Statement of Changes in Financial Position." Under APB Opinion No. 19, corporations may use one of the three alternative concepts of "financial resources" in their statement of changes in financial position — cash, working capital, or "all financial resources." What is problematical in governmental accounting is that different concepts of financial resources (either cash or varying portions of receivables) are being applied

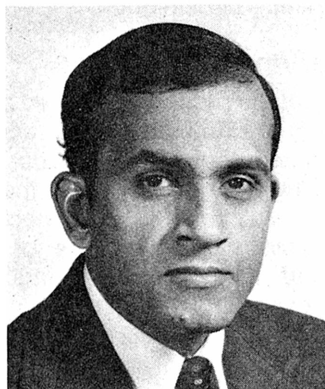
simultaneously. The NCGA (or the GASB) needs to adopt a single concept of financial resources based on the perceived needs of the users of governmental financial statements. A uniform GAAP definition of financial resources will serve to enhance the comparability of the financial statements of different governmental units. In this section, some tentative suggestions are offered.

In evaluating the information needs of financial statement users in the *corporate* context, the Financial Accounting Standards Board[7] (FASB) has expressed a preference for the use of the cash concept in the statement of changes in financial position. The cash concept is objective since it is free from the influence of accounting allocations and accruals, and may provide a good basis for comparing the activities of different enterprises. The FASB believes that a statement of cash inflows and outflows will be useful for the assessment of the amount, timing and uncertainty of future cash flows. However, in governmental accounting the "revenue-expenditure" statement is the *only* operating statement, i.e., the burden of adequate disclosure is not shared by an income statement and a statement of changes in financial position. Since cash flows are influenced by variations in the timing of receipts and payments, the use of the cash concept in governmental accounting may not provide an overall fair representation of the activities of the period.

The NCGA appears to prefer a concept of revenue recognition in governmental accounting which is tied to the receipt or anticipated availability of cash soon enough after year-end to pay the current year's bills. If the definition of "soon enough after year-end" in terms of a short arbitrary cutoff related to the normal bill-paying cycle (as does NCGA Interpretation No. 3), is acceptable, then similar specific guidance should be provided for all major revenue sources.

On the expenditure side, it may be possible for some governmental units to delay their creditors beyond the normal-bill paying cycle. In the interest of conservatism,[8] a longer cutoff for expenditure recognition is favored. Recommended is a consistent and well defined cutoff which follows the corporate concept of recognizing as current liabilities those amounts expected to be paid during the 12 months of the ensuing fiscal year, without making the recognition of expenditures contingent on the availability of financial resources. Thus, all expenditures would be recorded as incurred if it is expected that the related liability will be paid off within 12 months of the end of the fiscal period. Liabilities expected to be liquidated beyond the end of the next fiscal year should be considered to be long-term and reported in the "General Long-Term Debt Account Group."

The efforts in recent years by the NCGA to provide guidance for governmental accounting and financial reporting should be applauded. The NCGA's pronouncements go a long way toward meeting the needs of government finance officials and their auditors for clearly defined accounting principles. However, the concerns discussed in the preceding pages indicate a need for more explicit and consistent guidance in accounting for governmental revenues and expenditures. The NCGA and the GASB are encouraged to address these concerns in order to provide governmental accountants and auditors with a body of literature that sets a clear and uniform standard in both theory and practice. Ω



K.K. Raman *is associate professor of accounting at North Texas State University. His teaching and research interests are in governmental and public utility accounting and financial reporting. His articles have appeared in a variety of academic and professional journals.*

R. Michael Moore *is with an electric utility holding company based in Dallas. Prior to that he was a senior manager in the Dallas office of Peat, Marwick, Mitchell & Co. Mr. Moore specialized in serving governmental units including the cities of Austin and Dallas, Texas, as well as over a dozen other cities, counties, and agencies in Texas.*

NOTES

1"Financial resources" is a phrase used in NCGA Statement No. 1. The phrase itself is undefined.

2An "expenditure" is an asset outflow (reduction in financial resources occasioned by the payment or incurrence of a liability for goods acquired), to be contrasted with an "expense" which is a measure of asset expiration (the amount of goods and services consumed during a period).

3D. Graber and J. Jarnagin, "The FASB — Eliminator of 'Managed Earnings' "? *Financial Analysts Journal* March-April 1979), pp. 72-76. *Wall Street Journal* "Slick Accounting Ploys Help Companies Improve Their Income," June 20, 1980, p. 1.

4This example is adapted from: *A Guide to Municipal Leasing* (MFOA, 1983).

5*A Guide to Municipal Leasing*, p. 24.

6"Basis of Expenditure Accounting and Financial Reporting," (Exposure Draft, 1983).

7FASB, "Reporting Funds Flows, Liquidity, and Financial Flexibility," (Discussion Memorandum, 1980); "Reporting Income, Cash Flows, and Financial Position of Business Enterprises," (Exposure Draft, 1981).

8In *corporate* accounting, conservatism is portrayed by the expression "anticipate no profit and provide for all possible losses." In governmental accounting we suggest conservatism to mean "do not recognize revenue if it is not expected to be collected within a short interval beyond the end of the fiscal period, but do recognize expenditure when incurred even if the liability will not be paid off within that same short interval."