Issues of Budgeting and Control

**Learning Objectives**

After studying this chapter you should understand:

- The key purposes of budgets
- The need for more than one type of budget
- The various ways of classifying expenditures
- The benefits of performance budgets
- The key phases of the budget cycle
- Why budgets are generally prepared on a cash basis
- The limitations of budget-to-actual comparisons
- How budgets enhance control
- The means by which governments incorporate budgets into their accounting systems
- How an encumbrance system prevents overspending
- The circumstances under which budgetary and encumbrance entries are most beneficial
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, 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, significant decisions—whether political or managerial—are reflected in their budgets. As also pointed out in Chapter 1, a key objective of financial accounting and reporting is assuring that an entity obtains and uses its resources in accordance with its budget. Budgeting exerts a major influence on accounting and 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, other 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 will describe budgetary procedures and related accounting practices mainly in the context of governments, most of the points can properly be extended to all 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 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 assure 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.

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**WHY IS MORE THAN ONE TYPE OF BUDGET NECESSARY?**

The benefits of the budgetary process cannot be fully achieved by a single budget or type of budget. A well-managed government or not-for-profit—just like a well-managed business—should prepare budgets for varying periods 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 construction of long-term assets
- **Flexible budgets,** which relate costs to outputs and are thereby intended to help control costs, especially those of business-types activities

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

A government’s **current or operating** budget covers its general fund. 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 jurisdictions the operating budget must, by law, be balanced. Public attention focuses on the 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 appropriation budgets be developed and approved for special revenue, debt service, or capital projects funds. 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.

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 and acquisition 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.

Capital budgets are closely tied to operating budgets. Each year a government must include current-year capital spending in its operating budget. If the capital projects are financed with debt, however, the capital expenditures will be offset with bond proceeds and will not affect the operating budget’s surplus or deficit.

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.

Enterprise funds, which account for business-type activities, 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 between fixed and variable amounts. Fixed budgets may be appropriate for governmental funds where the expenditures and level of activity are pre-established by legislative authorization. Flexible budgets are especially suited to enterprise funds in which the level of activity depends on customer demand.
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. Table 3-1 illustrates an excerpt of this type of budget for one department.

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, for example, 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.

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. The GASB recommends 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 source classifications include:

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

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

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• 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.
What Are the Key Phases of the Budget Cycle?

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. Comprehensive performance budgeting systems require managers to specify objectives, consider alternative means of achieving them, establish workload indicators, and perform cost-benefit analyses.

To be sure, other sound managerial approaches can overcome the limitations of object classification budgeting. Performance budgets, however, institutionalize effective decision processes and help assure that they are carried out.

The most common type of performance budgets are program budgets, whereby resources and results are identified with programs rather than traditional organizational units, and expenditures are typically categorized by activity rather than by object.

Table 3-2 illustrates an excerpt from a program budget. Program budgeting is discussed in detail in Chapter 14.

**What Are the Key Phases of the Budget Cycle?**

Budgeting practices in neither governments nor not-for-profits are standardized; they differ from entity to entity. However, irrespective of whether the budget is of object classification or performance type, in most organizations budgeting is a continuous, four-phase process:

- Preparation
- Legislative adoption and executive approval

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**Table 3–2**

**Excerpt from a Program Budget**

**Summary of Request**

<table>
<thead>
<tr>
<th>Agency Code:</th>
<th>111</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agency Name:</td>
<td>Department of Environmental Quality</td>
</tr>
<tr>
<td>Prepared By:</td>
<td>John Daily</td>
</tr>
<tr>
<td>Date:</td>
<td>08/01/04</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Goal 1: Improve Air Quality in Texas</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reduce Air Pollutants to Reach Federal Standards by 2008</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Implement EPA’s Ozone Policy</td>
<td>$10,500,000</td>
<td>$11,100,000</td>
<td>$11,000,000</td>
<td>$11,125,000</td>
<td>$11,125,000</td>
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<tr>
<td>Promote and Enforce Local Air Quality Programs</td>
<td>250,000</td>
<td>250,000</td>
<td>250,000</td>
<td>250,000</td>
<td>250,000</td>
</tr>
<tr>
<td>Reduce Air Toxics Emissions by 40 Percent b/w 2003 and 2009</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Implement Comprehensive Air Toxics Program</td>
<td>$4,800,000</td>
<td>$5,000,000</td>
<td>$5,000,000</td>
<td>$5,000,000</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>By 2009, Analyze 90 Percent of Potential Cases of Toxic Chemical Exposure Through Air Pollution</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Conduct Ongoing Studies of Toxic Chemical Exposure</td>
<td>500,000</td>
<td>500,000</td>
<td>500,000</td>
<td>1,250,000</td>
<td>1,250,000</td>
</tr>
<tr>
<td>Total, Goal 1</td>
<td>$16,050,000</td>
<td>$16,850,000</td>
<td>$16,750,000</td>
<td>$17,625,000</td>
<td>$17,625,000</td>
</tr>
</tbody>
</table>

| Goal 2: Improve Water Availability and Water Quality | | | | | |
| Increase Compliance to 90 Percent of Regulated Sites by 2009 | | | | | |
| Enforce Water Quality Standards | $4,200,000 | $4,200,000 | $4,000,000 | $4,000,000 | $4,000,000 |
| Monitor Maintenance Standards in Water Districts | 800,000 | 800,000 | 800,000 | 800,000 | 800,000 |
| By 2009, Increase by 12 Percent the Amount of Water Available for Beneficial Use | | | | | |
| Negotiate Water Rights with Local and Other Entities | 1,400,000 | 1,400,000 | 1,500,000 | 1,190,000 | 1,125,000 |
| Total, Goal 2 | $6,400,000 | $6,400,000 | $6,300,000 | $5,990,000 | $5,925,000 |
Budgets are most commonly prepared by an organization’s executive branch (e.g., the office of the mayor or executive director) and submitted to the legislative branch (e.g., a city council or board of trustees) for approval. In some jurisdictions, particularly states, the legislature may either prepare its own budget (a legislative budget as opposed to an executive budget) or join with the executive branch in developing a common budget.

Budgeting generally necessitates flows of policies and information to and from all parties involved in the budgetary process. Legislators, for example, will apprise the executive branch as to what they think is politically feasible for revenue measures. Department heads will inform the legislative or executive budget committees as to what they see as their requirements. The committees, in turn, will develop guidelines for funding priorities and establish ranges of funding increases and cuts.

The preparation of a budget requires both forecasts and estimates. Relatively few types of revenues can be determined accurately in advance of the budget period. These types are limited mainly to those that are contractually established (e.g., from lease agreements), have been previously promised (e.g., grants from other governments), or are set by law and affect a known number of parties (e.g., property taxes and special assessments). Most, however, depend on factors that are largely outside the government’s control. Most types of tax revenues, for example, are influenced by economic conditions; revenues from fines and fees are affected by the predilections of the citizenry.

Some expenditures are fixed by legislative fiat or can be determined accurately. Examples of these types of expenditures include salaries of key officials (assuming no turnover), grants to other organizations, acquisitions of equipment, payments of interest, and repayments of debt. Others, however, are affected by acts of God or man. Snow removal, parades for championship sports teams, repair of equipment, and purchases of fuel are some examples of unpredictable expenditures.

The literature of public budgeting is replete with descriptions of forecasting models and techniques. Yet, as is made clear in the accompanying description of budgeting at the federal level (“In Practice: Budgeting Cannot Be Divorced from Politics”), the models or techniques are no better than the underlying assumptions. Moreover, as indicated by testimony of a senior White House official, the forecasting techniques are not always as scientific as they might appear (see “In Practice: Federal Budgetary Legerdemain”). As might be expected, and as is evidenced by an actual study, the differences between actual results and budgetary estimates can be substantial (see “In Practice: Misestimating Revenues and Expenditures”).

Significant errors in budget estimates, irrespective of direction or cause, thwart the political process and may lead to a distribution of resources that misrepresent what was expressed by voters through their elected representatives. At the very least, as suggested by “In Practice: Budgeting Cannot Be Divorced from Politics,” they can make for colorful political contretemps. Insofar as budgets are used by investors or creditors, they may contribute to misguided fiscal decisions and misallocation of resources.

When the budget is presented to a legislature for consideration, it is typically turned over to one or more committees for review. In some legislatures, such as the U.S. Congress, the committees that act on revenues are separate from those that recommend expenditures. Moreover, the committees authorizing new programs may be different from those determining the amount to be spent on them. The committees
What Are the Key Phases of the Budget Cycle?

In Practice

Nothing indicates the political ramifications of budgetary projections as does an economic downturn. Consider, for example, the November 2002 gubernatorial election in New York.

According to the New York Times (October 17, 2002), state spending was sharply higher than anticipated and state revenues were sharply lower. “While no one disputed the numbers,” the Times noted, “in the overheated air of a campaign for governor, there was sharp disagreement over whether it came as a surprise.”

H. Carl McCall, the Democratic candidate for governor, charged that his Republican opponent, incumbent governor George E. Pataki, “built the budget on a foundation of shaky revenues and backroom deals.” Once the election was over, he predicted, the state would have to report a deficit of between $5 billion and $10 billion for the year.

Whereas the governor had predicted that general fund revenue would drop during the year by only 5 percent, in the first six months of the year they were down by 16 percent. Personal income taxes, which are the state’s prime revenue source, were projected to decline by only 10 percent, but in fact were down by 23 percent.

The governor, as might be expected, placed the blame for the forecasting errors on events beyond his control—in this case on the events of September 11, 2001 (an all-purpose excuse in the year following the World Trade Center disaster). Moreover, he asserted, the ultimate results may not be as bad as the six-month data would suggest, because taxes are not collected uniformly throughout the year.

Budgeting Cannot Be Divorced from Politics

The budget is executed (carried out) by an organization’s executive branch. In some jurisdictions, expenditures are assigned particular months or quarters by allotments or apportionments. Both allotments and apportionments are periodic allocations of funds to departments or agencies, usually made by the chief executive’s office, to assure that an entire year’s appropriation is not dissipated early in the period covered by the budget. They also prevent a department or agency from spending resources that may not be available in the event that actual revenues fall short of budgeted revenues.

As shall be discussed later in this chapter, governments integrate their budgets into their accounting systems. In that way they are able to monitor continually how revenues and expenditures to date compare with the amounts that have been estimated.
CHAPTER 3 / ISSUES OF BUDGETING AND CONTROL

Governments, like businesses, should issue interim financial statements to report on their progress in executing their budgets. Per the GASB Codification:

Appropriate interim budgetary reports should be prepared during the fiscal period to facilitate management control and legislative oversight of governmental fund financial operations. Such reports are important both to revenue and expenditure control processes and to facilitate timely planning and budgetary revisions.4

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4 Codification, Section 2900.103.

IN PRACTICE

When you project a federal budget, someone must make crucial economic assumptions. Many federal payments, such as Social Security, are tied to the inflation rate, so first you must decide what that rate is likely to be. Since income taxes depend on corporate profits and thus on Gross National Product (GNP), you need to know how much you can reasonably expect GNP to go up (or possibly even down). Interest payments on federal debt depend on the market interest rate, so you must have some idea of what that rate is likely to be. These numbers, and others, are interrelated: move one, and they all move.

Every forecaster, including the Office of Management and Budget (OMB), the Treasury, and the Congressional Budget Office (CBO), has a complex computer model of government finances and the economy. If you enter one set of numbers, the model will give you a complete, consistent set of output numbers on which the budget is based. But what are the “best” numbers and assumptions to use? That depends in large part on who your boss is. The OMB, in the executive office of the president, tends to generate numbers that will make the president look good—usually low inflation, high real growth, low interest rates, and a shrinking budget deficit.

David Stockman, head of the OMB during a portion of the Reagan administration, in his remarkable book The Triumph of Politics, tells how the Reagan administration arrived at its economic input numbers in the spring of 1981. Competing groups of experts were haggling over the numbers. As the deadline approached for locking up the Reagan budget, Stockman called in Murray Weidenbaum, chairman of the Council of Economic Advisers, and made a political deal. If Weidenbaum would agree to a “reasonably high” real growth rate, Stockman would accept whatever inflation rate was consistent with it.

When the “deal” was announced at the final economic meeting, there were grumbles from all of the contending factions. Finally someone turned to Weidenbaum and asked, “What model did this come from, Murray?”

“Weidenbaum,” wrote Stockman, “glared at his inquisitor a moment and said, ‘It came right out of here.’ With that he slapped his belly with both hands. ‘My visceral computer.’” And thus were determined the economic assumptions that would shape a $745 billion national budget.

ON WHAT BASIS OF ACCOUNTING ARE BUDGETS PREPARED?

In Practice

A study of 125 U.S. cities having populations more than 100,000 revealed substantial variances between estimated and actual revenues and expenditures.

For all revenues combined, sixty-eight cities (54 percent) overestimated revenues. Twenty-nine (23 percent) overestimated revenues by more than 5 percent and twenty (16 percent) underestimated them by more than 5 percent. Thus, 39 percent of the sample had variations greater than 5 percent.

For all expenditures combined, the average budget variance was considerably larger than for revenues. Eighty-nine cities (71 percent) overestimated expenditures. Of these, sixty-four (51 percent) overestimated expenditures by more than 5 percent. Eleven cities (9 percent) underestimated expenditures by more than 5 percent. Hence, 60 percent of the sample had variances greater than 5 percent.

This study revealed that budget estimates were significantly biased in the direction of conservatism. However, the data were drawn from a single year (1983), one of relative prosperity for local governments. Were the study repeated using data from the late 1980s and early 1990s, a period of economic lethargy, the bias might have been in the opposite direction.


Despite the importance of budgets and the influence of budgeting on financial reporting, both the GASB and the Financial Accounting Standards Board (FASB) establish generally accepted principles only for financial reporting, not for budgeting. Budgetary principles are established either by individual governments or organizations or by the governments or organizations that supervise them (e.g., states may establish the principles for their cities, towns, and districts; national associations may establish principles for their local chapters).
Although it lacks the authority to establish standards for budgeting, the GASB nevertheless recommends that governments prepare their annual budgets for governmental funds on the modified accrual basis—the same basis they are required to use for reporting on the governmental funds in their external financial statements.\(^5\)

The modified accrual basis does not allow for balance sheet recognition of long-term assets and debts. However, it does permit a wide array of transactions and events to be recognized when they have their substantive economic impact, not merely when they result in cash inflows and outflows.

Many governments, however, reject the GASB's advice. They opt to prepare budgets on a cash basis or a slightly modified cash basis.

Governments that budget on a cash basis assign revenues and expenditures to the period in which the government is expected to receive or disburse cash. Some governments modify the cash basis by requiring that encumbrances (commitments to purchase goods or services) be accounted for as if they were the equivalent of actual purchases. Others permit certain taxes or other revenues to be recognized in the year in which they are due rather than expected to be collected, as long as they are expected to be collected within a reasonable period of time.

Governments have valid reasons for budgeting on a cash basis. After all, bills must be paid with cash, not receivables or other assets; therefore, the required cash must be on hand in the year the payments have to be made. And goods or services must be paid for in the year of acquisition (or in the periods set forth in a borrowing agreement), not necessarily in the year or years in which the benefits will be received.

Correspondingly, when a government is able to defer payments, it need not have the cash on hand until disbursements are required. Taxpayers are understandably reluctant to part with their dollars so that the government can retain the cash as “savings” until the year needed. Suppose, for example, that government employees are permitted to defer until future years vacations that are earned in a current year. Although the services of the employees unquestionably benefit the period in which the vacations are earned, the government does not need—and the taxpayers might object to providing—the cash for the vacation payments until the employees actually take the vacations. Thus, in the face of a balanced budget requirement, the cash basis of accounting assures that the government receives in taxes and other revenues only what it is required to disburse.

The adverse consequences of the cash basis should not be overlooked. The cash basis may distort the economic impact of a government’s planned fiscal activities. A budget that is balanced on a cash basis may be decidedly unbalanced as to economic costs and revenues. It may give the appearance of a budget that has achieved interperiod equity when it really has not.

The cash basis permits a government to balance its budget by taking any number of steps that artificially delay cash disbursements and advance cash receipts. Consider, for example, the quintessential budget-balancing tactic employed by the federal government and a number of states and local governments: changing the date on which employees are paid from the last day of the month to the first of the next month. In the year of the change the government is able to pay its employees for one fewer payroll period than it would otherwise.

On the revenue side, a comparable scheme works equally well: advancing the due date of taxes or fees from early in the following budget year to late in the current year, thereby picking up an extra tax or fee payment in the year of the change. This

\(^5\)Codification, Section 1700.116.
tactic, like that of delaying the payday, can be employed only once for each revenue or expenditure. New devices (such as the uncommon ones described in “In Practice: Do Taxpayers Really Want Honest Budgeting?”) must continually be developed.

The deleterious consequences of cash basis budgeting are exacerbated by the use of fund accounting. Because each fund is a separate accounting entity, governments can readily transfer resources from a fund that has a budget surplus or that does not require a balanced budget to one that needs extra resources. Some governments budget interfund “loans” for the last day of one fiscal year and repayments for the first day of the next. Others delay, for one day, required payments from the general fund to other funds. Still others sell assets, sometimes to entities that they themselves created and control, and lease them back (as illustrated by “In Practice: Balancing the Budget by Selling Assets to Yourself”).

These “one shot” budget balancing techniques would generally not affect revenues and expenditures as reported in the annual financial statements. Governments must prepare the external financial reports of their governmental funds on a modified accrual basis. As defined by the GASB, the modified accrual basis requires that short-term loan proceeds, whether from another fund or from an outside source, be accounted for as liabilities rather than revenues. Similarly, most required outlays are reported as expenditures in the period to which they apply, irrespective of when they are actually paid.

Cash basis budgeting complicates financial accounting and reporting. Governments must maintain their accounts to facilitate preparation of two sets of reports—one that demonstrates compliance with the budgetary provisions and one in accordance with GAAP.

**What Cautions Must Be Taken in Budget-to-Actual Comparisons?**

As emphasized in Chapter 1, a primary objective of government financial reporting is to “demonstrate whether resources were used in accordance with the entities’ legally

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**In Practice**

A watchful accountant wrote an op-ed piece in a local newspaper pointing out several budgetary gimmicks, such as advancing the due date of tax payments, that the state comptroller had proposed to balance the budget. He was surprised by the response by a representative of the comptroller’s office in the form of a letter to the editor. The taxpayers, he asserted would much prefer the proposed “bookkeeping adjustments” to the alternative—a tax increase.

The comptroller’s representative may well be correct. The comptroller, an elected official, is no doubt far more politically astute than the accountant. But one wonders if the taxpayers would be equally willing to acquiesce to the proposed budgetary legerdemain if the question was posed as follows: Do you favor balancing the budget by (1) use of artificial bookkeeping devices that pass the cost of the government services that you enjoy today unto your children and grandchildren or (2) use of accounting that best captures the economic substance of the transactions in which the government engages even if it requires you to pay the full cost of the services that you enjoy today?

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**Do Taxpayers Really Want Honest Budgeting?**
CHAPTER 3 / ISSUES OF BUDGETING AND CONTROL

The differences between legally adopted budgets and the GAAP-based financial statements can be attributed to several factors. Among them are:

- **Differences in basis of accounting.** As previously noted, governments often prepare their budgets on a cash or near-cash basis, whereas their financial statements must be prepared on a modified accrual basis.

- **Differences in timing.** As shown in its budget, a government may appropriate resources for a particular project rather than for a particular period. For example, in approving resources for a construction project, the government will typically establish the total amount that can be spent. It will not allocate resources to specific years. By contrast, the annual report of the fund in which the project is accounted would have to present the expenditures year by year. Moreover, governments may permit departments to carry over to subsequent years resources not spent in the year for which they were budgeted. Thus, expenditures in a particular year may not have been budgeted in that year.

On April 1, 1991—April Fools Day—New York’s Governor Mario Cuomo announced the sale of Attica prison to the state itself for over $200 million—all of which was counted as general revenues. The buyer was a state agency that financed the purchase by floating bonds. The bonds were backed by the state and were, therefore, economic obligations of the state. The purchaser immediately leased the prison back to the state under terms specifying that the “rent” payments would be exactly equal to the debt service on the bonds. In essence, the state balanced its operating budget with a loan in the amount of the prison’s sale price. The benefits of the loan were reaped by the taxpayers of the year of the transaction; principal and interest will be paid by the taxpayers of the future.

In the previous year, the state sold its Cross Westchester Expressway to the New York Thruway Authority—also to itself—but that transaction was only for $20 million. Following the lead of its neighbor, New Jersey sold a portion of its highway system to a state-owned agency, the New Jersey Turnpike Authority.

One can only marvel at such ingenuity and wonder what these governments will do for an encore. Perhaps, they will repurchase the assets and sell them, at a profit, to the same or another state agency.

*Adopted budget.” Accordingly, generally accepted accounting principles dictate that governments include in their annual reports, as required supplementary information, a comparison of actual results with the budget for each governmental fund for which an annual budget has been adopted.*

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**DIFFERENCES IN HOW ACTUAL RESULTS ARE DETERMINED**

Whereas the GASB specifies the principles of accounting to which governments must adhere in reporting on their governmental funds, it is silent on those they can use in preparing their budgets. Unless a government reports its actual results using budgetary principles or its budget using generally accepted accounting principles (GAAP), a comparison between the budget and actual results would not be meaningful. Therefore, per Statement No. 34, the GASB now requires that governments present their budget versus actual comparisons on a **budgetary** basis and include a schedule that reconciles the budgetary and the GAAP amounts.

The differences between legally adopted budgets and the GAAP-based financial statements can be attributed to several factors. Among them are:

- **Differences in basis of accounting.** As previously noted, governments often prepare their budgets on a cash or near-cash basis, whereas their financial statements must be prepared on a modified accrual basis.

- **Differences in timing.** As shown in its budget, a government may appropriate resources for a particular project rather than for a particular period. For example, in approving resources for a construction project, the government will typically establish the total amount that can be spent. It will not allocate resources to specific years. By contrast, the annual report of the fund in which the project is accounted would have to present the expenditures year by year. Moreover, governments may permit departments to carry over to subsequent years resources not spent in the year for which they were budgeted. Thus, expenditures in a particular year may not have been budgeted in that year.

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• **Differences in perspective.** Governments may structure their budgets differently from their financial reports. For example, a government may budget on the basis of programs. The programs, however, may be financed by resources accounted for in more than one fund. Thus, the amounts expended in each of the funds cannot be compared to any particular line item in the budget.

• **Difference in the reporting entity.** As you will learn in Chapter 11, GAAP requires that a government’s reporting entity include organizations that are legally independent of the government yet, in political or economic reality, an integral part of it. For example, a city may create a financing authority—a separate legal entity—to issue bonds on behalf of the city. If the city has political control over the authority (e.g., the mayor appoints the majority of the governing board) or is responsible for its financial affairs (e.g., approves its budget), then GAAP dictates that the authority be reported upon in the city’s financial statements. Yet because the authority is a separate legal entity, the city may exclude it from its legally adopted budget.

Budget-to-actual comparisons may demonstrate either legal compliance or managerial effectiveness in adhering to budget estimates. One of the major improvements of the new GASB model over the old is that the new model requires governments to report their actual results and both their original and final appropriated budgets. Under the old model, governments could report only their amended (final) budget. For some governments, their final budget incorporates changes they authorized only after they were aware of the actual revenues and expenditures of the year. Thus, governments typically reported no significant variance between budgeted and actual amounts.

The GASB encourages, but does not require, governments to present in a separate column the variances (i.e., differences) between actual results and the budget. It recommends that the variances be based on the final rather than the original budget. However, inasmuch as governments must include columns that show both the original budget and the final budget—statement users can readily calculate the differences between actual results and the original budget as well as the changes in the budget that were authorized during the year.7

Table 3-3 presents the budget-to-actual comparison of Charlotte’s general fund.

---

7 GASB Statement No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, para. 130 (June 1999); see also GASB Statement No. 41, *Budgetary Comparison Schedules—Perspective Differences* (May 2003).
TABLE 3–3
Charlotte, North Carolina

Statement of Revenues, Expenditures, and Changes in Fund Balance—Budget and Actual General Fund
(Non-GAAP Basis)
For the Year Ended June 30, 2002

<table>
<thead>
<tr>
<th>Variance with Final Budget Positive (Negative)</th>
<th>Budgeted Amounts</th>
<th>Actual (Budgetary Basis)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Original</td>
<td>Final</td>
</tr>
</tbody>
</table>

**Revenues**

**Taxes—**

Property

- **Current year** $182,909 $182,909 $186,551 $3,642
- **Prior years** 3,136 3,136 3,648 512
- **Interest and penalties** 1,352 1,352 1,658 306
- **Less rebates** (2,031) (2,031) (2,587) (556)

**Total property** 185,366 185,366 189,270 3,904

Other

- **Sales** 37,327 37,327 33,435 (3,892)
- **Occupancy** 2,985 2,738 2,228 (510)
- **Rental car** 1,500 1,500 1,643 143

**Total other** 41,812 41,565 37,306 (4,259)

**Total taxes** 227,178 226,931 226,576 (355)

Intergovernmental—State of North Carolina

- **Utility franchise tax** 26,700 16,700 15,251 (1,449)
- **Inventory tax reimbursement** 6,459 4,900 4,530 (370)
- **Intangible tax reimbursement** 4,900 4,900 4,530 (370)
- **Beer and wine** 2,400 2,400 — (2,400)
- **Other** 2,260 2,153 1,526 (627)

**Total state of North Carolina** 42,719 32,612 23,798 (8,814)

Federal government—Grant income

- **177** 678 505 (173)

Mecklenburg County

- **ABC Board contribution** 2,192 2,192 1,431 (761)
- **Law enforcement services** 11,673 11,673 12,847 1,174
- **Other** 1,851 2,290 2,087 (203)

**Total Mecklenburg County** 15,716 16,155 16,365 210

Charlotte–Mecklenburg Board of Education

- **1,257** 1,257 1,332 75

Local municipalities—Service fees

- **1,396** 1,396 1,404 8

**Total intergovernmental** 61,265 52,098 43,404 (8,694)

Licenses, fees, and fines—

- **Business privilege licenses** 7,800 7,800 8,686 886
- **Motor vehicle licenses** 1,987 1,987 1,967 (20)
- **Solid waste fees** 8,912 8,912 9,027 115
- **Cable TV franchise** 5,300 5,300 5,638 338
- **Burglar alarm fines** 1,300 1,300 844 (456)
- **Parking fees** 2,880 2,880 2,915 35

(Continues)
# Table 3–3  
**Charlotte, North Carolina (Continued)**

**Statement of Revenues, Expenditures, and Changes in Fund Balance—Budget and Actual General Fund (Non-GAAP Basis)**

*For the Year Ended June 30, 2002*

<table>
<thead>
<tr>
<th>Revenues (continued)</th>
<th>Original</th>
<th>Final</th>
<th>Actual (Budgetary Basis)</th>
<th>Variance with Final Budget Positive (Negative)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other</td>
<td>3,021</td>
<td>3,031</td>
<td>3,463</td>
<td>432</td>
</tr>
<tr>
<td>Total licenses, fees, and fines</td>
<td>31,200</td>
<td>31,210</td>
<td>32,540</td>
<td>1,330</td>
</tr>
<tr>
<td>Investment earnings</td>
<td>5,100</td>
<td>4,392</td>
<td>4,925</td>
<td>533</td>
</tr>
<tr>
<td>Administrative charges—</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equipment services</td>
<td>$ 14</td>
<td>$ 2,371</td>
<td>$ 2,357</td>
<td>$(14)</td>
</tr>
<tr>
<td>Cost allocation</td>
<td>14,094</td>
<td>14,094</td>
<td>11,475</td>
<td>(2,619)</td>
</tr>
<tr>
<td>Total administrative charges</td>
<td>14,108</td>
<td>16,465</td>
<td>13,832</td>
<td>(2,633)</td>
</tr>
<tr>
<td>Charges for current services—</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private street cuts</td>
<td>2,000</td>
<td>2,000</td>
<td>1,920</td>
<td>(80)</td>
</tr>
<tr>
<td>Other</td>
<td>3,732</td>
<td>3,755</td>
<td>3,802</td>
<td>(1,953)</td>
</tr>
<tr>
<td>Total charges for current services</td>
<td>5,732</td>
<td>5,755</td>
<td>3,802</td>
<td>(1,953)</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>1,966</td>
<td>4,066</td>
<td>4,127</td>
<td>61</td>
</tr>
<tr>
<td>Total revenues</td>
<td>346,549</td>
<td>340,917</td>
<td>329,206</td>
<td>(11,711)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expenditures</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current—</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Public safety</td>
<td>187,448</td>
<td>188,068</td>
<td>187,820</td>
<td>248</td>
</tr>
<tr>
<td>Sanitation</td>
<td>32,596</td>
<td>32,204</td>
<td>31,059</td>
<td>1,145</td>
</tr>
<tr>
<td>General administration:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Finance</td>
<td>7,774</td>
<td>7,774</td>
<td>7,095</td>
<td>679</td>
</tr>
<tr>
<td>Human resources</td>
<td>2,286</td>
<td>2,286</td>
<td>2,140</td>
<td>146</td>
</tr>
<tr>
<td>City manager</td>
<td>3,871</td>
<td>3,878</td>
<td>3,698</td>
<td>180</td>
</tr>
<tr>
<td>Corporate communications</td>
<td>1,790</td>
<td>1,800</td>
<td>1,667</td>
<td>133</td>
</tr>
<tr>
<td>City attorney</td>
<td>1,360</td>
<td>1,360</td>
<td>1,350</td>
<td>10</td>
</tr>
<tr>
<td>Budget and evaluation</td>
<td>1,166</td>
<td>1,181</td>
<td>1,055</td>
<td>126</td>
</tr>
<tr>
<td>City council</td>
<td>1,078</td>
<td>1,092</td>
<td>1,092</td>
<td>—</td>
</tr>
<tr>
<td>Retiree health and life insurance</td>
<td>4,250</td>
<td>5,976</td>
<td>5,976</td>
<td>—</td>
</tr>
<tr>
<td>Elections office</td>
<td>1,562</td>
<td>1,562</td>
<td>1,548</td>
<td>14</td>
</tr>
<tr>
<td>Annexation</td>
<td>—</td>
<td>1,409</td>
<td>1,409</td>
<td>—</td>
</tr>
<tr>
<td>Other</td>
<td>1,738</td>
<td>2,761</td>
<td>2,086</td>
<td>675</td>
</tr>
<tr>
<td>Total general administration</td>
<td>26,875</td>
<td>31,079</td>
<td>29,116</td>
<td>1,963</td>
</tr>
<tr>
<td>Support services</td>
<td>15,433</td>
<td>18,425</td>
<td>15,718</td>
<td>2,707</td>
</tr>
<tr>
<td>Engineering and property management</td>
<td>23,888</td>
<td>21,874</td>
<td>19,300</td>
<td>2,574</td>
</tr>
<tr>
<td>Streets and highways:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Transportation</td>
<td>20,574</td>
<td>20,248</td>
<td>18,016</td>
<td>2,232</td>
</tr>
<tr>
<td>Street lighting</td>
<td>7,731</td>
<td>6,086</td>
<td>6,086</td>
<td>—</td>
</tr>
<tr>
<td>Total streets and highways</td>
<td>28,305</td>
<td>26,334</td>
<td>24,102</td>
<td>2,232</td>
</tr>
</tbody>
</table>

(Continued)
### TABLE 3–3
Charlotte, North Carolina (Continued)

Statement of Revenues, Expenditures, and Changes in Fund Balance—Budget and Actual General Fund (Non-GAAP Basis)
For the Year Ended June 30, 2002

<table>
<thead>
<tr>
<th></th>
<th>Original</th>
<th>Final</th>
<th>Actual (Budgetary Basis)</th>
<th>Variance with Final Budget Positive (Negative)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Expenditures (continued)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Current (continued)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Community planning and development:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Community relations</td>
<td>$ 1,059</td>
<td>$ 1,349</td>
<td>$ 941</td>
<td>$ 408</td>
</tr>
<tr>
<td>City–County Planning Commission</td>
<td>4,166</td>
<td>4,169</td>
<td>3,772</td>
<td>397</td>
</tr>
<tr>
<td>United Arts Council</td>
<td>2,942</td>
<td>2,942</td>
<td>2,942</td>
<td>—</td>
</tr>
<tr>
<td>Convention Visitor’s Bureau</td>
<td>3,020</td>
<td>2,314</td>
<td>2,249</td>
<td>65</td>
</tr>
<tr>
<td>Other</td>
<td>1,084</td>
<td>2,270</td>
<td>2,042</td>
<td>228</td>
</tr>
<tr>
<td><strong>Total community planning and development</strong></td>
<td>$12,271</td>
<td>$13,044</td>
<td>$11,946</td>
<td>$1,098</td>
</tr>
<tr>
<td><strong>Total expenditures</strong></td>
<td>326,816</td>
<td>331,028</td>
<td>319,061</td>
<td>11,967</td>
</tr>
<tr>
<td><strong>Excess of revenues over expenditures</strong></td>
<td>$19,733</td>
<td>$9,889</td>
<td>$10,145</td>
<td>$256</td>
</tr>
<tr>
<td><strong>Other financing sources (uses)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales of capital assets</td>
<td>1,195</td>
<td>1,195</td>
<td>1,035</td>
<td>(160)</td>
</tr>
<tr>
<td>Transfers in—</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt service</td>
<td>35</td>
<td>35</td>
<td>35</td>
<td>—</td>
</tr>
<tr>
<td>Capital projects</td>
<td>1,476</td>
<td>1,783</td>
<td>1,783</td>
<td>—</td>
</tr>
<tr>
<td>Special revenue—Convention Center tax</td>
<td>—</td>
<td>1,050</td>
<td>1,050</td>
<td>—</td>
</tr>
<tr>
<td>Permanent—Perpetual care</td>
<td>140</td>
<td>140</td>
<td>117</td>
<td>(23)</td>
</tr>
<tr>
<td><strong>Total transfers in</strong></td>
<td>1,651</td>
<td>3,008</td>
<td>2,985</td>
<td>(23)</td>
</tr>
<tr>
<td>Transfers out—</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt service</td>
<td>16,600</td>
<td>15,868</td>
<td>15,868</td>
<td>—</td>
</tr>
<tr>
<td>Special revenue</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Public safety grants</td>
<td>944</td>
<td>3,569</td>
<td>3,471</td>
<td>98</td>
</tr>
<tr>
<td>Neighborhood development</td>
<td>4,038</td>
<td>3,571</td>
<td>3,535</td>
<td>36</td>
</tr>
<tr>
<td>Employment and training</td>
<td>997</td>
<td>990</td>
<td>936</td>
<td>54</td>
</tr>
<tr>
<td><strong>Total transfers out</strong></td>
<td>22,579</td>
<td>23,998</td>
<td>23,810</td>
<td>188</td>
</tr>
<tr>
<td><strong>Total other financing sources (uses)</strong></td>
<td>(19,733)</td>
<td>(19,795)</td>
<td>(19,790)</td>
<td>5</td>
</tr>
<tr>
<td>Revenues and other sources over (under) expenditures and other uses</td>
<td>$ —</td>
<td>$(9,906)</td>
<td>$(9,645)</td>
<td>$ 261</td>
</tr>
<tr>
<td><strong>Reconciliation to GAAP basis</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current year encumbrances</td>
<td></td>
<td></td>
<td></td>
<td>11,273</td>
</tr>
<tr>
<td>Prior year encumbrances</td>
<td></td>
<td></td>
<td></td>
<td>(9,871)</td>
</tr>
<tr>
<td><strong>Net change in fund balance</strong></td>
<td></td>
<td></td>
<td></td>
<td>(8,243)</td>
</tr>
<tr>
<td>Fund balance—beginning</td>
<td></td>
<td></td>
<td></td>
<td>100,613</td>
</tr>
<tr>
<td>Fund balance—ending</td>
<td></td>
<td></td>
<td></td>
<td>$ 92,370</td>
</tr>
</tbody>
</table>

The notes to the financial statements are an integral part of this statement.
to generate revenues and hence must adjust the level of services they provide to the corresponding level of revenues.

The general approach to budgeting suggested in this chapter for governments is relevant, with some obvious modifications, to not-for-profits. The budget process is the same four-phase process: preparation, adoption (although by a board of directors or trustees rather than a legislature), execution, and reporting and auditing.

Not-for-profits, of course, are not subject to the same types of penalties for violating budgetary mandates as governments are. Nevertheless, reliable estimates of revenues and expenditures are no less important. The consequences of underestimating costs or overestimating revenues are obvious. Not-for-profits, like businesses, are not guaranteed continued existence. The consequences of overestimating costs or underestimating revenues, while not as potentially devastating as the reverse, can also be severe—especially to the organization’s intended beneficiaries. A homeless shelter may unnecessarily reduce the number of people that it serves; a church or synagogue can cut back programs that it otherwise could have provided; a private college may defer maintenance only to have to incur greater costs to play catch-up in the future.

**HOW DO BUDGETS ENHANCE CONTROL?**

Owing to the adverse consequences of violating budgetary mandates, both governments and not-for-profits can build safeguards into their accounting systems that help assure budgetary compliance. These include preparing journal entries both to record the budget and to give recognition to goods and services that have been ordered but not yet received. We begin the discussion by describing the basic books of account maintained by governments and not-for-profits and showing how they accommodate these safeguards.

The basic books of account of both governments and not-for-profits correspond to those of businesses. They consist, either in manual or electronic form, of:

- **Journals**, in which journal entries are recorded. Most transactions are entered initially in a special journal, such as a property tax cash receipts journal, a parking fines cash receipts journal, a purchases journal, or a cash disbursements journal. Both nonroutine transactions and account totals from special journals are recorded in a general journal.

- **Ledgers**, in which all balance sheet and operating accounts are maintained. The general ledger consists of control accounts that summarize the balances of the detailed subsidiary accounts that are maintained in subsidiary ledgers.

A city or other general purpose government is likely to maintain hundreds of accounts. For example, the control account, general property taxes, may be subdivided as follows:

**General property taxes**
- Real property (e.g., land and buildings)
- Personal property
  - Tangible personal (e.g., business inventories, machinery, household furnishings, and vehicles)
  - Intangible personal (e.g., stocks, bonds, and bank deposits)

In addition, these accounts would be further divided into accounts for each individual taxpayer.
Similarly, one branch of the expenditure tree for police might be structured as follows (with only a small number of the object classification accounts displayed):

**Police**

Crime control and investigation
- Crime laboratory
  - Salaries
    - Regular
    - Overtime
  - Social Security contributions
- Rentals
  - Land and buildings
  - Equipment and vehicles
- Supplies
  - Custodial
  - Fuel
  - Office

As in a ledger for a business, each account consists of columns for debits, for credits, and for the balance (the difference between the two). However, the ledger accounts of governments (and some not-for-profits) incorporate budgetary control features not conventionally found in those of businesses.

The ledger accounts for revenues incorporate an additional debit column, estimated revenues. In this column the government posts the revenue side of an entry (to be described and illustrated in the next section) to record the budget. The difference between the estimated revenues (a debit), actual revenues recognized to date (credits), and any unusual adjustments (debts or credits) equals the amount of budgeted revenues still to be recognized. Thus, for example, the subledger account “Real Property Taxes” might appear as follows (dates and references omitted):

<table>
<thead>
<tr>
<th>Revenues—Real Property Taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated Revenues (Dr.)</td>
</tr>
<tr>
<td>15,000,000</td>
</tr>
<tr>
<td>1,100,000</td>
</tr>
<tr>
<td>500,000</td>
</tr>
</tbody>
</table>

Based on the data shown, the government budgeted real property tax revenue of $15 million and has recognized $3.9 million to date. Therefore, $11.1 million remains to be recognized.

Similarly, the ledger accounts for expenditures incorporate two extra columns. One column, appropriations, corresponds to estimated revenues. In this column the government posts a credit for the amount appropriated per the budget. In the second extra column the government posts, as debits, encumbrances—commitments to purchase goods or services. The difference between the appropriation (a credit), resources encumbered (debits), actual expenditures to date (also debits), and any unusual adjustments equals the amount of the appropriation that is still uncommitted.
and is therefore available to be spent (the unencumbered balance). Thus, crime laboratory expenditures might appear as follows:

<table>
<thead>
<tr>
<th>Appropriations (Cr.)</th>
<th>Encumbrances (Dr.)</th>
<th>Expenditures (Dr.)</th>
<th>Adjustments (Dr. or Cr.)</th>
<th>Unencumbered Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>300,000</td>
<td>50,000</td>
<td>250,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>30,000</td>
<td>220,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>15,000</td>
<td>165,000</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

This account indicates that the government appropriated $300,000 for the crime laboratory. To date it has spent $120,000 and has outstanding commitments for goods and services of $15,000. Therefore, it has $165,000 available for future spending.

**WHAT ARE THE DISTINCTIVE WAYS GOVERNMENTS RECORD THEIR BUDGETS?**

By recording its budget, a government builds into its accounting system a gauge that warns of excesses in spending and deficiencies in collections. This gauge serves only as an *internal* control function. The budgetary entries are reversed at year-end and have no impact on year-end financial statements. To external report users, budgetary entries are irrelevant. Nevertheless, because of their significance in controlling both revenues and costs, students need to be aware of how they affect the accounts.

Most students initially find budgetary entries counterintuitive and confusing. Mainly, that’s because when a government records its budget it *debits* estimated revenues and *credits* appropriations (in effect, estimated expenditures). Most students, of course, are used to crediting revenues and debiting expenditures. The practice of debiting estimated revenues and crediting appropriations makes sense, however, when you understand that each estimated revenue and appropriation account will be tied directly to its related *actual* revenue and *actual* expenditure account. (See “Example: Budgetary Entries” for a case in point.) The resulting differences equal the revenues yet to be recognized and the appropriations still available to be spent. Thus (ignoring encumbrances):

\[
\text{Estimated revenues (Dr.)} - \text{Actual revenues (Cr.)} = \text{Revenues still to be recognized}
\]

\[
\text{Appropriations (Cr.)} - \text{Actual expenditures (Dr.)} = \text{Balance available for expenditure}
\]

In a sense, the estimated revenue and appropriations accounts can be thought of as contra accounts to the actual revenue and expenditure accounts.

Moreover, the entries appear to put the cart before the horse. The difference between the debit to estimated revenues and the credit to appropriations is offset by fund balance. Thus, the entity’s fund balance may be increased or decreased upon merely adopting the budget—that is, wishes and whims—rather than actual transactions. Fortunately, as with other widely used bookkeeping procedures that allow accounts to be temporarily in error (e.g., periodic inventory methods), the entries cause no harm as long as appropriate adjustments are made prior to the preparation of financial statements.
EXAMPLE  Budgetary Entries

A school district adopts a budget calling for total revenues of $400 million and total expenditures of $390 million. The following entries would record the budget:

(b1) Estimated revenues $400
     Fund balance $400
     To record estimated revenues

(b2) Fund balance $390
     Appropriations $390
     To record appropriations (estimated expenditures)

The entries illustrated in this chapter will be made only to control accounts. In reality, corresponding entries would be made to the estimated revenue and appropriation subaccounts that support the control accounts. The sum of the debits and credits to the subaccounts should, of course, equal the entries to the respective control accounts.

Suppose that during the year both revenues and expenditures were as estimated and that all transactions were for cash. The transactions would be recorded with standard revenue and expenditure entries (with appropriate entries to the subaccounts as well):

(1) Cash $400
     Revenues $400
     To record revenues

(2) Expenditures $390
     Cash $390
     To record expenditures

At year-end, each of the budgeted and actual revenues and expenditures accounts would be closed (i.e., reversed) to fund balance. Thus:

(cl 1) Appropriations $390
     Fund balance 10
     Estimated revenues $400
     To close budgetary accounts

(cl 2) Revenues $400
     Expenditures $390
     Fund balance 10
     To close revenues and expenditures

The net effect of the entries is to increase fund balance by the difference between the actual revenues and expenditures—the same increase as would have been recorded had the budgetary entries not been made.

Suppose alternatively that actual revenues and expenditures differed from what were budgeted—for example, that actual revenues were $420 and actual expenditures were $415. Actual revenues and expenditures would have been recorded as follows:

(1a) Cash $420
     Revenues $420
     To record revenues
WHAT ARE THE DISTINCTIVE WAYS GOVERNMENTS RECORD THEIR BUDGETS?

Closing entries would take the same form as illustrated previously:

<table>
<thead>
<tr>
<th>Appropriations</th>
<th>Fund balance</th>
<th>Estimated revenues</th>
<th>Revenues</th>
<th>Expenditures</th>
<th>Fund balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>( \text{(cl 1a)} )</td>
<td>$390</td>
<td>10</td>
<td>$400</td>
<td>$420</td>
<td>$415</td>
</tr>
</tbody>
</table>

To close budgetary accounts

To close revenues and expenditures

In this situation, as shown in the T-accounts presented in Figure 3-1, year-end fund balance would again be the difference between actual revenues and actual expenditures. Actual revenues were $420 and actual expenditures were $415. Ending fund balance, after the closing entries have been posted, is thus $5—the same as if the budgetary entries had not been made.

The components of both the budgetary and the closing entries could, of course, have been combined differently. For example, appropriations and expenditures (rather than appropriations and estimated revenues) and revenues and estimated revenues (rather than revenues and expenditures) could have been closed in the same entry. The net impact on fund balance would have been the same.

**FIGURE 3-1** Illustration of Budgetary Entries

(Assuming Differences Between Budgeted and Actual Amounts)
Some governments maintain an account called budgetary fund balance. In recording the budget they debit or credit this account instead of fund balance. Budgetary fund balance is a temporary account. At year-end, the appropriations and estimated revenues are closed to this account, so that after the closing entries are made its balance is always zero.

Governments prefer (in some cases, must take) this approach so as to avoid contaminating the actual fund balance with appropriations and estimated revenues. The actual fund balance is affected only by authentic revenues and expenditures, which, as in the “Budgetary Entries” example, are closed at year-end, to fund balance. The account reflects only genuine transactions, not forecasts (and in some cases mere hopes) of what will occur during the year.

Thus, when the government adopted the budget, it would make the following entry:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated revenues</td>
<td>$400</td>
</tr>
<tr>
<td>Appropriations</td>
<td>$390</td>
</tr>
<tr>
<td>Budgetary fund balance</td>
<td>$10</td>
</tr>
</tbody>
</table>

To record estimated revenues and appropriations (estimated expenditures)

At year-end, irrespective of actual revenues and expenditures, the budgetary entry would be reversed:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Budgetary fund balance</td>
<td>$10</td>
</tr>
<tr>
<td>Appropriations</td>
<td>$390</td>
</tr>
<tr>
<td>Estimated revenues</td>
<td>$400</td>
</tr>
</tbody>
</table>

To close revenues and expenditures

During the year actual revenues and expenditures would be recorded in the normal manner, and at year-end they would be closed to the budgetary fund balance account.

**AN ALTERNATIVE METHOD: CREDITING OR DEBITING THE DIFFERENCE BETWEEN REVENUES AND EXPENDITURES TO “BUDGETARY FUND BALANCE”**

Governments and some not-for-profits record encumbrances to help prevent overspending the budget. The entry to record an encumbrance is usually prepared when a purchase order is issued, a contract is signed, or a commitment is made (e.g., when a university makes faculty and staff appointments for a semester or year). Most organizations do not encumber all anticipated expenditures. Many, for example, do not encumber salaries and wages, expenditures below a specified amount, and expenditures that are adequately controlled by other means.

The entry to record an encumbrance reduces the budgeted amount available for expenditure (as if the amount had already been spent) and concurrently designates a portion of what would otherwise be unreserved fund balance as reserved for encumbrances (i.e., for expenditures to which the organization is committed). The entry is reversed as the goods or services are received and expenditures are recorded, as shown in “Example: The Encumbrance Cycle—Year 1.”

Whereas both budgetary entries and encumbrances are mainly internal control devices, encumbrances are of slightly greater concern to external parties since they have a minor impact on the basic financial statements. Outstanding commitments at year-end are reported on the entity’s fund (not government-wide) balance sheet as a reservation of fund balance and accordingly reduce the unreserved portion of fund balance.
**EXAMPLE  The Encumbrance Cycle—Year 1**

A state university contracts for repair services that it estimates will cost $5,000. The following entry will reserve the funds to meet the anticipated expenditure:

\[
\begin{align*}
\text{Encumbrances} & \quad 5,000 \\
\text{Reserve for encumbrances} & \quad 5,000 \\
\text{To encumber $5,000 for repair services}
\end{align*}
\]

In addition to these control account entries, corresponding entries would be made in the repair-related subaccounts (e.g., encumbrances—electrical contractors).

The reserve for encumbrances account is a balance sheet account—a reservation of fund balance. The encumbrance account, although most definitely not an expenditure, is similar to an expenditure in that at year-end any remaining balance is closed to unreserved fund balance. The encumbrance account indicates the net amount that was transferred during the period from unreserved fund balance to fund balance reserved for encumbrances.

The repairs are completed and, as anticipated, the university is billed for $5,000. The repair expenditure must be recorded with the usual entry:

\[
\begin{align*}
\text{Expenditures} & \quad 5,000 \\
\text{Accounts payable} & \quad 5,000 \\
\text{To record repair expenditures}
\end{align*}
\]

In addition, the reserve for encumbrance is no longer required. The services have been received and the expenditure has been charged. The reserve must be eliminated by reversing the entry establishing it:

\[
\begin{align*}
\text{Reserve for encumbrances} & \quad 5,000 \\
\text{Encumbrances} & \quad 5,000 \\
\text{To reverse the encumbrance entry upon receipt of services}
\end{align*}
\]

At year-end the expenditures would be closed out in standard fashion, thereby reducing fund balance.

Consider two alternative possibilities. Assume first that the contractor completes the repairs but bills the university for only $4,800, not the encumbered $5,000. The university must now record an expenditure for the actual amount to be paid:

\[
\begin{align*}
\text{Expenditure} & \quad 4,800 \\
\text{Accounts payable} & \quad 4,800 \\
\text{To record repair expenditures}
\end{align*}
\]

As before, it must eliminate the entire reserve. With regard to the repairs, the university has no further commitment; it therefore needs no reserve:

\[
\begin{align*}
\text{Reserve for encumbrances} & \quad 5,000 \\
\text{Encumbrances} & \quad 5,000 \\
\text{To reverse the encumbrance entry upon receipt of services}
\end{align*}
\]

If the contractor’s bill were for more than the encumbered amount, the same approach would be taken. The expenditure would be charged for the amount to be paid; the full amount of the reserve would be eliminated. The university’s error in encumbering less than its actual commitment would have no consequences for financial reporting. At worst, it temporarily increased the university’s risk of overspending its budget.

As the second possibility, assume that in the current period the contractor completes only 40 percent of the repairs and accordingly bills the university for only $2,000. It expects to fulfill the remainder of its contract in the following period. In
this situation, only a part of the encumbrance entry can be reversed; the university still has an outstanding commitment for $3,000. Thus:

- **Expenditures**  $2,000
- **Accounts payable**  $2,000
  *To record repair expenditures*
- **Reserve for encumbrances**  $2,000
- **Encumbrances**  $2,000
  *To reverse the encumbrance entry upon the contractor’s completion of $2,000 of the $5,000 in anticipated services*

At year-end, the expenditures and the encumbrances would be closed to fund balance. (The reserve for encumbrances need not be closed because it is a balance sheet account.) Continuing with the last set of assumptions (expenditures of $2,000; balance in the encumbrances account of $3,000), the following closing entry would be in order:

- **Fund balance**  $5,000
- **Expenditures**  $2,000
- **Encumbrances**  $3,000
  *To close expenditures and encumbrances*

As a consequence of these entries, $3,000 of the university’s fund balance—the amount committed for completion of the repairs—remains reserved for encumbrances.

Governments differ in how they budget—and therefore how they account—for commitments outstanding (left over from the prior year). Many governments require that the cost of goods or services be charged against budgeted appropriations of the year in which they are received. In other words, all appropriations lapse at year-end. To satisfy its outstanding commitments, a government must reappropriate the funds for the following year or meet them out of whatever resources are budgeted for the following year within an applicable expenditure classification.

Other governments, either for all or only selected types of commitments (particularly long-term projects), allow appropriations to continue into future years. When the goods or services are received, they are charged against the budget of the year of appropriation.

In the circumstances in which appropriations lapse and the government charges the cost of goods or services against appropriations of the year in which they are received, the accounting for commitments made in a previous year is relatively simple, as is shown in “Example: The Encumbrance Cycle—Year 2.” At the start of the new year the government need only restore the encumbrances that were closed at the end of the previous year. This can be accomplished by reversing the closing entry (i.e., debiting encumbrances and crediting fund balance). By restoring the encumbrances, both the reserve for encumbrances (which, as a balance sheet account, was never closed) and the encumbrances would have the same balances as if the closing entries had not been made. Thereafter, the entries to record the fulfillment of the commitments would be the same as if the goods or services were received in the year the encumbrances and the reserve were initially established.
**EXAMPLE**  *The Encumbrance Cycle—Year 2*

At the end of the first year—the start of the second—the university had $3,000 of outstanding commitments for repairs. The following entry would restore the $3,000 of encumbrances for repairs:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Encumbrances</td>
<td>$3,000</td>
</tr>
<tr>
<td>Fund balance</td>
<td>$3,000</td>
</tr>
</tbody>
</table>

*To restore encumbrances at the start of the new year*

When the contractor completes the repairs, the university will charge expenditures for the amount billed and reverse the encumbrances and the reserve for encumbrances:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expenditures</td>
<td>$3,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$3,000</td>
</tr>
</tbody>
</table>

*To record repair expenditures*

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserve for encumbrances</td>
<td>$3,000</td>
</tr>
<tr>
<td>Encumbrances</td>
<td>$3,000</td>
</tr>
</tbody>
</table>

*To reverse the encumbrances entry upon the contractor’s completion of the remaining $3,000 of repairs*

The next example, “Impact of Encumbrances on Fund Balance,” highlights the impact of the encumbrance procedures on fund balance by focusing on a single commitment. Note that over the two-year period the total reduction in fund balance equals the total expenditures.

**EXAMPLE**  *Impact of Encumbrances on Fund Balance*

**Year 1**

As of January 1, a government’s general fund balance sheet shows the following:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$1,000</td>
</tr>
<tr>
<td>Fund balance—unreserved</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

8 If the appropriation does not lapse and the government charges the cost of goods or services against appropriations of the year in which the commitment was made, then the encumbrance should not be restored. Instead, when the commitment is fulfilled, the expenditure should be “dated” to indicate that it is applicable to the previous year. Thus, for example:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expenditures—Year 1 (prior year)</td>
<td>$3,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$3,000</td>
</tr>
</tbody>
</table>

*To record repair expenditures*

These expenditures would then be closed to the previously established reserve for encumbrances:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserve for encumbrances</td>
<td>$3,000</td>
</tr>
<tr>
<td>Expenditures—Year 1 (prior year)</td>
<td>$3,000</td>
</tr>
</tbody>
</table>

*To close expenditures for the previous year and eliminate the applicable reserve for encumbrances*
During the year, the government orders $1,000 of supplies (which are to be charged as expenditures when received):

(a)  
\[
\begin{align*}
\text{Encumbrances} & \quad \$1,000 \\
\text{Reserve for encumbrances} & \quad \$1,000
\end{align*}
\]
*To encumber $1,000 for supplies on order*

Part of the supplies order costing $800 is received and paid for in cash:

(b)  
\[
\begin{align*}
\text{Supplies expenditures} & \quad \$800 \\
\text{Cash} & \quad \$800
\end{align*}
\]
*To record the receipt of, and payment for, supplies*

\[
\begin{align*}
\text{Reserve for encumbrances} & \quad \$800 \\
\text{Encumbrances} & \quad \$800
\end{align*}
\]
*To reverse the encumbrance entry for the portion of the supplies order received*

The government prepares the following year-end closing entries:

(cl 1)  
\[
\begin{align*}
\text{Fund balance—unreserved} & \quad \$1,000 \\
\text{Encumbrances} & \quad \$200 \\
\text{Supplies expenditures} & \quad \$800
\end{align*}
\]
*To close encumbrances and expenditures*

**Year 2**

The government expects to honor its commitment for the supplies on order, and its budgeting policies dictate that the cost of the supplies on order be charged as expenditures of the year in which they are received. Therefore, at the start of the new year it restores the encumbrances that had been closed at the end of the prior year:

(d)  
\[
\begin{align*}
\text{Encumbrances} & \quad \$200 \\
\text{Fund balance—unreserved} & \quad \$200
\end{align*}
\]
*To restore encumbrances*

It receives, and pays for, the remainder of the supplies. However, the additional charges are only $150, not $200 as encumbered:

(e)  
\[
\begin{align*}
\text{Supplies expenditures} & \quad \$150 \\
\text{Cash} & \quad \$150
\end{align*}
\]
*To record the receipt of, and payment for; supplies*

\[
\begin{align*}
\text{Reserve for encumbrances} & \quad \$200 \\
\text{Encumbrances} & \quad \$200
\end{align*}
\]
*To reverse the encumbrance entry for the remainder of the supplies*

It prepares appropriate year-end closing entries:

(cl 2)  
\[
\begin{align*}
\text{Fund balance—unreserved} & \quad \$150 \\
\text{Supplies expenditures} & \quad \$150
\end{align*}
\]
*To close expenditures (Note: the balance in the encumbrances account is zero; it need not be closed.)*
Figure 3-2 summarizes the entries to the accounts. The government began the two-year period with an unreserved fund balance of $1,000. During the two years it incurred expenditures of $950. As shown in the T-account, its unreserved fund balance at the end of the second year is $50—the same as if an encumbrance system were not being employed. The fund’s balance sheet at the end of each of the two years and a schedule explaining the change in unreserved fund balance follow:

### Balance Sheet

<table>
<thead>
<tr>
<th></th>
<th>End of Year 1</th>
<th>End of Year 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$200</td>
<td>$50</td>
</tr>
<tr>
<td><strong>Fund balance</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reserve for encumbrances</td>
<td>$200</td>
<td>$0</td>
</tr>
<tr>
<td>Unreserved</td>
<td>$0</td>
<td>$50</td>
</tr>
<tr>
<td><strong>Total fund balance</strong></td>
<td>$200</td>
<td>$50</td>
</tr>
</tbody>
</table>

### Schedule of Changes in Unreserved Fund Balance

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Expenditures</td>
<td>$800</td>
<td>$150</td>
<td>$950</td>
</tr>
<tr>
<td>Excess of revenues over expenditures</td>
<td>(800)</td>
<td>(150)</td>
<td>(950)</td>
</tr>
<tr>
<td>Less: Increase/(decrease) in reserve for encumbrances</td>
<td>200</td>
<td>(200)</td>
<td>0</td>
</tr>
<tr>
<td>Net change in unreserved fund balance</td>
<td>(1,000)</td>
<td>50</td>
<td>$(950)</td>
</tr>
<tr>
<td>Add: Beginning of year balance</td>
<td>1,000</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td><strong>End of year balance</strong></td>
<td>$0</td>
<td>$50</td>
<td></td>
</tr>
</tbody>
</table>

*Note:* If the appropriations did not lapse, then the entry to restore the encumbrances would *not* have been made. Instead, when the goods were received, the following entries would be necessary:

**To record the receipt of, and payment for, supplies**

- Supplies expenditures—year 1 $150
- Cash $150

**To close the supplies expenditures for year 1 and eliminate the reserve for encumbrances**

- Reserve for encumbrances $200
- Supplies expenditures—year 1 $150
- Fund balance $50

---

**ARE BUDGETARY AND ENCUMBRANCE ENTRIES REALLY NEEDED?**

Some governments and most not-for-profits do not integrate their budgets into their accounting systems or encumber the cost of goods or services for which they are committed. Under what circumstances should they do so? The general answer is that they should do so when the benefits of added control are worth the costs (in both dollars and inconvenience).

Consistent with this answer, governments are more likely to establish these controls than are other not-for-profits because the penalties for overspending government budgets are likely to be more severe. Similarly, governments are more likely to
implement these mechanisms in their general fund than in some other governmental funds, such as their capital projects funds or their debt service funds, since adequate controls may already be in place in those funds. For example, sufficient controls over the cost of a capital project may be established simply by assuring that the agreed-upon price with the contractor is within the amount of bond proceeds. The expenditures of a debt service fund may be set by the payments of principal and interest spelled out in the bond indentures.

Modern computer systems make it possible for the controls provided by both budgetary entries and encumbrances to be achieved by means other than formal journal entries. For example, a government can simply “load” the budget into its computer. The computer can be programmed to issue a warning whenever actual expenditures and commitments exceed a specified percentage of budgeted expenditures.

Almost all aspects of management in government and not-for-profit organizations revolve around the entities’ budgets. The budget is at the center of planning, controlling, administering, evaluating, and reporting functions.

Budgets can take many forms. Appropriation budgets indicate governments’ estimated revenues and authorized expenditures. Capital budgets concentrate on long-lived assets. Flexible budgets, which governments use for enterprise funds, contain alternative budget estimates based on different levels of output. Performance budgets focus on measured units of effort and accomplishment and relate costs to objectives.

Most governments follow a four-phase cycle for budgeting: preparation, legislative adoption and executive approval, execution, and reporting and auditing.

For legislative purposes, most governments prepare cash or near-cash budgets. But these may fail to capture the economic cost of carrying out government activities and are not an adequate basis for planning and assessing results.

To demonstrate that they complied with their budgets, governments are required to include in their annual reports a budget-to-actual comparison on a budget basis (that is, the same basis on which they prepare their budget, usually cash or near-cash). However, the revenues and expenditures from the budget may not be readily comparable to those in GAAP-based statements. Differences may be attributable to basis of accounting (e.g., cash vs. modified accrual), timing (e.g., period over which a project will be completed vs. a single year), perspective (e.g., program vs. object classification),
and reporting entity (legal vs. economic). Therefore, governments must both explain and reconcile the differences between budgeted and actual amounts on a GAAP basis.

The accounting systems of governments are similar to businesses in that they use comparable journals and ledgers. However, they differ in that governments include corporate budgetary control features to ensure adherence to spending mandates. In addition, they encumber goods and services on order to prevent themselves from overcommitting available resources.

**EXERCISE FOR REVIEW AND SELF-STUDY**

To enhance control over both revenues and expenditures, a government health care district incorporates its budget in its accounting system and encumbers all commitments. You have been asked to assist the district in making the entries to record the following transactions:

1. **Prior to the start of the year, the governing board adopted a budget in which agency revenues were estimated at $5,600 (all dollar amounts in this exercise are expressed in thousands) and expenditures of $5,550 were appropriated (authorized). Record the budget using only the control (summary) accounts.**

2. **During the year, the district engaged in the following transactions. Prepare appropriate journal entries.**
   a. It collected $5,800 in fees, grants, taxes, and other revenues.
   b. It ordered goods and services for $3,000.
   c. During the year it received and paid for $2,800 of goods and services that had been previously encumbered. It expects to receive the remaining $200 in the following year.
   d. It incurred $2,500 in other expenditures for goods and services that had not been encumbered.

3. **Prepare appropriate year-end closing entries.**

4. **Prepare a balance sheet showing the status of year-end asset and fund balance accounts.**

5. **Per the policy of the district’s board, the cost of all goods and services are to be charged against the budget of the year in which they are received, even if they had been ordered (and encumbered) in a previous year. The next year, to simplify the accounting for the commitments made in the prior year, the district reinstated the encumbrances outstanding at year-end. Prepare the appropriate entry.**

6. **During the year, the district received the remaining encumbered goods and services. However, the total cost was only $150, rather than $200 as estimated. Prepare the appropriate entries.**

**QUESTIONS FOR REVIEW AND DISCUSSION**

1. Why is it important that governments and not-for-profits coordinate their processes for developing appropriations budgets with those for developing capital budgets?

2. Why may flexible budgets be more important to a government’s business-type activities than to its governmental activities?

3. What is the main advantage of an object classification budget? What are its limitations? How do performance budgets overcome these limitations?

4. Why do most governments and not-for-profits budget on a cash or near-cash basis even though the cash basis does not capture the full economic costs of the activities in which they engage?

5. A political official boasts that the year-end excess of revenues over expenditures was significantly greater than was budgeted. Are “favorable” budget variances necessarily a sign of efficient and effective governmental management? Explain.

6. What are allotments? What purpose do they serve?

7. Why may a government’s year-end results, reported in accordance with generally accepted accounting principles, not be readily comparable with its legally adopted budget?

8. The variances reported in the “final” budget-to-actual comparisons incorporated in the financial statements of many governments may be of no value in revealing the reliability of budget estimates made at the start of the year. Why? How can you rationalize this limitation of the budget-to-actual comparisons?

9. In what way will budgetary entries and encumbrances affect amounts reported on year-end balance sheets or operating statements?

10. Why do many governments consider it unnecessary to prepare appropriation budgets for, and incorporate budgetary entries into the accounts of, their capital projects funds?
CHAPTER 3 / ISSUES OF BUDGETING AND CONTROL

EXERCISES

3-1

1. Appropriation budgets are typically concerned with
   a. The details of appropriated expenditures
   b. Long-term revenues and expenditures
   c. Current operating revenues and expenditures
   d. Capital outlays

2. Which of the following types of budgets would be most likely to include a line item, “purchase of supplies”:
   a. Object classification
   b. Performance
   c. Capital
   d. Program

3. Per GASB Statement No. 34, an budget-versus-actual comparison must include columns for the actual results and
   a. The original budget only
   b. The final budget only
   c. Both the original and the final budgets
   d. Both the amended and the final budget

4. Apportionments are made during which phase of the budget cycle:
   a. Preparation
   b. Legislative adoption and executive approval
   c. Execution
   d. Reporting and auditing

5. In adopting and recording the budget a government should
   a. Debit estimated revenues and credit revenues
   b. Credit estimated revenues and debit fund balance
   c. Debit revenues and credit fund balance
   d. Debit estimated revenues and credit fund balance

6. In closing budgetary and expenditure accounts at year-end a government should
   a. Debit appropriations and credit expenditures
   b. Credit appropriations and debit expenditures
   c. Debit expenditures and credit fund balance
   d. Credit appropriations and debit fund balance

7. The prime function of budgetary entries is to
   a. Apportion appropriated expenditures to specific accounts
   b. Help the government monitor revenues and expenditures
   c. Amend the budget during the year
   d. Facilitate the end-of-year budget-to-actual comparisons

8. A government should debit an expenditure account upon
   a. Recording the budget
   b. Approving an apportionment
   c. Ordering supplies
   d. Recording the receipt of an invoice from its telephone service provider

9. If a government records the budget, and actual revenues exceed budgeted revenues, what would be the impact on the end-of-year finance statements?
   a. The difference between actual and budgeted revenues would not be reported on either the balance sheet or the statement of revenues and expenditures
   b. The difference between actual and budgeted revenues would be recorded as a budgetary reserve on the balance sheet
   c. The difference between actual and budgeted revenues would be shown as a revenue contra account on the statement of revenues and expenditures
   d. The actual revenues would be shown on the statement of revenues and expenditures as a deduction from estimated revenues

10. A “cash basis” budget relative to a “modified accrual basis” budget
    a. Better facilitates the preparation of year-end financial statements in accordance with generally accepted accounting principles
    b. Better facilitates the day-to-day management of an organization’s cash flows
    c. Limits the opportunities of an entity to balance its budget by arbitrarily delaying cash payments from one period to the next
    d. Better assures that a government will achieve interperiod equity

3-2

1. Upon ordering supplies a government should
   a. Debit encumbrances and credit reserve for encumbrances
   b. Debit reserve for encumbrances and credit encumbrances
   c. Debit expenditures and credit encumbrances
   d. Debit expenditures and credit vouchers payable

2. Upon receiving supplies that had previously been encumbered a government should
   a. Debit reserve for encumbrances and credit encumbrances
   b. Debit fund balance and credit reserve for encumbrances
   c. Debit expenditures and credit encumbrances
   d. Debit expenditures and credit vouchers payable

3. Upon closing the books at year-end a government should
   a. Debit fund balance and credit reserve for encumbrances
b. Debit encumbrances and credit reserve for encumbrances
c. Debit fund balance and credit encumbrances
d. Debit reserve for encumbrances and credit encumbrances

4. A government requires that all appropriations lapse at the end of a year. At the end of Year 1 that government has $100,000 of goods and services on order. At the start of Year 2 the government should
a. Debit fund balance and credit encumbrances
b. Debit reserve for encumbrances and credit encumbrances
c. Debit fund balance and credit encumbrances

d. Debit reserve for encumbrances and credit encumbrances

5. Which of the following accounts would a government be most likely to debit as part of its year-end closing process?
a. Appropriations, encumbrances, and estimated revenues
b. Estimated revenues, appropriations, and reserve for encumbrances
c. Revenues, appropriations, and encumbrances
d. Revenues, appropriations, and fund balance

6. A government places an order for a particular item of equipment and encumbers $5,500. The item arrives accompanied by an invoice for $5,200. The entries that the government should make should include (but not necessarily be limited to)
a. A debit to expenditures for $5,200, a debit to fund balance for $300, and a credit to reserve for encumbrances for $5,500
b. A debit to expenditures for $5,200, a credit to encumbrances for $5,200, and a credit to accounts payable for $5,200
c. A debit to expenditures for $5,200, a credit to encumbrances for $5,500, and a credit to accounts payable for $5,200
d. A debit to expenditures for $5,200, a credit to reserve for encumbrances for $5,200, and a credit to accounts payable for $5,200

7. A primary virtue of an object classification budget is that it
a. Covers a period of more than one year
b. Facilitates control in that it establishes detailed spending mandates
c. Shows the impact on the budget of various possible levels of output
d. Relates inputs to measurable outcomes

8. Per GASB Statement No. 34, governments must
a. Prepare a general fund budget on a cash basis
b. Prepare a general fund budget on a modified accrual basis
c. Prepare a schedule that reconciles any differences between amounts reported on a GAAP basis and a budgetary basis
d. Prepare a schedule that reconciles any differences between the original budget and the amended budget

9. The amount that a government has available to spend would be indicated by
a. Encumbrances minus the sum of appropriations, expenditures, and net adjustments
b. Reserve for encumbrances plus appropriations minus the sum of expenditures and net adjustments
c. Appropriations plus encumbrances minus the sum of expenditures and net adjustments
d. Appropriations minus the sum of expenditures, encumbrances, and net adjustments

10. For which of the following funds would a government be least likely to record its annual budget and thereby integrate it into its accounting system:
a. General fund
b. Special revenue fund
c. Capital project fund
d. Enterprise fund

3-3

A county engages in basic transactions.

Kilbourne County engaged in the following transactions in summary form during its fiscal year. All amounts are in millions.
1. Its commissioners approved a budget for the current fiscal year. It included total revenues of $860 and total appropriations of $850.
2. It ordered office supplies for $20.
3. It incurred the following costs, paying in cash:
   Salaries $610
   Repairs $ 40
   Rent $ 25
   Utilities $ 41
   Other operating costs $119
4. It ordered equipment costing $9.
5. It received the equipment and was billed for $10, rather than $9 as anticipated.
6. It received the previously ordered supplies and was billed for the amount originally estimated. The county reports the receipt of supplies as expenditures; it does not maintain an inventory account for supplies.
7. It earned and collected revenues of $865.
a. Prepare journal entries as appropriate.
b. Prepare closing entries as appropriate.
c. What would have been the difference in the year-end financial statements, if any, had the county not made the budgetary entries?

3-4

Encumbrances are recorded in a capital projects fund similar to a general fund.

Wickliffe County authorized the issuance of bonds and contracted with the USA Construction Company (UCC) to build a new sports complex. During 2004, 2005, and 2006
the county engaged in the transactions that follow. All were recorded in a capital projects fund.

1. In 2004 the county issued $310 million of bonds (and recorded them as “bond proceeds,” an account comparable to a revenue).
2. It approved the sports-complex contract for $310 million and encumbered the entire amount.
3. It received from UCC an invoice for construction to date for $114 million, an amount that the county recognized as an expenditure.
4. It paid UCC the amount owed.
5. In 2005 it received from UCC an invoice for an additional $190 million.
6. It paid the amount in full.
7. In 2006 UCC completed the sports facility and billed the county an additional $7 million. The county approved the additional costs, even though the total cost was now $311, $1 million more than initially estimated.
8. The county transferred $1 million from the general fund to the capital projects fund.
9. The county paid the $7 million.

a. Prepare the journal entries, including closing entries, to record the transactions in the capital projects fund. Assume that expenditures do not have to be appropriated each year. Hence, the county need not reestablish encumbrances at each year subsequent to the first. Instead, it can close the expenditures of the second and third years to reserve for encumbrances rather than fund balance.
b. What other funds, other than the capital projects fund, or schedules would be affected by the transactions?

3-5

Both budgeted and actual revenues and expenditures are closed to the fund balance.

The budgeted and actual revenues and expenditures of Seaside Township for a recent year (in millions) were as presented in the schedule that follows.

<table>
<thead>
<tr>
<th>Budget</th>
<th>Actual</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property taxes</td>
<td>$7.5</td>
</tr>
<tr>
<td>Sales taxes</td>
<td>2.1</td>
</tr>
<tr>
<td>Other revenues</td>
<td>1.6</td>
</tr>
<tr>
<td><strong>Total revenues</strong></td>
<td><strong>$11.2</strong></td>
</tr>
</tbody>
</table>

3-6

Encumbrance accounting has no lasting impact on fund balance.

London Township began Year 1 with an unreserved balance of $10 million in its bridge repair fund, a capital projects fund.

At the start of the year, the governing council appropriated $6 million for the repair of two bridges. Shortly thereafter, the town signed contracts with a construction company to perform the repairs at a cost of $3 million per bridge.

During the year the town received and paid bills from the construction company as follows:

- $3.2 million for the repairs on Bridge 1. The company completed the repairs, but owing to design changes approved by the town, the cost was $0.2 million greater than anticipated. The town did not encumber the additional $0.2 million.
- $2.0 million for the repairs, which were not completed, on Bridge 2.

At the start of the following year, the governing council reappropriated the $1 million to complete the repairs on Bridge 2. During that year the town received and paid bills totaling $0.7 million. The construction company completed the repairs, but the final cost was less than anticipated—a total of only $2.7 million.

1. Prepare journal entries to record the events and transactions over the two-year period. Include entries to appropriate, reappropriate, encumber, and reencumber the required funds, to record the payment of the bills, and to close the accounts at the end of each year.
2. Determine the unreserved fund balance at the end of the second year. Is it equal to the initial fund balance less the total cost of the repairs?

3-7

Encumbrances have an impact on unreserved fund balance, but do not affect total fund balance.

At the start of its fiscal year on October 1, Fox County reported the following (all dollar amounts in thousands):

<table>
<thead>
<tr>
<th>Fund balance:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserved for encumbrances</td>
</tr>
<tr>
<td>Unreserved</td>
</tr>
<tr>
<td><strong>Total fund balance</strong></td>
</tr>
</tbody>
</table>

During the year, the county (all dollar amounts in thousands):

- Estimated that revenues for the year would be $6,300.
• Appropriated $6,500 for operations.
• Ordered goods and services estimated to cost $6,000. Of these, the county received (and used) goods and services that it had estimated would cost $5,000. Actual cost, however, was $5,200.
• Received (and used) all goods that it ordered in the previous year. Actual cost was only $180.
• Recognized actual revenues of $6,400.

1. Prepare a schedule, similar to that illustrated in the text, of changes in unreserved fund balance.
2. Show how the total fund balance (including the reserved and unreserved portions) would be displayed at year-end.
3. Does the total fund balance at the beginning of the year, plus the actual revenues, minus the actual expenditures, equal the total fund balance at the end of the year?

PROBLEMS

Continuing Problem

1. In which section of the Comprehensive Annual Financial Report (CAFR) are the budget-to-actual comparisons of the major funds?
   a. Are the actual amounts on a GAAP or a budgetary basis? Do the statements include a reconciliation of any differences between GAAP and budgetary amounts? If so, what are the largest reconciling items?
   b. Are the reported variances based on the original budget or the end-of-year amended budget?
2. Does the CAFR include budget-to-actual comparisons of nonmajor funds? If so, in what section?
3. Does the government encumber goods or services that have been ordered but have not yet been received? How, if at all, are encumbrances reflected on the governmental fund balance sheet? How, if at all, are they reflected on the government-wide statement of net assets?
4. Do encumbrances outstanding at year-end lapse? That is, do the amounts that will be expended in the following year, when the goods or services are received, have to be rebudgeted in the following year? How can you tell?

3-1

Is accrual-based budgeting preferable to cash-based budgeting?

The Disability Research Institute receives its funding mainly from government grants and private contributions. In turn, it supports research and related projects carried out by universities and other nonprofit organizations. Most of its government grants are reimbursement (expenditure driven) awards. That is, the government will reimburse the institute for the funds that it disburses to others. The institute estimates the following as to the forthcoming year:

• It will be awarded $5,000,000 in government grants, all of which will be paid out to subrecipients during the year. Of this amount, only $4,500,000 will be reimbursed by the government during the year. The balance will be reimbursed in the first six months of the next year. The institute will also receive $200,000 in grant funds that were due from the previous year.
• It will receive $600,000 in pledges from private donors. It expects to collect $450,000 during the year and the balance in the following year. It also expects to collect $80,000 in pledges made the prior year.
• It will purchase new furniture and office equipment at a cost of $80,000. It currently owns its building, which it had purchased for $800,000, and additional furniture and equipment that it acquired for $250,000. The building has a useful life of twenty-five years; the furniture and equipment have a useful life of five years.
• Employees will earn wages and salaries of $340,000, of which they will be paid $320,000 during the forthcoming year and the balance in the next year.
• It will incur other operating costs of $90,000, of which it will pay $70,000 in the forthcoming year and $20,000 in the next year. It will also pay another $10,000 in costs incurred in the previous year.

1. Prepare two budgets, one on a cash basis, the other on a full accrual basis. For convenience show both on the same schedule, the cash budget in one column and the accrual in the other.
2. Comment on which budget better shows whether the institute is covering the economic cost of the services that it provides.
3. Which is likely to be more useful to
   a. Institute managers?
   b. Members of the institute’s board of trustees?
   c. Bankers from whom the institute seeks a loan?

3-2

Missing data can be derived, and journal entries constructed, from information in the accounts.

The following schedule shows the amounts related to expenditures that a nonprofit welfare organization debited
and credited to the indicated accounts during a year (not necessarily the year-end balances), excluding closing entries. The organization records its budget, encumbers all of its expenditures, and initially vouchers all payments.

Some information is missing. You are to determine the missing data and construct all entries (in summary form), excluding closing entries, that the organization made during the year.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$0</td>
</tr>
<tr>
<td>Vouchers payable</td>
<td>?</td>
</tr>
<tr>
<td>Estimated</td>
<td>expenditures</td>
</tr>
<tr>
<td>Appropriations</td>
<td>0</td>
</tr>
<tr>
<td>Encumbrances</td>
<td>?</td>
</tr>
<tr>
<td>Expenditures</td>
<td>30</td>
</tr>
<tr>
<td>Reserve for encumbrances</td>
<td>32</td>
</tr>
<tr>
<td>Fund balance</td>
<td>?</td>
</tr>
</tbody>
</table>

3-3

Missing data can be derived, and journal entries constructed, from information in the accounts.

The following schedule shows the amounts related to supplies that a city debited and credited to the indicated accounts during a year (not necessarily the year-end balances), excluding closing entries. The organization records its budget, encumbers all of its expenditures, and initially vouchers all payments. All revenue was collected in cash.

Some information is missing. By reconstructing the entries that the organization made during the year, you are to determine the missing data and construct the journal entries (in summary form), excluding closing entries.

<table>
<thead>
<tr>
<th>(in thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debits</td>
</tr>
<tr>
<td>Cash</td>
</tr>
<tr>
<td>Estimated revenues</td>
</tr>
<tr>
<td>Revenues</td>
</tr>
<tr>
<td>Vouchers payable</td>
</tr>
<tr>
<td>Appropriations</td>
</tr>
<tr>
<td>Encumbrances</td>
</tr>
<tr>
<td>Expenditures</td>
</tr>
<tr>
<td>Reserve for encumbrances</td>
</tr>
<tr>
<td>Fund balance</td>
</tr>
<tr>
<td>Credits</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>$117</td>
</tr>
<tr>
<td>?</td>
</tr>
<tr>
<td>0</td>
</tr>
<tr>
<td>70</td>
</tr>
<tr>
<td>54</td>
</tr>
<tr>
<td>?</td>
</tr>
<tr>
<td>32</td>
</tr>
<tr>
<td>?</td>
</tr>
<tr>
<td>115</td>
</tr>
</tbody>
</table>

3-4

A city imposes an overhead charge on one of its departments to alleviate its fiscal problems.

A city’s visitors’ bureau, which promotes tourism and conventions, is funded by an 8 percent local hotel occupancy tax (a tax on the cost of a stay in a hotel). Inasmuch as the visitors’ bureau is supported entirely by the occupancy tax, it is accounted for in a restricted fund.

You recently received a call from the director of the visitors’ bureau. She complained that the city manager is about to impose an overhead charge of a specified dollar amount on her department. Yet the statute creating the hotel occupancy tax specifies that the revenues can be used only to satisfy “direct expenditures” incurred to promote tourism and bookings at the city’s convention center. The manager says that she understands the city is having difficulty balancing its budget, but fails to see how the charge to her department will do much to alleviate the city’s fiscal problems.

1. In light of the city’s fiscal problems, what is the most likely motivation for the new charge? Will the new overhead charge achieve its objective?

2. What would be the impact of the new charge on the city’s annual fund financial statements, prepared in accordance with GAAP (which requires that the city account for its governmental funds on a modified accrual basis)? Would the impact be the same if the city accounted for its governmental funds on a cash basis?

3. What would be the impact of the new charge on the city’s government-wide statements in which all governmental funds are consolidated? Would it have an impact on reported net assets?

4. In what way might the charge have a substantive impact on the city’s economic condition?

5. Assuming that the city provided accounting, legal, and purchasing services to the visitors’ bureau, do you think the charge would be consistent with the statutory requirement that the hotel occupancy tax be used to meet only “direct expenditures” related to tourism and use of the convention center (an issue not addressed in this text)?

3-5

Government activities may be less “profitable” than they appear.

A city prepares its budget in traditional format, classifying expenditures as to fund and object. In 1999, amid considerable controversy, the city authorized the sale of $20 million in bonds to finance construction of a new sports and special events arena. Critics charged that, contrary to the predictions of arena proponents, the arena could not be fiscally self-sustaining.

Five years later, the arena was completed and began to be used. After its first year of operations, its general managers submitted the following condensed statement of revenues and expenses (in millions):

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues from ticket sales</td>
<td>$5.7</td>
<td></td>
</tr>
<tr>
<td>Revenues from concessions</td>
<td>2.4</td>
<td>$8.1</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>6.6</td>
<td></td>
</tr>
<tr>
<td>Interest on debt</td>
<td>1.2</td>
<td>7.8</td>
</tr>
<tr>
<td>Excess of revenues over expenses</td>
<td>$0.3</td>
<td></td>
</tr>
</tbody>
</table>
At the city council meeting at which the report was
submitted, the council member who championed the cen-
ter glowingly boasted that his prophecy was proving cor-
rect; the arena was “profitable.”

Assume that the following information came to your
attention:

1. The arena is accounted for in a separate enterprise
   fund.
2. The arena increased the number of overnight visi-
tors to the city. City administrators and economists
calculated that the additional visitors generated ap-
proximately $0.1 million in hotel occupancy tax rev-
enues. These taxes are dedicated to promoting
tourism in the city. In addition, they estimated that
the ticket and concession sales, plus the economic
activity generated by the arena, increased general
sales tax revenues by $0.4 million.
3. The city had to improve roads, highways, and utilities
   in the area surrounding the arena. These improve-
ments, which cost $6 million, were financed with gen-
eral obligation debt (not reported in the enterprise
fund). Principal and interest on the debt, paid out of
general funds, were $0.5 million. The cost of main-
taining the facilities was approximately $0.1.
4. On evenings in which events were held in the arena,
   the city had to increase police protection in the
arena’s neighborhood. Whereas the arena compen-
sated the police department for police officers who
served within the arena itself, those that patrolled
outside were paid out of police department funds.
The police department estimated its additional
costs at $0.1 million.
5. The city provided various administrative services (in-
cluding legal, accounting, and personnel) to the arena
at no charge at an estimated cost of $0.1 million.
6. The city estimates the cost of additional sanitation,
   fire, and medical services due to events at the center
to be approximately $0.2 million.

1. Would you agree with the council member that the
   arena was fiscally self-sustaining?
2. In which funds would the additional revenues and ex-
   penditures be budgeted and accounted for?
3. Comment on the limitations of both the traditional
   object classification budget and fund accounting sys-
tem in assessing the economic costs and benefits of a
project such as the sports and special events arena.
4. What changes in the city’s budgeting and accounting
   structure would overcome these limitations? What ad-
   ditional problems might these changes cause?

To what extent do the unique features of government account-
ing make a difference on the financial statements?
the department had available to spend in Year 2 on goods or services not previously ordered?

Different budget-to-actual comparisons serve different purposes. The following information was drawn from a county’s general fund budgets and accounts for a particular year (in millions):

<table>
<thead>
<tr>
<th>Actual Results (Budget Basis)</th>
<th>Amended Budget</th>
<th>Original Budget</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenues</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property taxes</td>
<td>$46.6</td>
<td>$42.5</td>
</tr>
<tr>
<td>Sales taxes</td>
<td>16.3</td>
<td>13.6</td>
</tr>
<tr>
<td>Licenses and permits</td>
<td>1.1</td>
<td>1.0</td>
</tr>
<tr>
<td>Other</td>
<td>3.2</td>
<td>2.9</td>
</tr>
<tr>
<td><strong>Total revenues</strong></td>
<td>$67.2</td>
<td>$60.0</td>
</tr>
<tr>
<td><strong>Expenditures</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>General government</td>
<td>$18.2</td>
<td>$16.2</td>
</tr>
<tr>
<td>Public safety</td>
<td>29.2</td>
<td>25.1</td>
</tr>
<tr>
<td>Sanitation</td>
<td>9.7</td>
<td>9.4</td>
</tr>
<tr>
<td>Culture and recreation</td>
<td>8.1</td>
<td>7.8</td>
</tr>
<tr>
<td>Interest</td>
<td>1.4</td>
<td>1.4</td>
</tr>
<tr>
<td><strong>Total expenditures</strong></td>
<td>$66.6</td>
<td>$59.9</td>
</tr>
<tr>
<td><strong>Excess of revenues over expenditures</strong></td>
<td>$ 0.6</td>
<td>$ 0.1</td>
</tr>
</tbody>
</table>

You also learn the following:

<table>
<thead>
<tr>
<th>Encumbrances (commitments)</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>outstanding</td>
<td>$2.7</td>
<td>$1.1</td>
</tr>
<tr>
<td>Supplies inventories on hand</td>
<td>1.8</td>
<td>1.0</td>
</tr>
<tr>
<td>Wages and salaries payable</td>
<td>0.5</td>
<td>0.7</td>
</tr>
</tbody>
</table>

1. Prepare the following four separate schedules in which you compare the budget to actual results and compute the budget variance. You need present only the total revenues, total expenditures, and excess of revenues over expenditures.
   a. Actual results on a budget basis to the amended budget
   b. Actual results on a budget basis to the original budget
   c. Actual results as would be reflected in the financial statements to the amended budget restated so that it is on a financial reporting basis
   d. Actual results as would be reflected in the financial statements to the original budget restated so that it is on a financial reporting basis

2. The county executive has boasted that the “better than anticipated results” (based on the comparison of the schedule that appears in the financial statements) are evidence of “sound fiscal management and effective cost controls” on the part of the county administration. Do you agree?


Budget variances have to be interpreted with caution.

The data presented below were taken from the books and records of the village of Denaville. All amounts are in millions. The village encumbers all outlays. As it is evident from the data, some goods or services that were ordered and encumbered have not yet been received. City regulations require that all appropriations lapse at year-end.

1. Prepare summary entries to record
   a. The budget
   b. The encumbrance of the goods and services
   c. The receipt of the goods and services (all invoices were paid in cash)
   d. The actual revenues (all cash receipts)

2. Prepare summary entries to close the accounts.

3. What would be the year-end
   a. Fund balance (unreserved)
   b. Reserve for encumbrance balance

4. Prepare a schedule comparing budgeted to actual revenues and expenditures.

5. A citizen reviews the budget-to-actual schedule that you have prepared. She comments on the rather substantial favorable variance between budgeted and actual expenditures and questions why the government did
A city’s note to its financial statements provides considerable insight into its budget practices.

Shown next is an excerpt from a note, headed Budgets, from the City of Raleigh, North Carolina’s annual report for the fiscal year ended June 30.

1. The note distinguishes between the “budget ordinance” and the “more detailed line item budgets.”
   a. Provide examples of expenditures that you would expect to see in the budget ordinance.
   b. Provide examples of expenditures that you would expect to see in the line-item budgets.
2. Why do you suspect that budgetary control is not exercised in trust and agency funds?
3. Generally accepted accounting principles require that governments reconcile differences between the entity’s budget practices and GAAP in either the financial statements themselves or in accompanying notes. Raleigh’s budget-to-actual comparison contained no such reconciliation. Why do you think a reconciliation was also omitted from the notes?
4. Explain how Raleigh’s appropriation process would differ between that for its general fund and that for its capital projects fund. How would this difference most likely affect the city’s budgetary entries?
5. Since the city had not yet adopted Statement No. 34, it was not required by GAAP to report on the amendments to its budget. Of what use to a statement reader is the note’s schedule comparing, by fund, the original and amended budgets?

Note D. Budgets
Budgetary control is exercised in all funds except the trust and agency funds. The budget shown in the financial statements is the budget ordinance as amended at the close of the day of June 30. The City is required by the General Statutes of the State of North Carolina to adopt a balanced budget by July 1 of each year. The General Statutes also provided for balanced project ordinances for the life of projects, including both capital and grant activities, which are expected to extend beyond the end of the fiscal year. The City Council officially adopts the annual budget ordinance and all project ordinances and has the authority to amend such ordinances as necessary to recognize new resources or reallocations of budget. At June 30, the effect of such amendments, less eliminating transfers, was as shown on the top of the next page.

All budgets are prepared on the modified accrual basis of accounting as is required by North Carolina law. Appropriations for funds that adopt annual budgets lapse at the end of the budget year. Project budgeted appropriations do not lapse until the completion of the project.

Budget control on expenditures is limited to departmental totals and project totals as specified in the budget ordinances. Administrative control is maintained through the establishment of more detailed line-item budgets, which correspond to the specific object of the expenditure. All budget transfers, both at the ordinance and the
line-item levels, are approved by the City Council. The City Manager is authorized to transfer line-item budgeted amounts up to $1,000 within a fund prior to their formal approval by the City Council.

Encumbrances represent commitments related to unperformed contracts for goods or services. Encumbrance accounting—under which purchase orders, contracts, and other commitments for the expenditure of resources are recorded to reserve that portion of the applicable appropriation—is utilized in all funds. Outstanding encumbrances at year-end for which goods or services are received are reclassified to expenditures and accounts payable. All other encumbrances in the annual budgeted funds are reversed at year-end and are either cancelled or are included as reapropriations of fund balance for the subsequent year. Outstanding encumbrances at year-end in funds that are budgeted on a project basis automatically carry forward along with their related appropriations and are not subject to an annual cancellation and reappropriation.

3-10
Different types of funds justify different practices as to budgets and commitments.

Review the budget note to the City of Raleigh’s financial statements presented in the previous problem. Assume that the city engaged in the following transactions in 2004 and 2005:

- In 2004 it signed a service contract with a private security company. The company agreed to provide security services to the city for one year at a cost of $72,000 ($6,000 per month). By year-end the company provided, and the city paid for, services for three months.
- In 2005, the company performed, and the city paid for, the remaining nine months of the contract. However, owing to agreed-upon changes in the services provided by the company, the total charges for 2005 were reduced from $54,000 to $50,000.

1. The city properly budgeted for the services and appropriated the funds consistent with policies set forth in the note. Prepare all budgetary, encumbrance, and expenditure entries relating to the service contract that would be required in 2004 and 2005. In 2004, when the city signed the contract, it appropriated the entire $72,000. Then, at the start of 2005, inasmuch as the city expended only $18,000 in 2004, it reapportioned $54,000.
   a. Assume first that the contract was accounted for in Raleigh’s general fund.
   b. Assume next that it was accounted for in a capital projects fund established for the construction of its Walnut Creek Amphitheatre. The city prepares annual financial statements for capital projects funds, but does not close out its accounts. Moreover, it prepares budgets for the entire project, not for particular periods. The project was started in 2004 and completed in 2005.

2. Justify the city’s practice of accounting differently for commitments in the two types of funds.

3-11
Journal entries can be derived from a city’s ledger.

Shown on the top of the next page is an excerpt from a city’s subsidiary ledger for the first two months of its fiscal year. Missing is the column that explains or references each of the entries.

1. Prepare the journal entries that were most likely made in the account, adding to each a brief note of explanation. Each line of the account records a single transaction (e.g., the receipt of an invoice); however, the entries on January 1 were made before the city engaged in any actual transactions (i.e., with outside parties).

2. The appropriation for consulting fees was intended to last for the entire year. Apparently, the city is spending or committing funds at a faster pace than planned. Can you propose an additional control mechanism to help ensure that the funds are spent evenly throughout the year?

3-12
Speeding up tax collections helps balance a state’s appropriations budget.

The following is an excerpt from Against the Grain, a series of recommendations by Texas’s State Comptroller as to how to “save” $4.5 billion and thereby balance the state’s budget:

- Require an Annual August Remittance of One-Half of August’s Sales Tax Collections by Monthly Taxpayers. The Legislature should require sales taxpayers to remit half of August’s collections during that month.

Background
Currently, sales tax payments are remitted either monthly, quarterly, or annually. They also may be prepaid either on a quarterly or on a monthly basis. Monthly taxpayers, including those who collect taxes on their own purchase or use of taxable items, are required by law to remit to the state all tax collections—less
any applicable discounts—by the twentieth day of the month following the end of each calendar month. The state’s fiscal year ends on August 31.

**Recommendation**

The Legislature should require all monthly taxpayers to remit one-half of each August’s sales tax collections during that month. Specifically, sales taxes collected between August 1 and August 15 would be due with their regular August 20th payment. Monthly taxpayers would remit tax in the usual manner during all other months.

This is not a prepayment plan, but a speeding up of the remittance of actual taxes collected and owed to the state. This would impose an additional burden and would reduce taxpayer cash flow, but should be considered as preferable to a tax increase.

**Implications**

An annual payment by monthly filers of taxes actually collected during the first fifteen days of August would increase August’s collections and decrease September’s collections. Although the initial imposition of this proposal might temporarily inconvenience some taxpayers, the prompt payment to the state of some of its sales tax revenues—collected, but not yet remitted—will enhance the revenue stream at a critical time each fiscal year. During the first year of implementation, all months would have normal collection patterns except August, which would be larger than usual, thereby producing a fiscal gain.

Each following year would see smaller than normal (current) collections in September and larger collections in August. These differences would essentially offset each other. It is important to stress that failure to speed up collections each year after implementation would cause a fiscal loss. The gain to the general fund in the year of implementation would be $215 million.

3. According to the comptroller (last paragraph), the change would have no impact on revenues of future fiscal years as long as collections are also speeded up in those years. Do you agree? If so, is there any reason not to adopt the proposal?

**3-13**

**Multiple funds provide multiple sources of revenue.**

The following is a recommendation from *Against the Grain*, a series of proposals by the State Comptroller of Texas on how the state could enhance revenues and decrease expenditures:

Amend the Lottery Act to Abolish the Lottery Stabilization Fund. The state should amend the Lottery Act to abolish the Lottery Stabilization Fund requirement and use the income to fund critical services.

**Background**

The State Lottery Act requires the establishment of a Lottery Stabilization Fund. The fund will contain lottery revenue in excess of the Comptroller’s Biennial Revenue Estimate. The Lottery Stabilization Fund is then to provide revenue to the General Revenue Fund if the lottery falls to generate monthly revenue as estimated.

In months that lottery revenue exceeds one-twelfth of the annual estimate, the Comptroller is required to deposit $10 million plus the amount of net lottery revenue in excess of the estimate to the Lottery Stabilization Fund. The Act provides only two circumstances under which revenue could be transferred from the Lottery Stabilization Fund to the General Revenue Fund. In months that lottery revenue is less than 90 percent of one-twelfth of the annual estimate, the difference is to be transferred from the Lottery Stabilization Fund to general revenue. The Act also provides for the transfer of one-half of the balance of the Lottery Stabilization Fund to the General Revenue Fund on the first day of every biennium.

In view of the seriousness of the state’s fiscal situation, the Legislature should set aside the stabilization fund requirement. The state already maintains a significant “rainy day” fund, and effective revenue forecasting should be adequate to avoid problems with potential future revenue stream instability.

**Recommendation**

The state should repeal the provision in the State Lottery Act that establishes the Lottery Stabilization Fund. This action would provide additional revenue to the General...
Revenue Fund to be used for state programs at the Legislature’s discretion.

**Implications**

Releasing Lottery Stabilization Funds would increase the available revenue for state programs without increasing taxes. General revenue is reduced by at least $10 million in months when lottery revenue exceeds one-twelfth of the annual lottery estimate. In effect, the state is penalized for correctly estimating lottery revenue and operating the lottery efficiently. Repealing the provision that establishes this fund would remove this penalty.

This action would increase general revenue about $65 million per year in the next biennium.

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**SOLUTION TO EXERCISE FOR REVIEW AND SELF-STUDY**

1. Estimated revenues $5,600
   Appropriations $5,550
   Fund balance 50

   **To record the budget**

   The budget would specify in detail the revenues anticipated and expenditures appropriated. Hence, the corresponding subledger accounts should be debited and credited for amounts estimated or authorized.

2. a. Cash $5,800
   Revenues $5,800
   **To record revenues**

   b. Encumbrances $3,000
      Reserve for encumbrances $3,000
      **To encumber resources reserved to fulfill commitments for goods and services on order**

   c. Expenditures $2,800
      Cash $2,800
      **To record expenditures**

      Reserve for encumbrances $2,800
      Encumbrances $2,800
      **To unencumber funds for goods and services already received that have been charged as expenditures**

   d. Expenditures $2,500
      Cash $2,500
      **To record other expenditures**

3. Revenues $5,800
   Estimated revenues $5,600
   Fund balance 200
   **To close revenue and estimated revenue accounts**

   Appropriations $5,550
   Expenditures $5,300
   Encumbrances 200
   Fund balance 50
   **To close expenditures, encumbrances, and appropriations**

The district’s closing entries deviate slightly from those illustrated earlier in the text in which the budget accounts were closed in one entry and the actual accounts in another. The end result is the same regardless of the grouping used for the closing entries.

4. The following schedule summarizes the impact of the transactions on fund balance:

   Revenues $5,800
   Expenditures 5,300
   Increase in total fund balance 500
   Less: Encumbrances (Transfer from unreserved to reserved fund balance) 200
   Net increase in unrestricted fund balance $300

The following balance sheet shows the status of year-end asset and fund balance accounts:

   Cash $500
   Fund balance
   Reserve for encumbrances $200
   Unreserved 300
   Total fund balance $500

5. Encumbrances $200
   Fund balance $200
   **To restore encumbrances of the previous year**

6. Expenditures $150
   Cash $150
   **To record expenditures**

   Reserve for encumbrances $200
   Encumbrances $200
   **To unencumber funds for goods and services already received and charged as expenditures (the entire $200 is reversed, inasmuch as the entire order has been fulfilled; no additional amount need be reserved).**