



Office of the City Manager

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To: Budget and Finance Policy Committee
From: Dee Williams-Ridley, City Manager
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Subject: Cash vs. Accrual Based Accounting and Budgeting

City management and fiscal staff use several different analysis methods to plan for Berkeley's fiscal and financial health, as well as to measure its past financial performance. This is done to make sure we are comparing the right amounts when examining the success and cost-effectiveness of City programs. It is also done to ensure we have the short and long-term resources available to meet our obligations to our citizens, customers, vendors, and employees. To see how these different methods apply to different situations, it is useful to understand the ways to account for financial transactions.

Basis of Accounting

Cash basis accounting is where transactions are recorded in a given period based on the movement of the actual funds. Recording of expenses occurs when invoices are paid, and revenues are recorded when payments are received from customers and taxpayers (Money is in the bank and can be spent). Using cash basis accounting gives you the current, real-time picture of available resources.

Accrual basis accounting is where transactions are recorded in a given period based on when the goods or services are provided. Expenses are recorded upon receipt of items purchased or when a vendor performs the services being paid for. The expense is *accrued* even though no funds have exchanged hands. The accrual principle also dictates that expenses for goods with a long useful life be recorded over the term of that life. Revenues are also recorded when services are provided, not when payment is made. In accrual accounting, both expenses and revenues are recorded when the *obligation* to pay is created, regardless of the timing of the ultimate payment. Accrual accounting takes into account future liabilities and amounts owed to the City, so that existing obligations can be factored in to analyses of current resources.

The **modified accrual basis** is a combination of the other two, in which cash basis revenues are supplemented by certain unreceived funds deemed "measurable and

available,” and where unpaid expenses that will need to be paid in the near future are added to cash basis expenses.

The Governmental Accounting Standards Board (GASB) mandates which accounting basis should be used in different parts of our year-end financial statements by adopting Generally Accepted Accounting Principles (GAAP). These rules ensure all organizations apply the same accounting treatment to similar transactions, and that the official financial reports produced by different agencies can be easily compared. GAAP requires that our financial statements present certain transactions recoded on cash basis, while others must be recorded on an accrual basis. This determination is based on the type of activity underlying the financial transaction in question.

For purposes of deciding which basis of accounting is appropriate, we generally engage in two types of activities: governmental services, where we provide services to citizens as a part of our obligation to serve City residents; and business-type (or proprietary) activities, where the City provides services in exchange for payments meant to fund those services. The financial reporting of business-type activities must be done using the accrual basis. Governmental activities must be reported using the modified accrual basis.

Budget Preparation and Adoption

GASB governs how all transactions are recorded and financial statements are compiled. These rules are totally governed by GASB. For budget purposes, GASB gives great latitude to Municipalities to choose which method they want to utilize. There are two major options: (I) Cash/Budgetary basis and (II) Accrual basis. Since GASB does not mandate a particular budgetary basis, municipalities have discretion to use the method best suited to its fiscal management. The different bases of accounting provide different perspectives that each have relevance in the planning of all City revenues and expenses.

We must ultimately ensure that our ongoing tax and other governmental revenues fund government service provision in the long-term. We plan capital expenditures to enable the provision of some governmental services knowing that there will be a long-term benefit received for the up-front cost. We must ensure that business-type activities have adequate resources to pay their bills when they come due, as well as looking at their long-term viability as ongoing enterprises. The City’s budget process must necessarily take both of these perspective into account.

However, while the budgeting of City revenues and expenses must be done with consideration of its long-term fiscal health, the biennial budget is most essentially a plan for the inflows and outflows of cash in that specific 2-year period. City management and Council must make sure there are adequate financial resources available to pay the amounts the City will owe its vendors and creditors. The fact that a new parking garage will provide benefits for decades does not change the fact that construction contractors will have to be paid immediately. To ensure the resources will exist to pay city employee salaries and vendor invoices, the City uses a conservative basis for budgeting.

One of the major responsibilities of a bond rating agency is to identify policies or practices in an entity that can create major risks to the effective and efficient functioning of that

entity, and assess and evaluate the risk to purchasers of bonds. As City's management discovered many years ago, aggressive budgeting practices is one such risk. The major risk that was discovered was that if you allow accounts receivable (especially grants receivable) to be a primary basis for determining the budgeted revenues in a fund (and thereby the budgeted expenditures), you risk not having enough resources to pay all the actual expenditures in that fund during the fiscal year. In other words, the risk was that budgeted revenues could be overstated. The reason it is a risk is because no one can guarantee that the amount of the receivable expected will be collected timely or even collected at all. As discussed below, City management found many instances over several years where many grant funds had deficit fund balances for this very reason. The problem was so serious that a full-time grants coordinator position was created to help control the situation, but it was not enough because the City has so many grant funds.

One sign of strong management is that when internal control risks are discovered, procedures and practices are put in place to prevent the risk in the future. That's what Berkeley's management did: They developed a conservative basis for determining the fund balance that could be used for budgeting purposes—a basis that could not be intentionally or unintentionally misrepresented.

That revised budget basis fund balance excludes receivables until they have been collected. This takes away the incentive and opportunity to intentionally or unintentionally misrepresent the fund balance used for the budget. You can't misrepresent the cash and investments balance, and there are no collectability problems.

These practices are among the reasons the City maintains a strong credit rating from credit ratings agencies. Standard & Poor's rated our recent T1 bond offering AA+ (one notch lower than its highest rating of AAA), in part, due to the City's "good financial policies and practices under [their] Financial Management Assessment (FMA) methodology."

The reason this practice is applauded is because it precludes the possibility of a major risk entering into the budget process. The City itself can attest to the fact that it is a risk. If the City goes back to this aggressive method of budgeting, which it knows has significant internal control weaknesses, then the City is unlikely to be applauded for its conservative budgeting practices and, the City might not be able to maintain the AA+ rating from S&P Global and the Aa1 rating from Moody's. If this happens, then the City's taxpayers will be paying higher bond taxes whenever the City issues General Obligation Bonds or Revenue Bonds.

Berkeley's budget basis consists of the following:

1. Expenditures/expenses: The City uses the modified accrual/accrual basis for expenditures/expenses, which includes the check and electronic payment disbursements actually made during the year, and the unpaid accounts payable and accrued salaries/wages and employee benefits liabilities incurred as of June 30th. The Budget Office also subtracts outstanding encumbrances from the available budget amounts.

2. Revenues: Only the cash expected to be received is budgeted and only the actual cash received is reflected as actual revenues. If the fund balance is used to balance a fund's budget, the available cash balance (budget basis fund balance) is used

This way, the City is assured of having adequate resources. Budgeting for accrued expenses ensures that we can pay our bills even if future revenue predictions are modified. Using a cash basis for revenue planning also prevents any concerns related to the timing of amounts owed to the City leaving us short on liquidity when we need to pay salaries or invoices. Using this conservative practice doesn't deprive management of anything, as the City uses the accrual basis/modified accrual basis for accounting, so the amount of the receivables are recorded in the City's general ledger for accounting purposes. City management has the same accounting information that a city that budgets on an accrual basis has. The only difference is that one practice is conservative and the other one isn't, perhaps because those cities that use the accrual basis for budgeting don't have a large grants receivable balance like Berkeley does.

In the past, departments were allowed to use the fund balance to make up for an anticipated shortfall in cash revenues. Since unpaid receivables were added to the revenue totals for budgeting purposes, however, they were counting on cash receipts which had no guarantee of materializing. Specific instances of this were what caused the City's management to tighten up on its budget practices and develop a more conservative method of budgeting, namely:

1. Numerous grant funds had significant deficit fund balances because they incurred more expenditures than revenues. They had no resources to make up for the shortfall. As a result, the City's General Fund had to make large transfers for several years to these funds to eliminate the deficits.
2. In one situation, the department reflected a grants receivable from the County of nearly \$2 million that was never received. The staff made an error, and the General Fund took the nearly \$2 million hit to its fund balance.

Using a more cautious and conservative budgeting method, whereby we only include revenues for which we actually expect to receive payment during the budgeted year, prevents such occurrences, and ensures that Berkeley maintains its fiscal health and can provide uninterrupted service to its citizens and other customers.