LAO POLICY BRIEF

The 2011-12 Budget: The Administration's Revenue Accrual Approach

MAC TAYLOR • LEGISLATIVE ANALYST • JANUARY 31, 2011

Summary

For four of the Governor's proposed tax increases, the administration has based its revenue forecasts on a new approach for accruing (attributing) revenues to each fiscal year. In the administration's budget figures, this new accrual approach *increases* revenues available for the 2011-12 budget process by over $700 million and *decreases* the 2011-12 Proposition 98 minimum funding guarantee for schools and community colleges by $1.5 billion below what it would have been under the same tax policies, but without this accrual change.

As we discuss in this brief, the state has a history of adjusting its accrual practices for short-term budgetary gain, and the administration's accrual change helps the state's "bottom line" in 2010-11 and 2011-12. Nevertheless, we find that the new approach—while imperfectly executed in the administration's forecast—has some merit. This new approach would move state budgetary accounting closer—in some respects—to compliance with generally accepted accounting principles (GAAP). We do fault the administration for not describing the new approach and its implications in its public budget documents and recommend that the Legislature take steps to require more transparency in the future. Over time, the Legislature should take additional steps to align California's budgetary accounting practices even more closely with GAAP.

Background

Governmental Accounting Standards. For decades, California generally has chosen to conform its financial practices with the developing accounting standards for state and local governments. Following New York City's calamitous financial crisis in the 1970s, interest arose in more formalized governmental accounting procedures. In 1984, the Governmental Accounting Standards Board (GASB), a not-for-profit organization, was formed to establish uniform GAAP standards for state and local governmental accounting and financial reporting. The GASB standards now adhere closely to corporate accounting standards in many respects, and in recent years, GASB has amended its standards to more closely align corporate and government accounting of capital assets and retirement liabilities. Chapter 1286, Statutes of 1984 (AB 3372, Stirling), sets a general goal that the state's budgetary practices conform as closely as possible with GAAP standards.

California's Budgetary and GAAP Accounting Statements. While Chapter 1286 establishes the conformity of state budgetary practices and GAAP as a general goal, the State of California—like many governments—does *not* prepare its annual budget strictly in accordance with GAAP. In fact, under Section 12460 of the Government Code, the state prepares two distinct annual financial reports for the public, investors, and elected officials: (1) a financial report prepared according to the "budgetary basis," or "legal basis," of accounting (the same accounting methods as that used in the Governor's budget and the annual budget act) and (2) a financial report that converts the budgetary basis financial statement into one that conforms strictly with GAAP. The GAAP financial statement explicitly "crosswalks" between the two financial reports by listing the changes made each year to convert the budgetary financial statement into one that complies with GAAP.

Differences Between Cash Basis and Accrual Accounting. The history of California's conversion to GAAP revenue accounting standards starts with its initial conversion from "cash basis" to "accrual" revenue accounting in 1966, which is discussed below. Cash basis accounting generally records revenue when an entity receives cash and records expenses when the cash is paid out—no matter when the revenues were earned or the expenses actually invoiced.

Accrual accounting, by contrast, is the method of accounting long used by businesses and now generally used by governments. Accrual accounting typically records revenues when income is earned (even if the money has not yet been received) and records expenses when obligations are incurred (not necessarily when they are paid out). Accrual accounting, when administered properly, allows policy makers and financial managers to understand the full benefits and costs of their decisions in the fiscal period in which those decisions are made.

History of Revenue Accounting

California Began Accruing Revenues in 1966. By 1966, the state already used accrual accounting for its expenditures. The *1966-67 Governor's Budget* proposed ending cash basis accounting and instituting accrual accounting for the state's revenues. Governor Pat Brown cited the need to conform with modern accounting practices as a rationale for this change. This revenue accrual change, however, also allowed the state to credit to the 1966-67 fiscal year $99 million of revenues that otherwise would have been attributed to later fiscal years. The Legislature approved the proposal. The nearby text box summarizes the 1966 legislation that approved accrual revenue accounting, as well as some subsequent changes to the law in this area. Over the years—beginning one year after the original 1966 legislation—the state has changed its revenue accounting practices several times, sometimes for short-term budgetary aid. (This has not been the only reason for revenue accounting changes. In 1973, for example, a statutory change switching the state back to cash basis revenue accounting served to *reduce* the year-end General Fund surplus that otherwise would have been projected in the 1973-74 budget package.)

1991 Budget: Switch Back to Accrual Revenue Accounting. For much of the 1970s and 1980s the state switched back to cash basis accounting for much of its revenues. Facing a multibillion dollar state budget problem, Governor Wilson proposed in his 1991-92 budget switching back to accrual revenue accounting—for a one-time revenue gain of $1.7 billion—and resuming accrual expenditure accounting in Medi-Cal for a one-time General Fund cost of around $1 billion. The administration cited its desire to adhere to emerging GASB standards in making these proposals, which subsequently were adopted by the Legislature. This accrual standard remained in state law for 17 years—until 2008.

2008 Budget: Accrual Changes Help Address the Budget Problem. As one part of its approach to addressing what it identified as a $14.5 billion state budget problem, the *2008-09 Governor's Budget* proposed amending the 1991 accrual law and increasing 2008-09 budgeted revenues by nearly $2 billion on a one-time basis. This one-time revenue boost resulted from shifting personal income tax (PIT) and corporation tax (CT) revenues that otherwise would have been attributed to 2009-10 to 2008-09 instead. Specifically, the Schwarzenegger administration sought to amend the 1991 accrual law to eliminate its requirement that only revenues due within two months of the end of the fiscal year could be accrued to that fiscal year. Specifically, the administration sought to allow the accrual of one-third of September estimated PIT and CT payments back to the prior fiscal year. The Schwarzenegger administration stated that its proposed changes would bring the state's revenue accruals closer to conformity with GAAP. The Legislature approved the proposal, and the 2008 amendments to the state's revenue accrual law remain in place today.

2008 Accrual Changes Were Not Consistent With GAAP… Despite the Schwarzenegger administration's assertions, the state's auditors did not concur that the budget act's accrual of a portion of September estimated payments to the prior fiscal year was consistent with GAAP. Accordingly, in converting its budgetary financial statements to GAAP financial statements, we understand that the state has had to remove the September estimated payment accrual.

Revenue Accrual Legislative History

The Legislature has amended state law concerning revenue accrual practices several times over the years. Below are summaries of some of those statutory changes.

1966. Chapter 144, Statutes of 1966 First Extraordinary Session (SBX1 34, O'Sullivan), provided that "amounts that shall be deemed earned [by the state] when the taxpayer receives the income in respect to which the tax is to be assessed." The statute—a proposal of Governor Pat Brown—declared legislative policy that all revenues "be accounted on an accrual basis to the fullest extent practicable."

1973. Chapter 402, Statutes of 1973 (AB 1000, Moretti), switched the state back to cash basis revenue accounting, with some exceptions.

1991. Chapter 92, Statutes of 1991 (SB 451, Maddy), switched the state back to accrual revenue accounting. This law—a proposal of Governor Wilson—provided for "accrual of revenues at the end of the fiscal year if the underlying transaction has occurred as of the last day of the fiscal year and the due date for the tax is within two months of the end of the (fiscal year) period."

2008. Chapter 751, Statutes of 2008 (AB 1389, Committee on Budget), amended Chapter 92 to provide for the "accrual of revenues at the end of the fiscal year if the underlying transaction has occurred as of the last day of the fiscal year, the amount is measurable, and the actual collection will occur either during the current (fiscal year) period or after the end of the current (fiscal year) period but in time to pay current year-end liabilities." This statutory language—currently in Section 13302 of the Government Code—was proposed by Governor Schwarzenegger and is very similar to current generally accepted accounting principles for governments.

...GAAP Requires a Different Type of Accrual. While auditors have determined the state needed to remove the September estimated payment accrual when converting its budgetary financial statements into GAAP statements, at the same time auditors have required the use of a *different* type of accrual in California's GAAP financial statements. Specifically, beginning in the state's 2008-09 GAAP financial statements, auditors started accruing a portion of "net final" income tax payments (such as final April payments, net of refunds) back to the prior fiscal year.

Why did auditors require this alternate accrual? Consider that personal and corporate taxpayers' final April 2009 tax payments were related to the 2008 tax year. That 2008 tax year included the second half of the state's 2007-08 fiscal year and the first half of the 2008-09 fiscal year. Accordingly, there is a logical basis for accruing about 50 percent of net final payments received in April 2009 back to the state's 2007-08 fiscal year.

The state's 2008-09 GAAP financial statements reported that this alternate accrual caused the General Fund balance displayed in the GAAP financial statements to *increase* by $838 million above that shown in the state's budgetary basis financial statements. (The GAAP financial statements also include various other adjustments to convert California's budgetary basis financial reports to GAAP.)

2008 and 2009 Tax Accelerations. To help address massive state budget and cash flow shortfalls, the Legislature approved measures in 2008 and 2009 to accelerate the state's receipt of PIT and CT revenues. These measures provided for billions of dollars of largely one-time budget and cash flow relief in 2008-09 and 2009-10. The measures increased suggested income tax withholding rates for individuals by 10 percent effective in November 2009 and "front loaded" required estimated tax payments by certain PIT and CT filers earlier in the calendar year. Historically, estimated tax payments have been required quarterly—in roughly equal amounts. But the changes enacted in 2008 and 2009 changed these requirements substantially: now, estimated tax filers must pay 30 percent of their expected annual tax liability in April, 40 percent in June, none in September, and the final 30 percent in December or January. These estimated tax changes allowed the state to move revenues from one fiscal year to the prior fiscal year for purposes of the state budget and budgetary basis financial reporting. According to the Franchise Tax Board (FTB), however, the state's auditors also have requested that these various types of accelerated payments be removed from the state's budgetary basis revenue calculations to make them compliant with GAAP. This is because GAAP accounting standards generally attribute revenue to the fiscal year in which the underlying economic transaction (the earning of income or the taxable sale of a product) occurs—regardless of when the tax payment is due to the governmental entity.

Accrual Changes in 2011-12 Governor's Budget

2011-12 Governor's Budget Summary*: No Accrual Changes Mentioned...* The *2011-12 Governor's Budget Summary* does not mention any proposed change in accrual policies. The "Revenues" section of the summary focuses instead on the Governor's major tax proposals: extensions of temporary increases in four taxes (including PIT), elimination of the enterprise zone tax credit, and implementation of a mandatory single sales factor for apportioning multistate and multinational business profits.

...But Estimates for Four Tax Proposals Were Based on Major Accrual Changes. While no accrual changes were mentioned in the *2011-12 Governor's Budget Summary*, administration officials informed us that estimates for four of the

Governor's revenue proposals (the two PIT, enterprise zone, and single sales factor proposals) were based on accrual methods not previously used in the state's budget process and the state's budgetary basis financial statements. Under accrual methods previously used in the state budget process, net final payments received in a subsequent calendar year have not been attributed back to the prior fiscal year. According to administration officials, however, the administration's recent revenue estimates for the four tax proposals *did* accrue a significant portion of net final payments to be received in 2012 back to the 2010-11 fiscal year.

New Accrual Method Increases Revenues Available for 2011-12 Budget Process. Figure 1 shows for 2010-11 and 2011-12 the revenues from the four tax proposals, as well as the other major General Fund tax revenues in the administration's revenue forecast. (The figure shows "state appropriation limit (SAL) revenues," which exclude non-tax revenues, transfers, and loans to the General Fund. Proposition 98 and other budgetary calculations rely on SAL revenues.) As shown in the figure, the Governor's budget forecast—including the accrual changes for the four tax proposals—assumes $177.2 billion of SAL revenues over the two fiscal years combined. By contrast, if there had been no accrual changes, revenues from the same set of proposed revenue policies would have totaled $176.5 billion over the two years under the Department of Finance's (DOF) prior budgetary accrual methods. Accordingly, the accrual change increases net revenue available for the 2011-12 budget process by $719 million.

Accrual changes do not change the amount of taxes owed by Californians or collected by the state. Accordingly, because the accrual changes increase revenues available for the 2011-12 budget process by $719 million, they also reduce revenues available for future years' budget processes by the same amount. Most of these "losses" will affect the 2012-13 and 2013-14 budget processes.

Figure 1

Administration's Accrual Method Increases Available General Fund Revenues in the Near Term

Budgetary Basis of Accounting (In Millions)

	2011-12 Governor's Budget— Accrual Changes for Tax Proposals			*2011-12 Governor's Budget—* Without Accrual Changes		
	2010-11	2011-12	Both Fiscal Years Combined	2010-11	2011-12	Both Fiscal Years Combined
Personal Income Tax						
0.25 percentage point surcharge	$1,187	$2,077	$3,264	—	$3,147	$3,147
Dependent credit reduction	725	1,248	1,973	—	1,655	1,655
Enterprise zone tax credit elimination	343	581	924	—	760	760
Mandatory single sales factor	468	942	1,410	—	1,290	1,290
Other General Fund SAL revenues	87,116	82,541	169,657	$87,116	82,541	169,657
Total, General Fund SAL Revenues[a]	**$89,839**	**$87,389**	**$177,228**	**$87,116**	**$89,393**	**$176,509**
Change Due to New Accrual Method[b]	**$2,723**	**-$2,004**	**$719**	—	—	—

[a] The General Fund's state appropriations limit (SAL) revenues include personal income, corporate, sales and use, and other tax revenues. These payments, which comprise the vast majority of total General Fund revenues are a key factor used in calculations of the Proposition 98 minimum funding guarantee for schools. (General Fund transfers and non-tax revenues are excluded from SAL revenues.)

[b] Changes in accrual methods do not change the amount of taxes owed by taxpayers or collected by the state. They change only the fiscal year to which the revenues are attributed for state budgetary purposes. Accordingly, the $2.7 billion revenue "gain" displayed for 2010-11 under the administration's accrual changes would result in the $2 billion revenue "loss" displayed for 2011-12, as well as $700 million of revenue "losses" in subsequent fiscal years.

Administration's Rationale for the Change. The administration notes correctly that the state's GAAP financial statements already include an accrual of a portion of net final payments received in the subsequent calendar year back to the prior fiscal year. Accordingly, the administration says, the new accrual method for the four tax proposals is more consistent with GAAP.

While we agree that including an accrual of net final payments in budgetary estimates is a feature of GAAP, we note that the administration's calculations do not appear to conform *strictly* with GAAP. We understand, for example, that the administration accrues back to 2010-11 more than 50 percent of the assumed 2012 net final payments related to these four tax increases—based on the fact that accelerated withholding and estimated tax payment schedules now require taxpayers to pay the state more than 50 percent of their expected annual tax liability in the first half of each calendar year. As we discussed earlier, GAAP generally does not recognize such accelerated tax payment schedules.

Accordingly, we conclude that the administration's rationale for the accrual change has some merit. In some respects, the new accrual method—as applied to the four tax proposals—would move the state's budgetary accounting closer into conformity with GAAP. The administration's method, however, appears to accrue revenues somewhat more aggressively to the prior fiscal year than GAAP would allow.

New Accrual Method Not Applied to Any Other Revenues. As illustrated in Figure 1, the administration reports that it did not apply the new accrual method to any other revenues. Accordingly, accrual methods for all other revenues were unchanged from prior DOF budgetary practices. Embedded within these estimates are revenue forecasts for a variety of tax sources, including a multitude of recent policy changes, that include *different* and *inconsistent* accrual practices, compared to those used for the four new tax proposals. For example, while the four tax proposals appear to be scored without reliance on the September estimated payments accrual adopted in 2008, other parts of the revenue forecast implicitly assume the September estimated payment accrual and omit accruals based on the new DOF approach. The administration has offered no rationale for this inconsistent accrual treatment.

Effects of Accrual Change on Proposition 98

2011-12 Proposition 98 Guarantee: $1.5 Billion Lower Due to New Accrual Approach. In 2010-11, the Legislature suspended the Proposition 98 minimum guarantee. As a result, the $2.7 billion increase in revenues from the new accrual approach has no impact on 2010-11 school funding (or the amount of maintenance factor outstanding). For 2011-12, the Governor's budget assumes that the state is in a "Test 1" year, in which the minimum guarantee is based on a fixed percentage (about 41 percent) of General Fund revenues ($87.4 billion, as shown in Figure 1). Accordingly, under the Governor's budget (with its accrual approach), the 2011-12 Proposition 98 minimum guarantee requires just over $36 billion of General Fund expenditures.

As a result of the administration's new accrual approach, the year-to-year change in General Fund revenues is affected significantly, as shown in Figure 1. This affects the Proposition 98 minimum guarantee calculation substantially. Under an alternative scenario, still assuming the Governor's proposed tax policies but *without* the new accrual method, the 2011-12 Proposition 98 minimum guarantee would have required about $37.5 billion of General Fund expenditures—$1.5 billion more than the amount shown in the Governor's budget.

Unknown Impact if Accruals Had Been Extended to Other Revenues. Above, we discussed the inconsistency between the administration's accrual methods for its four tax proposals and the accrual methods used in the rest of the revenue estimates. If, alternatively, the administration had extended its new accrual treatment consistently to the rest of its revenue estimates, we do not know what revenues might have been displayed for 2010-11 and 2011-12. Accordingly, we cannot say how such a consistent display of revenue accruals would have affected 2011-12. We believe it would take some time for the administration, the State Board of Equalization (BOE), and FTB to adjust all of their revenue estimates in this manner.

LAO Comments

State Accrual Practices Now Inconsistent and Complicated. For decades, it has been general state policy to align budgetary accounting practices as closely as possible with modern accounting principles. The state has made progress on this front over the decades. In recent years, however, facing severe budget and cash flow problems, the state has altered its accrual practices and accelerated or delayed various revenue sources and expenditures. These changes make it more difficult to accurately estimate revenues and expenditures for each fiscal year, risk inconsistency among the multiple state departments that develop and audit state financial records, promote confusion for investors who use the state's financial statements, and facilitate the state spending more than it can afford in some fiscal years. The inconsistencies embedded in both the state's budgetary revenue and expenditure accounting have been multiplying in recent years. This is a troubling trend.

GAAP Compliance Should Continue to Be a Goal. We advocate continued efforts for the state to meet its long-established goal of conforming budgetary figures to GAAP as closely as possible. Accounting is always subject to some interpretation. Adherence, when possible, to uniform accounting standards set by a board of accounting professionals is preferable to the state's existing, inconsistent budgetary accounting standards. In particular, adherence to GAAP should promote increased confidence among investors, bond raters, and the public.

Administration's Accrual Method Makes Progress Toward GAAP Compliance. As described above, the administration's new accrual approach for the four tax proposals does not appear to conform precisely with GAAP. In particular, it allocates net final payments to the prior fiscal year somewhat too aggressively. Nevertheless, the basic concept of accruing a portion of net final payments paid in the subsequent year back to the prior fiscal year *is* consistent with GAAP. The state's GAAP financial statements already include a similar accrual. Moreover, the administration's decision to abandon the 2008 action to accrue one-third of September estimated payments to the prior fiscal year (in estimates for the four tax proposals) is a step in the right direction. In summary, we find that the administration's new accrual approach—while imperfectly executed in the administration's forecast—has some merit.

Consistent Accrual Practices Needed for Future Revenue Forecasts. Unfortunately, we do not believe that the accrual method the administration used for its four tax proposals can be credibly extended to the rest of its revenue forecast in the short term. This new treatment, we believe, would require new estimates for many recent tax policy changes by FTB and BOE, as well as various other new calculations by administration officials. Especially given the short timeline for approval of the budget package advocated by the Governor, we believe it will be necessary to rely on the administration's imperfect revenue estimates for now. The inconsistencies in the administration's revenue accrual approach mean there is a greater chance that the final accounting of 2010-11 and 2011-12 revenue will end up significantly different from the administration's estimates. To reduce this problem in the future, we recommend the Legislature express a clear set of expectations that future years' revenue forecasts will involve consistent, appropriate accrual methods.

Recommend Statutory Language to Increase Accrual Transparency. Under existing law, DOF has the lead role in devising and managing the state's financial reporting system. To encourage the administration to improve its accrual methodology and to increase transparency in future budget cycles, we recommend that the Legislature pass a law to require DOF to develop a simple "accrual guide," summarizing the major elements of its accrual methodologies for PIT, CT, and the sales and use tax. Further, the accrual guide—based on DOF's consultations with FTB and BOE—should summarize any alternate methodologies used by those departments in estimating the effects of proposed tax policy changes. Finally, the guide should summarize—based on DOF's consultations with the Bureau of State Audits—the major areas in which GAAP accrual of tax revenues differs from the accrual methods used by DOF in its development and presentation of the state budget. We propose that DOF be required to complete the accrual guide by January 10, 2012—in time for its presentation of the *2012-13 Governor's Budget*—and be required to update it online, describing any changes to state accrual methods, each January and May when it presents new revenue estimates to the Legislature. We believe that this simple guide would promote increased transparency concerning accrual changes and reduce the chances for confusion and inconsistency among the various state offices that collect, report, and forecast state revenues.

Recommend Future Legislative Actions to Align State Budgetary and GAAP Standards. Over time, the Legislature will have the opportunity to "undo" some of the various tax payment accelerations and accrual changes undertaken in recent years. We believe the new accrual guide can provide a clear description of areas where the Legislature can take future steps to alter budgetary financial reporting to make it more consistent with GAAP. We encourage the Legislature to take these steps over time. Moreover, the Legislature should take steps to align state expenditure reporting with GAAP standards as well. Just as the recent approvals of accrual changes and payment date changes have provided the state with one-time financial benefit, undoing these changes often will result in one-time costs. The long-term benefit of undoing many of these changes, however, would be more reliable and more trusted state budgetary numbers. Improving the reliability of state budgetary data, we believe, will be a key step in enhancing public trust in state government.

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