

Budgetary Basis of Accounting

White Paper

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Basis of Accounting—Modified Accrual and the Budgetary Basis

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Beginning with fiscal year 2005, the General Appropriation Act establishes the modified accrual basis of accounting for governmental funds as the budgetary basis of accounting for the State of New Mexico. This is a significant change in policy by the State. It was made to bring about meaningful interim financial reporting, promote accountability, and strengthen managerial oversight.

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Introduction

The General Appropriation Act of 2004 applies to fiscal year 2005 budgets. Two provisions in the Act establish the *modified accrual basis of accounting* as the budgetary basis of accounting for the State of New Mexico. These provisions, which are in section three of the act, are as follows:

N. For the purpose of administering the General Appropriation Act of 2004, the state of New Mexico shall follow the modified accrual basis of accounting for governmental funds in accordance with the manual of model accounting practices issued by the department of finance and administration.

O. When approving budgets based on appropriations in the General Appropriation Act of 2004,

the state budget division is specifically authorized to approve budgets in accordance with generally accepted accounting principles and the authority to extend the availability period of a an appropriation through the use of an encumbrance shall follow the modified accrual basis of accounting for governmental funds in accordance with the manual of model accounting practices issued by the Department of Finance and Administration.

These provisions represent a significant change in the State's accounting policy by conforming the State's budgetary basis to generally accepted accounting principles. Most of the change's impact will occur on June 30, 2005. Agencies are encouraged to carefully plan the transition.

The Change in Accounting Policy

The change will impact how agencies account for commitments and transactions, mainly in the following areas: 1) encumbrances; 2) expenditures and related accounts payables; and 3) accounts receivable. Since accounting practices vary between agencies, the impact will not be the same for every agency.

Encumbrances:

The change in policy does away with "prior year encumbrances." Prior year encumbrances allow state agencies to expend money in one fiscal year, while charging the expenditure to another fiscal year's budget. This practice misstates expenditures between fiscal years, under-mining the accuracy of interim financial reporting (budgetary, cost, etc.).

Eliminating the use of prior year encumbrances changes the way the State views budgetary control: the focus has been on fiscal year; the new focus is on "appropriation period."

Under the new policy, so long as the appropriation period has not lapsed, and a budget has been approved by the Department of Finance and Administration, an encumbrance can be charged against that budget. However, when the appropriation period lapses, so does the authority for the budget. The result is the encumbrance can no longer be charged to that budget.

The Legislature sets the appropriation period. Most appropriation periods are for twelve months and coincide with the fiscal year (July 1 through June 30). Other periods extend beyond twelve months and may or may not coincide with a fiscal year. These are often referred to as "multiple-year" appropriations.

The important things to remember about the change in accounting policy are: 1) prior year encumbrances will no longer exist; and 2) when the appropriation period lapses so does the authority for the related budget, preventing an encumbrance from being charged against that budget.

What happens to an encumbrance after the appropriation lapses? If the Legislature has provided a new appropriation, the encumbrance is carried forward to a new appropriation period to be charged against the new budget. If the Legislature has not, the encumbrance is no longer authorized and the amount of the encumbrance must be restored to unreserved fund balance. (For "reverting funds," unreserved fund balance must revert to the State General Fund at the end of the appropriation period).

Expenditures and Related Accounts Payable

The General Appropriation Act of 2003, like the ones before it, defined "expenditure" as follows:

"...expenditures" means costs, expenses, encumbrances and other financing uses, other than refund authorized by law, recognized in accordance with generally accepted accounting principles for the legally authorized budget amounts and budget period.

The Legislature did not include the language above in the General Appropriation Act of 2004. Instead it included the following:

N. For the purpose of administering the General Appropriation Act of 2004, the state of New Mexico shall follow the modified accrual basis of accounting for governmental funds in accordance with the manual of model accounting practices issued by the department of finance and administration.

O. When approving budgets based on appropriations in the General Appropriation Act of 2004, the state budget division is specifically authorized to approve budgets in accordance with generally accepted accounting principles and the authority to extend the availability period of a an appropriation through the use of an encumbrance shall follow the modified accrual basis of accounting for governmental funds in accordance with the manual of model accounting practices issued by the

department of finance and administration.

The language establishes the modified accrual basis of accounting for governmental funds as the State's budgetary basis. This means agencies must follow generally accepted accounting principles when recording expenditures and related accounts payable. Where options exist in the application of generally accepted accounting principles, agencies must follow the model accounting practices established by the Financial Control Division.

It is important to note that the language refers to "accounting for governmental funds." Consequently, expenses such as depreciation are not part of the budgetary basis. Agencies should not confuse the accounting for the entity wide financial statements with the accounting for governmental funds.

Accounts Receivable

Both the new accounting policy and the old provide for the recognition and recording of accounts receivable. However, the following guidelines will be added to the Department of Finance and Administration's *Manual of Model Accounting Practices* referenced in the General Appropriation Act of 2004:

1. Agencies shall record accounts receivable on a timely basis so that the interim budget status reports issued by the Central Accounting System reflect receivables.
2. The "availability" criterion for revenue shall be 60 days following the end of the fiscal year. (Please note, the availability criterion has limited application under generally accepted accounting principles. It is also important to note that the 60 day period of time relates to the point in time that a legal claim arises, which may not coincide with the receipt of cash.)

The major impact to agencies of this change in policy is that receivables must be recorded on a timely basis, not just at the end of a fiscal year.

Questions and Answers

1. **How soon does the change in policy take place?**

The general applicability of the Appropriation Act of 2004 is fiscal year 2005. To implement modified accrual accounting, the act provides for guidance by the Department of Finance and Administration through the issuance of the Department's model accounting practices. Given this, much of the change in policy will take place on June 30, 2005.

For example, for the fiscal year ended June 30, 2004, the old policy will still be in place (except for supplemental and deficiency appropriations that lapse June 30, 2004). This gives agencies approximately a fifteen-month period to properly plan and make their purchases, thus lessening any impact the policy change may have. It also gives an agency a complete budget request cycle to request funding, should the agency determine it needs additional funding to make up for the loss of prior year encumbrances.

2. **Our agency makes most of its capital outlay purchases at the end of the fiscal year and usually receives the equipment in the following fiscal year. How will the new policy impact this practice when a twelve-month appropriation period is involved?**

Since the policy impacts mostly fiscal year 2005, it will have little impact at June 30, 2004 (except for supplemental and deficiency appropriations that lapse June 30, 2004). However, any equipment ordered on or before June 30, 2005, but received after June 30, 2005, must be charged against the budget for the appropriation period ended June 30, 2006, assuming a budget exists.

Assuming a new appropriation period has been authorized by the Legislature, by way of an appropriation, and the related budget approved, what will happen on midnight June 30, 2005 is all encumbrances will carry forward to the new appropriation period. In essence, fiscal year 2005 encumbrances will become 2006 encumbrances. (The Legislature must authorize an appropriation for an encumbrance in order for it to exist. This means an encumbrance cannot carry forward between appropriation periods unless an appropriation exists for it in the new period.)

3. **Our agency receives its utility bill for June in July. How would we pay the June bill in July?**

Since the services were received in June, under the modified accrual basis of accounting, the Financial Control Division will allow your agency to record an accounts payable at June 30, 2005, thus charging the expenditure to the appropriation period ended June 30, 2005. The mechanics of during this will depend on the system used by the Central Accounting System on June 30, 2005.

4. **Our agency has professional contracts that span four fiscal years. Our agency has always encumbered the entire amount of the contract against the fiscal year's budget in which the contract was signed. May our agency continue to do this after June 30, 2005?**

No. Your agency should only encumber in each appropriation period the amount of the contract related to the goods and services that will be delivered that appropriation period. The wording in professional services contract should specifically note that the agency can only be liable for the amount encumbered and that any future liability is subject to the agency receiving an appropriation.

5. **Our agency plans to encumber the cost of its 2005 audit in fiscal year 2005. However, the independent auditors will not begin work until after June 30, 2005. Even though the work will be done in fiscal year 2006, can our agency charge fiscal year's 2005 budget by referencing the 2005 encumbrance?**

No. At the end of June 30, 2005, fiscal year 2005 encumbrances will carry forward to the appropriation period ended June 30, 2006 and become fiscal year 2006 encumbrances. Referencing an expenditure to these encumbrances will result in a fiscal year 2006 expenditure. (See item 2 above).

Questions and Answers (continued)

- 6. Our agency received an appropriation for fiscal year 2005 and 2006. It plans to encumber the full amount of the appropriation in August 2004. In this case, what happens to that encumbrance on June 30, 2005?**

The focus is no longer on fiscal years: Your agency received a appropriation for a period of twenty-four months from July 1, 2004 through June 30, 2006. An encumbrance entered into in August 2004 is authorized through June 30, 2006.

- 7. Our agency has received a federal grant. The grant period is July 1, 2004 through September 30, 2005, with authorization to expend balances 12 months beyond the grant period. Since the grant period is 27-months, can our agency continue to charge the fiscal year 2005 budget by referencing 2005 encumbrances?**

No, “grant period” should not be confused with “appropriation period.” Expenditure (expenses) must be recorded in the appropriation period in which they were incurred. Consequently, expenditures incurred in fiscal year 2006 (including those associated with accounts payable) must be charged against that fiscal year’s budget. To ensure that this occurs, at the end of business on June 30, 2005, the Financial Control Division will carry forward fiscal year 2005 encumbrances, and thus convert them to fiscal year 2006 encumbrances.

- 8. Our agency has an appropriation from an act other than the General Appropriation Act of 2004. This appropriation includes language requiring unexpended or unencumbered balances remaining at the end of fiscal year 2005 to revert; however, this language, unlike the language in the General Appropriation Act, clearly indicates that encumbered amounts do not revert. How do we handle this situation?**

In this case, the Legislature has provided for an appropriation period beyond fiscal year 2005. To accommodate this Legislative authority—for an amount equal to the amount of valid encumbrances on June 30, 2005—your agency must request a fiscal year 2006 budget from the State Budget Division. (This process will work no differently than requesting a budget for a special appropriation.)

At the end of business on June 30, 2005, the Financial Control Division will roll forward encumbrances into the new fiscal year, so that they can be charged against the 2006 fiscal year budget established for them. This process will accommodate both legal compliance and generally accepted accounting principles.