

Basic Governmental Accounting

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Objectives

- Government accounting and financial reporting – why is it different?
- Government accounting and financial reporting – the basics
- Financial best practices

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*Government Accounting and
Financial Reporting –
Why is it Different?*

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“Why can’t government operate like a business?”

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Government vs. Business	
<u>Government</u>	<u>Business</u>
Service-driven	Profit-driven
Taxpayers	Customers
Taxes paid / services	Price / product
Cash flow	Cost of service
Legal budget	Operating budget
Restricted resources	Common resources
Elected officials	Hired officers

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Government vs. Business

- Taxes often bear little direct relationship to services received by the taxpayer (unless a customer paying for goods / services)
 - Result: focus on how public resources are acquired and used; are current resources meeting current service costs?
- Governments do not have owners, measures of net income have no meaning.
 - Result: focus on stewardship of public resources, how resources are devoted to specific services and costs of providing those services

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Government vs. Business

- Creditors of both are interested in information on the ability to repay debt.
 - Government creditors focus more on the government's ongoing ability to raise taxes and costs of activities that could compete for those resources.
- Return on investment (business) vs. sustainability of the level of services and ability to meet future levels of demand for services (government)

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Government financial-statement users

- Management
 - Planning purposes
 - Ensure / demonstrate compliance
 - Internal budgetary restrictions
 - External restrictions (grantors)
- Legislative and oversight bodies
 - Allocation of scarce resources
 - Monitor management's compliance
- Investors and creditors
 - Evaluate creditworthiness of government
 - Evaluate compliance with contractual provisions (debt covenants)
- Citizens
 - Evaluate financial stewardship

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Result of difference: Are we making money?

- Were current-year taxes and other revenues sufficient to cover cost of current-year services?
- What resources support programs?
- What are the spending priorities?
- Did the government's ability to provide services improve or deteriorate from the previous year?
- Does the government have capacity to meet future obligations?
- What resources are available for future expenditures?

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Government Accounting and Financial Reporting – The Basics

- Financial reporting
- Accounting basics
- Budgeting

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Government reporting options

1. GAAP: generally accepted accounting principles
 - Guidance issued by the Governmental Accounting Standards Board (GASB)
2. Cash or Modified Cash basis
 - Cash basis: cash receipts and disbursements only
 - Modified cash basis: cash receipts and disbursements, with modifications
 - Having substantial support in GAAP, and
 - Having been derived from cash transactions or events
3. Regulatory basis

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Modified cash basis

Some common modifications:

- Receivables resulting from a cash outflow (loans)
- Capital assets purchased with cash
- Long-term bonds or notes arising from cash transactions

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Modified cash basis

Modifications that are NOT appropriate:

- Recording accounts receivable resulting from services provided (billed or unbilled)
- Recording accounts payable for good or services received
- Recording accrued compensated absences, accrued interest payable

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Government reporting: Financial reporting entity

- What entities are included in the financial statements?
 - Government itself (primary government)
 - All state and general-purpose local governments
 - Legally separate units for which the primary government is financially accountable or whose exclusion would make the primary government's financial statements misleading (component units)
 - Certain special purpose governments may be separate primary governments, and not included

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Government accounting basics

- Standards set by Governmental Accounting Standards Board (GASB)
- Certain standards set by the Financial Accounting Standards Board (FASB) may apply to proprietary fund types

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Government accounting: The basics

- Governments use fund accounting
- Governments have required budgetary reporting
- Governments use different bases of accounting / measurement focuses within a single set of financial statements

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Cash basis vs. GAAP reporting

Cash basis –

- Focus is on current year, cash received and spent / obligated
 - Ensure and demonstrate accountability
- Reflects current public policy priorities
- Are current resources sufficient to meet current service costs?
- Revenues: recognized when received
- Expenditures: recognized when paid or (on budgetary statements) when encumbered

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Cash basis vs. GAAP reporting

GAAP (generally accepted accounting principles):

- Greater focus on economic resources – resources available for future expenditures and capacity to meet future obligations (longer-term focus)
- Revenues: recognized when earned
- Expenditures: recognized when incurred
- Capital assets and long-term debt recognized as well

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Financial statement presentation: cash or modified cash basis

- Financial statements should meet the presentation requirements of GAAP, including government-wide and fund financial statements, and related notes
 - It's just that accounts included within those financial statements will include different things
- However, Required Supplementary Information (RSI) is not required for cash & modified cash basis, as RSI is required by GASB in GAAP-basis F/S
 - Would include: MD&A, pension & OPEB schedules of funding progress, budgetary comparison information
 - However, such information could still be included, though it would be considered voluntary Supplementary Information (SI) or Other Information (OI)

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Fund accounting

- Governmental funds:
 - General fund
 - Special revenue funds
 - Capital-project funds
 - Debt-service fund
 - Permanent funds
- Proprietary / business-type funds:
 - Enterprise funds
 - Internal service funds
- Fiduciary funds

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Fund accounting

- General fund: chief operating fund, used to account for all financial resources other than those required to be accounted for in another fund
- Special-revenue funds: account for the proceeds of specific revenue sources, for specific purposes
 - Grants, enabling legislation, etc.
 - Use is *permitted* rather than *required*

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Fund accounting

- Capital-project funds: account for resources to be used for the acquisition or construction of capital assets other than those financed by proprietary funds
- Debt-service fund: accounts for the accumulation of resources for and the payment of general long-term debt principal and interest

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Fund accounting

- Permanent funds: report resources legally restricted to the extent that only earnings, and not principal, may be used for purposes that support the government's programs or its citizenry
- Enterprise funds: may be used to report any activity for which a fee is charged to external users for goods and services (required in certain situations)
 - Not required to recover full cost of operations (for example – Transit operations)

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Fund accounting

- Internal service funds: may be used to report any activity that provides goods or services to other funds, departments, or agencies of the primary government and its component units, or to other governments, on a cost-reimbursement basis
 - Example: fleet pools, IT systems, self-insurance or other risk financing
 - Use is *never* required

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Fund accounting

- Fiduciary funds: used for pension or other employee benefit trust funds, investment trust funds, private-purpose trust funds or agency funds
 - Gov't is acting in a fiduciary or custodial capacity.
 - Trust funds are created as official legal "trusts."
 - Private purpose trusts – principal and income can benefit individuals, private organizations or other governments (for example, escheat assets)
 - Agency funds – role is purely custodial; all assets offset by liabilities (no net assets)

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Financial statements

- Budgetary statements
- Fund financial statements
- Government-wide financial statements
- Notes to the financial statements

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Budgetary statements

- Reported for each individual fund, with focus on compliance with legal budget and cash-basis laws
- Cash basis, modified for encumbrances
- Comparison of:
 - Original budget vs. final budget
 - Actual results vs. final budget

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Fund financial statements

- Reported by fund type (governmental, proprietary, fiduciary)
 - Focus on “major” funds
 - Demonstrates fiscal accountability
- Current financial resources focus / modified accrual basis of accounting (if GAAP)
 - Principal & interest payments on long-term debt are recorded as expenditures
 - Costs of construction or other capital outlay are recorded as expenditures
 - Proceeds from bond issues are recorded as revenues

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Fund financial statements

Governmental funds:

- Balance sheet
- Statement of revenues, expenditures and changes in fund balance

Proprietary funds:

- Statement of net assets
- Statement of revenues, expenses and changes in net assets
- Statement of cash flows

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Government-wide financial statements

- Report governmental activities and business type activities in total
- Excludes fiduciary funds
- Economic resources focus / full accrual basis of accounting (if GAAP)
 - Includes all long-term assets and liabilities

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Statement of net assets

- What does the government own, and what does it owe?
- What are the government's short-term financial needs, and what are its available resources?
- What are its liquid assets?
- What's left over after all liabilities are paid? (net assets)
 - Is this money the government can spend?

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Statement of net assets (cont'd.)

- What does the statement really tell me about the government?
 - Overall financial condition: ability to meet obligations as they come due and finance the services its constituency requires
 - Current assets vs. current liabilities (liquidity)
 - Long-term viability (solvency): degree to which assets are financed through borrowing – i.e., extent to which assets will be needed to satisfy debts rather than be available for providing public services
 - Trend data from prior years: see the MD&A or the Statistical Section (if preparing a CAFR)

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Statement of activities

- Starting point: total cost of governmental services by function (i.e., expenses)
- What program revenues does the entity generate to support its services?
 - Charges for services
 - Grants and contributions
- Net cost of services = taxpayer burden
- Change in net assets (equivalent of net income in a for-profit entity)

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Statement of activities

- What does this statement tell me?
 - The cost of providing services
 - The tax burden on citizens to finance services
 - Degree to which each functional area requires taxes or general revenues for financing
 - Whether the government is raising enough resources to finance its operations
 - Diversity of revenues and trends over past years – can demonstrate exposure to financial difficulty if a source of revenue dries up
 - Did the government finance that year's services with revenues from that year (intergenerational equity)?
 - See MD&A and Statistical Section for trend data. AGH

Basic financial statements – other info

- Reconciliation between fund statements and government-wide statements (likely will not have this if on a cash basis; might if modified cash)
- Notes to the financial statements
- GAAP financial statements:
 - Required supplementary information
 - Budget vs. GAAP explanation
 - Funded status of pension plans
 - Management's discussion and analysis
- Comprehensive Annual Financial Report
 - Transmittal letter
 - Statistical section

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Statistical section (CAFRs only)

- Debt per capita
- Debt to assessed value
- Legal debt margin
- Debt service as a % of total expenditures
- Major industries and employers – now vs. 10 years ago

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GAAP: pros / cons if not required

Pros:

- Provides data on long-term asset needs, and long-term obligations
- Presents a full economic picture of the entity
- May result in better interest rates and easier access to capital, if bond market participants have access to more data

Cons:

- Cost of producing GAAP financial statements is higher
 - Need for internal processes, expertise, and expanded IT systems
 - Higher audit costs
- Information on long-term obligations and assets may be available for decision-making purposes already, without need to prepare GAAP statements.
- If not going to bond market frequently, GAAP statements may not result in a significant enough benefit from lower interest rates compared to the cost incurred to produce them.

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Budgeting: The basics

- Role shared with the private sector
 - Financial-planning tool
- Role unique to the public sector
 - Set public policy
 - Control on taxing and spending

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Classifying budgets

- Period
 - Annual
 - Biennial
 - Project-length
- Character
 - Operating
 - Capital

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Capital budgets

- Replacement schedules should anticipate the inevitable aging and obsolescence of facilities and equipment. Depreciable assets should be financed through internal funds whenever possible.
- Realistically assess future revenues and avoid commitments for projects that lack economic feasibility.
- Disciplined borrowing – appropriate as a means of matching facilities' costs with the benefits enjoyed by future residents
- Capital expenses usually add operating costs. Capital plans should include projected changes in operating and maintenance costs, workforce requirements and risk-management considerations.

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Encumbrances and uncommitted appropriations

Appropriations (budget)
Less: Actual account (expenditures paid)
Less: Encumbrances (commitments)

Equals: Uncommitted appropriation

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Encumbrances outstanding at year-end

Two approaches:

- Reappropriation
 - Would need to be reappropriated as part of the subsequent year's budget
- Extension of budget period for encumbrances (lapse period)
 - When the encumbrance is finally liquidated, it is charged against the prior year's budget, rather than against the budget of the current year.

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Legal level of budgetary control

The lowest level at which a government's management may not reallocate resources without special approval from the governing body. Most common:

- Fund level
- Department level
- Object-code level (personnel, contractual, materials and supplies)

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Financial Best Practices

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Financial policies

- Investment policy
 - Types of securities, liquidity, maturity, default risk, investment return, etc.
 - Use of brokers / bankers in a competitive program with reputable financial institutions
- Cash-management policy
 - Designed to facilitate maximum cash flow, and investment income
 - Safety first: security of public deposits should be assured through proper collateralization

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Financial policies

- Debt management plan
 - Assess the government's long-term capacity to absorb and repay debt
 - Ensure appropriate bond counsel and financial advisors assist on bond issues
 - Competitive vs. negotiated underwriting: competitive sales should be used whenever feasible. In negotiated underwritings, ensure that underwriter profits are reasonable and that costs are truly minimized. Interest rates, fees and fee structure should be part of negotiations.

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Financial policies

- Procurement policy
 - Should promote maximum value and economy through a competitive process
 - Minimize opportunities for favoritism
 - Set specific dollar amounts for competitive bidding, and authorization limits for others.
 - Consider special procedures for selecting service providers such as financial advisors, auditors, consultants.
 - Consider procurement cards for smaller items (need separate policy).

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Financial policies

- Reserves policy / fund balance policy
 - Essential for mitigating current and future risks, revenue shortfalls and unanticipated expenditures. Also helps ensure stable tax rates.
 - GFOA recommended practice is to have no less than two months of regular general-fund operating revenues or expenditures (depending on which is more predictable).
 - Consider: predictability of revenues and volatility of expenditures, exposure to one-time outlays (disasters, immediate capital needs), liquidity, previous commitments

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Resources

For Cash Basis, Modified Cash Basis or
Regulatory Reporting:

AICPA Practice Aid: *Applying OCBOA in
State and Local Government Financial
Statements*

www.cpa2biz.com

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Questions?

Thank you!

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