PacificCPE

COURSE

211511A

# Government Financial Reporting, Disclosure, and Analysis

Pulling it all together, this course focuses on how governments present and disclose financial information—and what those reports actually reveal. You'll explore the components of comprehensive annual financial reports, key disclosure requirements, and how to analyze governmental financial statements for signs of fiscal stress. Real-world examples show why balanced budget requirements don't always produce truly balanced budgets. Ideal for CPAs and analysts who need to evaluate or communicate the financial condition of governmental entities.

CREDIT HOURS 2 | FIELD OF STUDY ACCOUNTING | EXAM QUESTIONS 10

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## LEARNING ASSIGNMENTS AND OBJECTIVES

## Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

## Course Objectives

- Recall the ways of reporting on component units.
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Recognize the components of the ACFR.

- Identify how to measure a government's fiscal effort.

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# Chapter 1: ISSUES OF REPORTING, DISCLOSURE, AND FINANCIAL ANALYSIS

*Chapter Objective*

**After completing this chapter, you should be able to:**

- Recall the ways of reporting on component units.
- Recognize the components of the ACFR.
- Identify how to measure a government's fiscal effort.

This chapter—the final chapter that deals mainly with external reporting by state and local governments— presents an overview of the annual financial report. We have now discussed each of the major fund types maintained by governments. This chapter highlights how individual fund statements can be consolidated into government-wide statements—the first of the statements to be presented in the ACFR. The chapter then considers the issue of the reporting entity—which associated organizations a primary entity must incorporate into its financial reports. Thereafter, it highlights the structure of the annual report and the need for statistical information to supplement the financial statements. It then addresses reporting issues faced by special-purpose governments. It concludes by presenting an approach to assessing a government's financial condition.

## HOW CAN A GOVERNMENT PREPARE GOVERNMENT-WIDE STATEMENTS FROM FUND STATEMENTS?

In this text we have taken a conceptual, rather than a procedural, approach to the government-wide statements. That is, we illustrated, often with journal entries, how various transactions would be reflected in those statements. We noted, however, that governments do not typically prepare two sets of journal entries or maintain two sets of books—one for their fund statements and the other for their government- wide statements. Instead, they maintain only one set of accounts—that on a fund basis. At year-end they convert the fund statements to government-wide statements. Some governments do this manually, using an Excel-type worksheet. Others rely on their accounting software to automatically prepare both fund and government-wide statements. In this section, we present an overview of the key adjustments required to convert fund statements to government-wide statements. In keeping with the conceptual approach of the text, our aim is mainly to summarize the differences between the two statements, not to provide a how-to guide to make the worksheet adjustments.

A quick overview of the differences between the two sets of statements can be found in the statements themselves. As illustrated in the financial statements of Milwaukee, Wisconsin, included in Chapter 1 of course 21152F, the governmental fund balance sheet contains a section that reconciles the total fund balances for governmental funds with the total net assets per the government-wide statement of net position (see Table 2-6). Similarly, the governmental statement of revenues, expenditures, and changes in fund balance incorporates a reconciliation of the net change in fund balances of the governmental funds with change in net position of governmental activities per the government-wide statement of activities (see Table 2-4).

In this section, we focus on the governmental funds, rather than on the enterprise funds, because the enterprise funds are already on a full-accrual basis and hence present few problems of conversion.

The following presents the general approach to converting the governmental fund statements to the government-wide statements:

- *Start with a year-end trial balance that combines all the governmental funds.*
- *Eliminate interfund transactions.* During the period reported on in the statements, there were likely numerous transactions made among the governmental funds. These may include transfers—such as from the general fund to a debt service fund or payments for services, as when *self-insurance* activities are accounted for in a governmental fund. These transactions must be backed out because they have no impact on the government as a whole. Similarly, any interfund payables and receivables must be eliminated.
- *Adjust capital asset-related accounts.* Capital assets are reported on the government-wide statements but not on the fund statements. The beginning balance in the capital asset accounts (per the previous year's government-wide statements) must be added to the trial balance (offset by additions to net assets). Then, a series of entries must be made to eliminate the expenditures for new capital assets and add the amounts expended to the balance of the capital assets. To eliminate the proceeds from the sale of capital assets (from other financing sources), subtract the original cost of the assets sold from the balance of the capital assets and credit or charge any difference to a gain or loss on the sale of capital assets. Record a charge for depreciation.
- *Adjust long-term, debt-related accounts.* Long-term obligations are reported on the government-wide statement but not the fund statements. Accordingly, entries similar to those for capital assets must be made. The beginning balance in the long-term debt accounts must be added to the trial balance. Then, entries must be made to eliminate the proceeds from the issuance of bonds or other certificates of debt (from other financing sources). Add the bond proceeds to long-term liabilities. To eliminate the expenditures for the retirement of debt, subtract the "book value" of the retired debt from the long-term

liabilities accounts and credit or charge any difference to a gain or loss on retirement of debt account. To adjust interest expenditure to interest expense, charge or credit the bond *discount*, bond *premium*, or prepaid or deferred interest as necessary.

- *Adjust for difference in basis of accounting.* Governmental funds are accounted for on a modified-accrual basis; government-wide statements are prepared on a full- accrual basis. Thus, there are revenue and expenditure/expense timing differences. Most notably, in the governmental fund statements, but not in the government-wide statements, revenues must satisfy the "available" criteria for recognition. Similarly, in governmental funds, prepaid items may be accounted for on a *consumption* or *purchases* basis; in the government-wide statements, only the consumption basis is acceptable. In governmental funds, compensated absences—such as vacation pay, pensions, and *claims and judgments*—are accounted for on what is, in essence, a pay-as-you- go basis; in the government-wide statements, they accounted for on an accrual basis. Therefore, to convert from the governmental fund to the government-wide statements, the governmental revenues and expenditures must be recomputed so that they are on a full-accrual basis. Correspondingly, an offsetting adjustment must be made to deferred revenues, prepaid expenses, long-term liabilities, or assets.
- *Consolidate internal service funds.* Although internal service funds are classified as proprietary funds, they provide services mainly to units that are accounted for in governmental funds. In the government-wide statements, any assets and liabilities that have not been eliminated as interfund receivables or payables are reported as governmental activities (unless the fund has provided goods or services mainly to enterprise funds). Similarly, any "profits" earned or "losses" incurred during the year are credited or charged back to the category of funds from which they originated. The required adjustments may necessitate a series of entries that are potentially complex and depend on the proportion of services used by units accounted for in governmental funds and those accounted for in enterprise funds.

Once a government-wide trial balance sheet is completed, the accounts must be divided first between the statement of net position and statement of activities and then among the various functional accounts (e.g., general government, public safety, health, and sanitation) and the various types of revenues (operating grants, capital grants, and general revenues). Suffice it to say that, in practice, the classification of revenues and expenses typically involves numerous intractable issues. Common among these are to what extent certain common administrative costs should be reported as general government expenses or allocated among the various functions.

## WHY IS THE REPORTING ENTITY AN ISSUE FOR GOVERNMENTS AND NOT-FOR- PROFITS?

The composition of the reporting entity has proven to be one of the most stubborn issues facing business, government, and not-for-profit standards setters. As has long been recognized in the

business sector, an organization's legal entity may differ from its economic entity. If a company controls another company, then its economic entity comprises the company itself plus its subsidiaries. Recall, governments may operate certain activities through separate public authorities, or issue debt through a conduit; not-for-profits might segregate certain assets (especially property or endowments) into separate legal entities. Yet in light of today's complex organizational relationships, satisfactory definitions of control have proven elusive.

The reporting entity issue in the government sector is delineated in the example that follows and its subsequent variations.

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**EXAMPLE: THE REPORTING ENTITY**

A city operates an electricity-generating facility that supplies power exclusively to its municipal subway system. The facility needs costly capital improvements, but owing to debt limitations, the city is unable to borrow the required funds. To circumvent the limitations, the city forms a new unit of government—a public power authority—to which it transfers the generating facility. The facility is to be governed by a board of directors, the members of which will be the same officials that compose the city council. The authority will issue city-backed bonds, which it will repay from revenues earned from the sale of electricity to the city.

In this example, the power authority, although an independent legal entity, is within the economic and political control of the city, no less than if it were another city department. City council members govern the authority, and the city is obligated for its debt. The city is the sole beneficiary of its resources. Therefore, if the city's financial statements were to report on all its economic assets and liabilities, they would have to encompass the assets and liabilities of the authority.

Consider, however, a continuum of modifications to the example:

- The authority's governing board, rather than being composed of city council members, is appointed by the city's mayor.
- The authority's governing board is independently elected, but the city retains the right to approve the authority's budget.
- The governing board is independently elected, and the city has no right to approve the authority's budget.

In this sequence of variations, the city's ability to control the authority is gradually eroded, and the economic borders between the city and the authority are made more pronounced. Consequently, with each variation the rationale for including the authority within the city's reporting entity is diminished. But where should standard setters draw the line?

This sequence of variations oversimplifies the problem, however, in that it focuses exclusively on whether the city controls the authority. In fact, the extent to which entities are economically intertwined cannot be assessed on the single vector of control. Economic interdependence is also measured by whether one organization shares geographic boundaries with the other, is responsible for its debts, must fund its deficits, can benefit from its surpluses, and is a major source of its revenues. Rule-making authorities have had to develop a multidimensional framework of standards that is appropriate for the approximately 90,000 U.S. governments, all of which are tied to at least one other government.

The following are but a very small sample of common intergovernmental relationships in the United States:

- Housing authorities established by cities to provide low-cost financing for residents of the cities
- Turnpike commissions established by states to finance and operate toll roads
- Volunteer fire departments partially funded by counties or towns
- Universities that receive state funds but are controlled by independently elected boards of regents.

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## WHAT CRITERIA HAVE BEEN ESTABLISHED FOR GOVERNMENT REPORTING ENTITIES?

GASB Codification Section 2100—Defining the Financial Reporting Entity, sets forth the criteria for determining the units that should be included in a reporting entity, and Section 2600—Reporting Entity and Component Unit Presentation and Disclosure guides how they should be reported.

### Types of Units Composing the Reporting Entity

Per GASB standards, a financial reporting entity should consist of a primary government (the larger, creating government) and its component units (the typically smaller, created government).

A **primary government** can be a state government, a general-purpose local government such as a municipality or a county, or a special-purpose state or local government. Codification Section 2100, paragraph 112 explicitly states, “A primary government is any state government or general-purpose local government (municipality or county).” Under the U.S. system of federalism, local governments are subunits of the states in which they are located and are subject to state control. Were the definition of a primary government not to include explicitly general-purpose local governments, then virtually all cities, towns, and counties would be component units of their states rather than primary governments.

Special-purpose governments include a vast array of authorities and districts, such as school districts, municipal utility districts, and transportation authorities. To qualify as a primary government, a special-purpose government must have a separately elected governing body, be legally separate from other primary governments, and be *fiscally independent* of other governments. Fiscal independence implies that the government has the authority, without approval from other governments, to:

- Determine its budget
- Levy taxes or set rates and charges
- Issue bonds

A component unit is a legally separate government for which the elected officials of the primary government are financially accountable. Governments create authorities, public benefit corporations, and other types of organizations, largely for the purpose of performing functions that are either not cost- effective for, or *prohibited* by, primary governments. Acomponent unit may also be an organization whose exclusion would cause a primary government's statements to be misleading or incomplete because of the nature and relationship between the two. Such a relationship would exist if the potential component unit were created solely to benefit the primary government. For example, to help New York City out of its financial difficulties in the mid-1970s, the State of New York established the Municipal Assistance Corporation (known as "Big MAC"). The function of the corporation was to supervise the city's fiscal affairs and to issue bonds on its behalf. Because the city was financially accountable to the corporation, not the other way around, the corporation would not qualify as a component unit were it not for this "misleading or incomplete" provision.

**Meaning of Financially Accountable Component Units**

**Appoint a Majority of the Board and Either Impose Will or There Is a Financial Benefit/Burden** Relationship

The key criterion as to whether a primary government is financially accountable for another government— thus qualifying the other government as a component unit—is that the primary government is financially accountable if it appoints a voting majority of the organization's governing body and (1) it is able to impose its will on that organization or (2) there is a potential for the organization to provide specific financial benefits to, or impose specific financial burdens on, the primary government. The primary government can impose its will on the potential component unit if it satisfies any one of the following criteria:

- It can remove appointed members of the potential component unit's governing board.
- It has the authority to modify or approve the unit's budget.
- It can approve or modify the unit's fee charges.

- It can veto, overrule, or modify decisions of the unit's governing board.
- It can appoint, hire, reassign, or dismiss the unit's managers responsible for day-to-day operations.

The component unit can provide specific financial benefits to, or impose specific financial burdens on, the primary government if

- The primary government is entitled to the potential component unit's financial resources, or
- It is legally obligated, or has assumed the obligation to finance, the unit's deficits or is otherwise obligated to support the unit's operations or
- It is obligated "in some manner" for the unit's debt, whether that obligation is expressed or implied.

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**EXAMPLE: FINANCIALLY ACCOUNTABLE COMPONENT UNITS**

The Jefferson Hospital District was established to furnish medical aid and hospital care to indigent persons residing in Jefferson County. The district is governed by a board of trustees that sets policy for the district and oversees its day-to-day operations. The district is located entirely within Jefferson County, and the county's commissioners' court appoints the members of the district's board of trustees. The commissioners' court has the authority to approve the hospital district's budget.

The hospital district is a component unit of the county. It satisfies the two criteria of financial accountability in that:

- The county appoints the voting majority of the district's governing board.
- The county's authority to approve the district's budget gives it the ability to impose its will on the district.

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**Fiscally Dependent and There Is a Financial Benefit/Burden Relationship**

As a general rule, a potential component unit is fiscally accountable to a primary government only if the primary government controls the appointment of its governing board. However, the GASB standards provide for an exception. Even if its board is independently elected and thereby outside the influence of the primary government, a potential component unit may be considered financially accountable to a primary government if the unit is **fiscally dependent** on the primary government. A unit is fiscally dependent on the primary government if it is unable to determine its own budget, levy taxes or set rates, or issue bonds without approval of the primary government, and there is the