

GAAFR REVIEW

The Government Finance Officers Association's Newsletter on Governmental Accounting, Auditing, and Financial Reporting

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REPORT FROM GASB

In November, the Governmental Accounting Standards Board (GASB) met to deliberate on issues arising in connection with several of its technical agenda projects including derivatives and hedging; pollution remediation; the conceptual framework; fund balance reporting; and economic condition reporting.

Derivatives and hedging

The GASB met with a panel of financial statement users who are also considered to be experts on derivatives. The board sought the panel's views on hedge accounting and how best to determine the effectiveness of a hedge. (This latter issue led to a discussion of the appropriate calculation methodology and financial statement presentation in situations where a hedge is determined *not* to be effective.) The panel also offered its views on the usefulness for analytical purposes of different types of potential disclosures.

The GASB plans to seek the panel's input on a variety of issues, including:

- The appropriateness of the Bond Market Association (BMA) index for benchmarking;
- The hedging of net positions; and
- The development of definitions that will distinguish derivatives from insurance, synthetic guaranteed insurance contracts, and when-issued securities.

The board plans to review a draft preliminary views (PV) document at an upcoming teleconference meeting.

Pollution remediation

After considering responses to its recent

PV on pollution remediation obligations, the GASB reached the following tentative conclusions regarding its forthcoming exposure draft (ED) on that topic:

- The ED will not make any change to the PV's proposed guidance on benchmarks;
- The discussion of the measurement of the liability to be reported:
 - will drop all reference to discounted present value,
 - will *not* address how to allocate employee benefits to pollution remediation outlays, and
 - will *not* discuss the government's policy for including or excluding indirect outlays;
- The ED will clarify that amounts spent for water filtration systems are *not* part of the pollution remediation liability because their primary purpose is to prepare water for sale to customers rather than to clean up pollution;
- The ED will make it clear that expected outlays are *not* the same thing as a government's reportable liability and expense in situations where recoveries are either realized or realizable; and
- The ED will clarify that expenditures reported in governmental funds are only reduced by *realized* recoveries.

Also, in response to concerns that disclosures could be harmful to an entity's bargaining position in legal disputes, the ED will add the following sample disclosure text to one of its examples:

The measurement of the liability represents a probability-weighted average of possible outcomes and is based on professional experience with similar claims, some of which are higher and

some of which are lower. The Borough has not admitted fault and intends to vigorously challenge the claim.

Conceptual framework

The GASB considered whether and to what extent a document devoted to defining financial statement elements should address the matter of measurement focus. Ultimately, the board concluded that, at a minimum, the eventual concepts statement should discuss how the definitions of the various financial statement elements would be affected (continued on page 6)

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Focus on Governmental Accounting

HELPING USERS TO INTERPRET FINANCIAL STATEMENTS (PART 3)

Last month's issue of *GAAFR Review* contained the second installment in a three-part series on how accounting and auditing professionals can help those without such a background to properly interpret the data contained in local government financial reports. The first two articles in the series focused on evaluating a government's *near-term financing situation* and its *financial position*. This final article will consider how to assess *economic condition*.

Assessing economic condition

As explained previously, *financial position* is concerned with an entity's assets and liabilities at a point in time. The concept of *economic condition* goes a step further, taking into account as well both financial and nonfinancial factors that could lead to financial position subsequently improving or deteriorating.

Much of the information needed for assessing economic condition involves either nonfinancial data (e.g., population and unemployment) or financial data presented for multiple years (e.g., ten-year trends). Such data typically are located either in the statistical section of the comprehensive annual financial report (CAFR) or as part of required supplementary information (RSI). This article will focus on just a few of the many data elements available for analysis.

Revenue and expenditure trends. It is axiomatic that past trends are often the best indicators of future directions. Thus, it is important in reviewing governmental fund data to analyze revenue and expenditure trends carefully. One particularly useful technique is to consider individual categories of revenues and expenditures as a percentage of total revenues or total expenditures. Assume, for example, that the schedule of changes in fund balances in the CAFR statistical section indicates that a local government has received the following amounts of intergovernmental revenue for the past ten years:

<u>Year</u>	<u>Dollar Amount</u>
1996	\$3,424
1997	\$3,522
1998	\$3,625
1999	\$3,735
2000	\$3,880
2001	\$4,055
2002	\$4,251
2003	\$4,461
2004	\$4,691
2005	\$4,950

If these amounts are considered in isolation, it is apparent that intergovernmental revenue not only has grown in amount each year for the past decade, but that the rate of growth has actually been slowly increasing as well:

<u>Year</u>	<u>Dollar Amount</u>	<u>Dollar Increase</u>	<u>Percentage Increase</u>
1996	\$3,424	\$94	2.82%
1997	\$3,522	\$98	2.86%
1998	\$3,625	\$103	2.92%
1999	\$3,735	\$110	3.03%
2000	\$3,880	\$145	3.88%
2001	\$4,055	\$175	4.51%
2002	\$4,251	\$196	4.83%
2003	\$4,461	\$210	4.94%
2004	\$4,691	\$230	5.16%
2005	\$4,950	\$259	5.52%

A very different picture emerges, however, when intergovernmental revenue is considered as a percentage of the local government's total revenue:

<u>Year</u>	<u>Dollar Amount</u>	<u>Dollar Increase</u>	<u>Percentage Increase</u>
1996	\$3,424	\$15,800	21.67%
1997	\$3,522	\$18,265	19.28%
1998	\$3,625	\$19,108	18.97%
1999	\$3,735	\$21,908	17.05%
2000	\$3,880	\$24,899	15.58%
2001	\$4,055	\$26,595	15.25%
2002	\$4,251	\$28,865	14.73%
2003	\$4,461	\$30,794	14.49%
2004	\$4,691	\$36,298	12.92%
2005	\$4,950	\$42,954	11.52%

By considering intergovernmental revenue as a percentage of total revenue, it becomes evident that over the past decade the government has been forced to rely increasingly upon own-source revenue to finance its operations. Whereas just ten years ago intergovernmental revenue was adequate to fund more than one fifth of the budget, it is now sufficient to cover only about one tenth of the budget.

This same approach is useful as well for analyzing functional and programmatic expenditures. For many financial statement users, the key analytical consideration will be the percentage of total expenditures devoted to a given function or program, *not* the dollar amount spent as such. That is, the question often is not so much, "how much is the government spending on public safety" as "how much is the government spending on public safety *in comparison with other types of spending?*" (e.g., "we used to spend 12 percent of our budget on public safety, but now we are spending almost 20 percent of the budget for that purpose").

Revenue capacity. Another key element in assessing economic condition for a typical local government is its ability to generate own-source revenue. Indeed, from the perspective of many creditors, the ability to raise own-source revenue is a government's greatest single "asset" even though it cannot properly be reported as such in the financial statements.

The total direct rate applied to a government's major own-source revenue base is an important factor to consider in assessing potential resistance to future rate increases. For example, it might reasonably be assumed, all things being equal, that property taxpayers in a city with a current millage of only 4.465 would be more receptive to a potential rate increase than taxpayers in another city with an outstanding millage of 8.225. Such an analysis, however, could be seriously defective if it failed to take into account the claims of other governments upon the same tax base. Assume, for example, that taxpayers in the city with the 4.465 millage (City A) also had to pay property taxes to the county, a school district, and various special districts, whereas taxpayers in the city with the 8.225 millage (City B) paid property taxes only to the city and the county. In that case, the citizens of City A might have a higher *overall* rate, as follows:

Millage	City A	City B
City millage	4.465	8.225
County	4.527	5.331
School district	7.228	N/A
Special districts	<u>1.838</u>	<u>N/A</u>
	18.058	13.556

Accordingly, it is important to consider not only the direct rate applied to a government's own-source revenue base, but also the rates of any overlapping governments.

A government also can face significant economic risks as the result of too great a dependence on too small a pool of rate payers. For example, if a local government relies upon just one or several rate payers for a significant portion of its own-source revenue, it could face an economic crisis were that rate payer or those rate payers to go out of business. The schedule of principal rate payers in the statistical section of the CAFR allows financial statement users to judge for themselves how great a risk a given local government might currently face in this regard. That schedule also makes it possible to determine the extent to which the composition of the pool of principal rate payers has changed over time, thereby indicating whether the risk of excessive reliance on one or more rate payers has increased or decreased.

Debt capacity. Another important consideration in assessing a government's economic condition is its debt capacity. Much valuable information in this regard can be found in the statistical section of the CAFR.

One common method of evaluating a government's debt burden is to compare debt service expenditures in the governmental funds to total noncapital expenditures (just as a bank

might choose to compare projected monthly house payments to a potential borrower's take-home pay). This ratio typically is provided for a ten-year period on the schedule of changes in fund balances (rather than with other debt-related data). The proportion of debt service to total noncapital expenditures is particularly important because debt service payments are essentially inflexible (i.e., they cannot potentially be trimmed in the same manner as other budgeted items).

It also is important to keep in mind that taxpayers often must bear the debt burden of more than one government, and that their ability and willingness to support further debt will be a function of their *overall* debt burden. Assume, for example, that the city itself has outstanding debt of \$40,615. Further assume that the county has outstanding debt of \$72,240 and that the city's property tax base represents 13.8 percent of the county's property tax base. In that case, the city's taxpayers not only will have to finance their own debt of \$40,615, but also \$9,969 of the county's debt (i.e., \$72,240 x .138 = \$9,969), creating an overall debt burden of \$50,584. Note that this amount is substantially higher (25 percent) than what would have been reported for the city alone. Accordingly, the statistical section of the CAFR always provides information on direct and overlapping debt for the current year.

Principal employers. Most taxpayers must be employed before they are in a position to be able to pay taxes. Consequently, the loss of a major employer can be a significant threat to a government's economic well being. Ideally, employment will be diversified, both by employer and by industry. In practice, however, a government's options are often quite limited in this regard. All the same, an evaluation of employment diversification is essential to an assessment of economic condition.

The statistical section of the CAFR provides data on a government's largest employers for both the current year and the period nine years previous. Key considerations in evaluating this information are: 1) the degree to which the government is dependent on just one or a few major employers for a major portion of its employment, 2) the degree to which the government is dependent upon a single industry for a significant portion of its employment (often all firms in a particular industry are affected to a greater or lesser extent by a downturn in that industry), and 3) changes in the past ten years (i.e., is diversification increasing or decreasing over time?).

Pension and OPEB liabilities. Employees often take a portion of their compensation in the form of pension benefits (e.g., retirement income) or other postemployment benefits (OPEB). Sometimes pension benefits and OPEB are offered through *defined contribution plans*. In that case, the employer commits only to making contractually agreed-upon payments to an individual account on behalf of the employee during the employee's active service life. Once such contributions have been made, the employer has no further obligation to the employee.

In other situations, pension benefits and OPEB are offered through *defined benefit plans*. Employers participating in such arrangements promise specific levels of benefits to employees after they have completed their service. For example, retirement income for an employee participating in a typical defined benefit pension plan will be calculated using a formula based upon factors such as the employee's final salary level and number of years of service.

In the public sector, the vast majority of pension plans are of the defined benefit type. Defined contribution plans, when they exist in the public sector, typically supplement rather than replace defined benefit plans.

Sometimes, employers offering defined benefits will participate in a multiple-employer *cost-sharing plan*. Such arrangements function much like insurance pools. That is to say, it is the pool itself, rather than the participating employers, that ultimately is responsible for providing benefits to employees. Employers fulfill their obligation when they make contractually required payments to the pool, as is the case for employers participating in defined contribution plans.

In other situations, employers remain solely responsible for paying defined benefits promised to employees after they have completed their service (i.e., *single-employer plans* and *agent multiple-employer plans*). For such employers, the present value of projected benefits earned by employees for services rendered is known as the *actuarial accrued liability*.

Each year, the actuary establishes the employer's *annual required contribution* (ARC), which is designed to recover the cost of benefits earned by employees during the period (*normal cost*). Furthermore, if assets accumulated to date are insufficient to cover the actuarial accrued liability, the actuary will include in the ARC an amount designed to recover a portion of this deficit (*unfunded actuarial accrued liability*).

Note that neither the actuarial accrued liability in total, nor the unfunded portion of the actuarial accrued liability, are reported as liabilities in the employer's financial statements. Rather, employers report a liability in the financial statements only to the extent that they have failed to fully fund the ARC for pension benefits (*net pension obligation*) or the ARC for OPEB (*net OPEB obligation*). Even in that case, this liability is reported only in accrual-based financial statements.

The existence of a net pension obligation or a net OPEB obligation should always be a matter of concern, for such liabilities result directly from an employer's failure to fully fund actuarially determined required contributions. Since the employer in a single-employer or agent multiple-employer plan ultimately has no choice but to fulfill its obligation to employees, such a failure to provide adequate funding on an ongoing basis has potentially serious implications for a government's economic condition.

To the contrary, an unfunded actuarial accrued liability should not, *of itself*, be the cause of undue concern regarding a

government's economic condition. Such a disparity between accumulated plan assets and the actuarial accrued liability can simply be the inevitable result of changes in benefit formulas and the use of actuarial assumptions to project benefit costs. Still, careful analysis is needed to ensure that further concern is unwarranted. The information needed for such an analysis is provided by the employer as RSI and in the notes to the financial statements.

The schedule of funding progress, which normally presents at least three years of trend data, compares accumulated plan assets to the actuarial accrued liability and expresses that relationship as a percentage ("funded ratio"). Thus, a plan with an actuarial accrued liability of \$1 million and \$900,000 in plan assets would be described as having a funded ratio of 90 percent. The important thing in analyzing the funded ratio is to consider its trend *over time*. For example, it might be tempting to consider a plan with a 90 percent funded ratio to be in better shape than a plan with an 85 percent funded ratio. In fact, however, the latter would be preferable to the former if the latter had been only 80 percent funded just three years earlier whereas the former had been 95 percent funded at that same time. In other words, what is most important is not where the funded ratio is today, but the direction in which it has been heading and at what speed.

Any acceptable actuarial method will produce the resources needed to pay benefits promised to employees in a timely fashion, provided that the employer faithfully funds each year's ARC in full. Therefore, a pattern of 100 percent funding of annual required contributions over time is an important positive factor in evaluating economic condition. Information on both required employer contributions and actual contributions for each of the past three years is presented in the notes. Analysis of this information is especially important in cases where the employer reports a net pension obligation or a net OPEB obligation, because it permits the financial statement user to determine whether the underfunding that created those liabilities to begin with is now a thing of the past.

Summary

Governments have no equivalent to a business's "bottom line." Instead, users of local government financial statements must approach a government's finances from three different but complementary perspectives: 1) the government's near-term financing situation, 2) the government's financial position, and 3) the government's economic condition. Assessments of a government's near-term financing situation tend to focus on the fund financial statements. The government-wide financial statements provide the most useful information for assessing financial position. Most of the information used for assessing economic condition can be found in the statistical section of the CAFR or RSI. It is important always to bear in mind that a local government's finances normally are best understood by examining trends over time. **SJG**

Technical Issues

CASH FLOWS REPORTING FOR DISCRETELY PRESENTED COMPONENT UNITS

It has now been more than 15 years since the Governmental Accounting Standards Board (GASB) first required cash flows reporting for proprietary funds. Most governments have experienced minimal difficulty in complying with this requirement for their own proprietary funds and for the proprietary funds of their blended component units. There has been some confusion in practice, however, regarding the applicability of this requirement to discretely presented component units. This article will explore the authoritative guidance governing cash flows reporting for discretely presented component units in the comprehensive annual financial report (CAFR) of the financial reporting entity.

Background

The basic rules governing cash flows reporting in the public sector were set by GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*. GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, paragraph 66, lists the statement of cash flows as one of the three basic financial statements for proprietary funds. Likewise, paragraph 138 of that same pronouncement lists the statement of cash flows as one of the three basic financial statements of special-purpose governments engaged only in business-type activities. Consequently, discretely presented component units that fall in either of these two categories must present a statement of cash flows in their separately issued reports.

Except in the case of component units that are fiduciary in character, data from discretely presented component units are presented in the government-wide financial statements of the financial reporting entity. Thus data from a component unit's statement of net assets are reported in the financial reporting entity's government-wide statement of net assets, while data from the component unit's statement of revenues, expenses, and changes in net assets are reported in the financial reporting entity's government-wide statement of activity. There is, however, no government-wide statement of cash flows, making it impossible to incorporate cash flows information from discretely presented component units into the financial reporting entity's government-wide financial statements. This situation has caused some financial statement preparers to question exactly what their responsibility is, if any, for including cash flows information on component units in the CAFR of the financial reporting entity.

Basic rule

As a basic rule, there is no requirement under generally accepted accounting principles to report cash flows in connection with discretely presented component units in the CAFR of the financial reporting entity. This fact is clearly stated in the Basis for Conclusions section of GASB Statement No. 34, paragraph 456:

This Statement requires the financial statement data of discretely presented component units to be included in the government-wide financial statements of the reporting entity, rather than with the funds of the primary government. Because there is no requirement for a government-wide statement of cash flows, discretely presented component units are not required to present this statement, either. Similarly, paragraph 126 requires governments to present information about each major component unit, taken from the component unit's government-wide statements (except special-purpose governments engaged only in business-type activities). Again, cash flow information for major component units is not required. *Users interested in cash flow information about a specific component unit should refer to the component unit's separately issued financial statements* [emphasis added].

Requirement if no separate report issued

As the previous quotation made clear, the GASB's decision *not* to require the presentation of cash flows information for discretely presented component units in the financial reporting entity's CAFR was motivated, at least in part, by the understanding that cash flows information would be available for those who desired it in the separately issued financial reports of the component units themselves. Accordingly, the GASB's *Comprehensive Implementation Guide*, question 7.373, reminds those who prepare the financial statements of the financial reporting entity that special steps must be taken if no such separate report is issued that provides the needed information on cash flows:

Question—Paragraph 456 in the Basis for Conclusions of Statement 34 explains that users interested in cash flow information about a specific component unit should refer to the component unit's separately issued financial statements. If a component unit does not issue separate financial statements, is cash flow information for the component unit required to be presented in the reporting entity's CAFR?

Answer—Yes. As explained in the answer to question 7.371, if a component unit does not issue separate financial statements, fund financial statements for that component unit should be included in the reporting entity's CAFR. Therefore, if the component unit has proprietary funds, cash flow statements for those funds would be included in the major component unit information in the reporting entity's CAFR as supplementary information. **DSJG**



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by differences in measurement focus.

For example, the meaning of the term *resource* would remain unchanged in the definition of the various financial statement elements, regardless of measurement focus, but the scope of what is measured would vary depending upon the measurement focus used. Thus, under the current financial resources measurement focus, only those *resources* that are financial in nature and available for spending would be reported.

The board intends for the planned ED to discuss *resources* before addressing the definitions of the various financial statement elements. The ED also will clarify that *resources* are to include human resources (as embodied by payroll costs).

Fund balance reporting

Previously, the GASB tentatively agreed that its fund balance reporting project should address different approaches to displaying *fund balance*. At its November meeting, the board concluded that the scope of the project should be broadened to specify the meaning of certain terms used in the definition of various fund types (e.g., *restricted revenues*) to ensure uniform application of any new standard regarding the presentation of *fund balance*.

It is not the board's intent to proceed directly to an ED on fund balance reporting, given the importance and sensitivity of the topic to both financial statement preparers and users. Instead, the GASB plans to first issue either an invitation to comment document or a PV.

Economic condition reporting

The GASB also used the occasion of its November meeting to review certain guidance proposed by the GASB staff for inclusion in a forthcoming implementation guide on GASB Statement No. 44, *Economic Condition Reporting: The Statistical Section*. Since the board had no objections to issuing the proposed guidance, the newest GASB implementation guide is scheduled for release in December 2005. **JWL**

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