

GAAFR REVIEW

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Report from GASB

In September, the Governmental Accounting Standards Board (GASB) met to deliberate on several of its technical agenda projects. The following are highlights from those deliberations.

Sales and pledges

The board unanimously agreed to issue an exposure draft (ED) on *Sales and Pledges of Receivables and Future Revenues*. The ED will be available on the GASB's Web site (www.gasb.org) starting in early October.

Pollution remediation

After considering responses to the preliminary views (PV) document, *Accounting and Financial Reporting for Pollution Remediation Obligations*, the board agreed to some revisions/clarifications:

- "Imminent endangerment to public health or welfare or to the environment" should mean that a government has little or no discretion whether to undertake pollution remediation actions. Such a situation may occur even in the absence of a law compelling such action.
- Determining whether there is evidence that a government will be named in a lawsuit or by a regulator as a "party responsible for remediation" is to be based on professional judgment using information already known to the government.
- It is *not* necessary that a regulator be aware of a government's potential involvement in a site under investigation for there to be evidence that a government "will be named" as a "responsible or potentially responsible party" in a pollution remediation action.

- There should be a presumption that lawsuits that are substantially the same as ones that previously were ruled to be without merit are to be excluded.

The board decided to retain the expected cash flow technique proposed in the PV as the measure for pollution remediation liabilities.

The board plans to identify situations where a government could appropriately use a state-developed average of pollution remediation costs.

Financial statement elements

The board tentatively agreed to use the terms *outflows* and *inflows* for amounts reported in change statements. The inherent characteristics in the definition will be 1) consumption and acquisition of resources by the entity and 2) applicability of the resource flows to the current period. The board also considered deferred items and agreed that the inherent characteristics of these items would be 1) consumption and acquisition of net resources by an entity and 2) applicability of the resource flows to a future period.

Derivatives and hedging

The board tentatively decided to describe hedge effectiveness in principle in its proposed guidance. The proposed guidance also will address specific criteria to determine hedge effectiveness. The board plans to organize an expert panel to help identify specific criteria for an effective hedge, as well as other information of potential value to financial statement users. If all proceeds as planned, the board hopes to meet with this panel in November.

Fund balance reporting

At this meeting the board considered

alternative approaches to the display of *fund balance*. Generally, the alternatives under consideration focus on displaying fund balance either on the basis of limitations on the use of resources from an individual fund perspective or on the basis of resources that are not available for appropriation. The board considered the pros and cons of both approaches, but did not reach a consensus. The board also considered whether to require that all unreserved, undesignated resources be reported in the general fund, but reached no conclusion. The board plans to continue to explore these issues at future meetings. **JWL**

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Focus on Governmental Accounting

HELPING USERS TO INTERPRET FINANCIAL STATEMENTS (PART 2)

Last month's issue of *GAAFR Review* offered the first in a series of articles on how accounting and auditing professionals can help those without such a background to properly interpret the data contained in local government financial reports. That first article explained that an effective analysis should approach a local government's finances from at least three different perspectives: 1) its near-term financing situation, 2) its financial position, and 3) its economic condition.

Assessing the near-term financing situation

Last month's article explained that assessments of a local government's near-term financing situation tend to focus on the fund financial statements rather than the government-wide financial statements.

Notes to the financial statements

The notes to the financial statements also provide useful information regarding a government's near-term financing situation.

Use of short-term debt. An important potential signal of pending near-term financing difficulties is a government's increasing reliance upon short-term debt. The financial statements themselves display only amounts of debt outstanding as of the end of the reporting period, making it impossible from an examination of the financial statements alone to determine the degree to which a government is having to rely upon short-term debt to meet its near-term financing needs during the period. To fill this information void, generally accepted accounting principles (GAAP) require that the notes to the financial statements provide a schedule of short-term debt (i.e., initial balance + new debt - retired debt = ending balance), even if no short-term debt is outstanding as of the end of the period. An examination of this schedule over time can be an invaluable tool for the early diagnosis of potentially serious financial problems.

Interfund activity. The movement of resources between funds through interfund borrowings and transfers can sometimes obscure potential near-term financing difficulties. Therefore, GAAP require that the notes to the financial statements provide information on the amounts and purpose of interfund balances and transfers. Also of interest is the disclosure of the portion of interfund receivables *not* expected to be collected within one year.

Amounts due within one year. It is important to bear in mind that governmental funds do not report certain significant liabilities until they are actually due and payable.

Specific items that fall within this category include bonds, notes, lease obligations, claims and judgments, and vacation leave. For example, the debt service fund of a government with a June 30 fiscal year end typically would report no liability at all for principal and interest payments due the following day. Consequently, it is important to consult the notes to the financial statements for the schedule of the portion of each long-term liability expected to be liquidated within the next 12 months.

Assessing financial position

Governmental funds have a relatively short time horizon because of their special current financial resources measurement focus. The government-wide financial statements, on the other hand, have no such limitation. Therefore, it is to the government-wide financial statements that interested parties should turn primarily to assess financial position.

Government-wide statement of net assets

The principal measure of financial position is *net assets*. Care is needed to properly interpret the significance of two of its components as they appear in the government-wide statement of net assets.

Unrestricted net assets. Because a government has the power to tax, its failure to recover costs in one period can be made up by raising additional taxes in a subsequent period. To the contrary, the customer of a private-sector business cannot be assessed an additional amount at some later date for goods and services already received and paid for just because the amounts charged ultimately proved insufficient to cover costs. Accordingly, a deficit for a private-sector business is always a matter for concern. A deficit for a local government, on the other hand, can only be properly understood over time and in context.

Vacation leave may serve as an instructive example in this regard. Employees earn vacation leave as part of their compensation for services rendered. Employees often do not use all of their vacation leave in the period in which it is earned, but instead carry an unused balance forward into the subsequent period. Thus, employees continuously earn and use vacation leave, with the balance rolling forward from one period to the next. From the individual employee's viewpoint, this process eventually ends upon termination of employment. From the perspective of a government with multiple employees, however, the process is perpetual. That is, the liability for unused vacation leave will never actually be paid off, but instead will continue to roll forward indefinitely (typically increasing gradually over time). As a result, most governments have been disinclined to raise taxes to fund a liability that will never be liquidated as such, thereby sometimes creating a deficit balance in *unrestricted net assets*.

Rather than being evidence of a potential financial crisis, a

deficit like the one just described reflects no more than the fact that the government has chosen to raise taxes to pay vacation leave when taken rather than when earned, a position that most believe to be quite defensible from the standpoint of a perpetual entity with the power to tax. It is a mistake then to focus solely on the balance of *unrestricted net assets* at any one point in time, or on whether that balance is positive or negative. Instead, the focus of analysis should be on the direction and magnitude of change over time and the underlying reasons for the change. Is the rate of change troubling or reassuring? Is the reason for committing future taxing power valid or just an excuse to place the burden of paying for today's services on tomorrow's taxpayers? For example, most would view a deficit resulting from pay-as-you-go funding for vacation leave very differently from a deficit resulting from pay-as-you-go funding for pensions.

Invested in capital assets net of related debt. Care also must be taken when interpreting the significance of the component of net assets labeled *invested in capital assets net of related debt*. It is common for governments to arrange for level debt service payments over the life of a debt issue. Most governments also use the straight-line method to calculate depreciation expense on their capital assets. If the life of the debt matches the life of the capital asset being financed by the debt, this combination of level debt service payments and straight-line depreciation will cause the book value of a capital asset (i.e., cost less accumulated depreciation) to decrease at a faster rate than the outstanding principal balance on the related debt, which could cause a deficit in *invested in capital assets net of related debt*, as illustrated in Exhibit 1. Naturally, a deficit

resulting from this combination of factors should be no cause for concern.

Government-wide statement of activities

From the viewpoint of financial position, the single most important element in the government-wide statement of activities is *changes in net assets*. The statement of activities also provides valuable information on the cost of each of the government's programs.

Changes in net assets. The amount reported as *changes in net assets* measures the extent to which a government's financial position has ultimately improved or deteriorated as the result of events and transactions of the period.

Nowhere is the analysis of changes in net assets more important than for *governmental activities*, which restate the data from the governmental funds using a different measurement focus. Specifically, by comparing *changes in fund balances* (as reported in the governmental fund operating statement) with *changes in net assets - governmental activities* (as reported in the government-wide statement of activities), the financial statement user can better appreciate the long-term economic impact of the near-term financing activities reported in the governmental funds.

Assume, for example, that a government issued long-term debt to finance an operating deficit. The proceeds of the borrowing would, of course, solve the government's immediate financing challenge by providing a fresh inflow of expendable resources. Accordingly, a governmental fund, consistent with its near-term financing focus, would report the issuance

Exhibit 1									
Calculation of Investment in Capital Assets Net of Related Debt (\$100,000 for 10 years @ 6% per annum with semiannual payments)*									
Payment Period	Starting Principal Balance	Payment Amount	Interest Portion	Principal Portion	Closing Principal Balance	Starting Capital Asset (Book Value)	Depreciation Expense	Closing Capital Asset (Book Value)	Investment in Capital Asset Net of Related Debt
1	\$100,000	\$6,722	\$3,000	\$3,722	\$96,278	\$100,000	\$5,000	\$95,000	-\$1,278
2	\$96,278	\$6,722	\$2,888	\$3,833	\$92,445	\$95,000	\$5,000	\$90,000	-\$2,445
3	\$92,445	\$6,722	\$2,773	\$3,948	\$88,497	\$90,000	\$5,000	\$85,000	-\$3,497
4	\$88,497	\$6,722	\$2,655	\$4,067	\$84,430	\$85,000	\$5,000	\$80,000	-\$4,430
5	\$84,430	\$6,722	\$2,533	\$4,189	\$80,242	\$80,000	\$5,000	\$75,000	-\$5,242
6	\$80,242	\$6,722	\$2,407	\$4,314	\$75,927	\$75,000	\$5,000	\$70,000	-\$5,927
7	\$75,927	\$6,722	\$2,278	\$4,444	\$71,484	\$70,000	\$5,000	\$65,000	-\$6,484
8	\$71,484	\$6,722	\$2,145	\$4,577	\$66,906	\$65,000	\$5,000	\$60,000	-\$6,906
9	\$66,906	\$6,722	\$2,007	\$4,714	\$62,192	\$60,000	\$5,000	\$55,000	-\$7,192
10	\$62,192	\$6,722	\$1,866	\$4,856	\$57,336	\$55,000	\$5,000	\$50,000	-\$7,336
11	\$57,336	\$6,722	\$1,720	\$5,001	\$52,335	\$50,000	\$5,000	\$45,000	-\$7,335
12	\$52,335	\$6,722	\$1,570	\$5,152	\$47,183	\$45,000	\$5,000	\$40,000	-\$7,183
13	\$47,183	\$6,722	\$1,415	\$5,306	\$41,877	\$40,000	\$5,000	\$35,000	-\$6,877
14	\$41,877	\$6,722	\$1,256	\$5,465	\$36,412	\$35,000	\$5,000	\$30,000	-\$6,412
15	\$36,412	\$6,722	\$1,092	\$5,629	\$30,783	\$30,000	\$5,000	\$25,000	-\$5,783
16	\$30,783	\$6,722	\$923	\$5,798	\$24,985	\$25,000	\$5,000	\$20,000	-\$4,985
17	\$24,985	\$6,722	\$750	\$5,972	\$19,013	\$20,000	\$5,000	\$15,000	-\$4,013
18	\$19,013	\$6,722	\$570	\$6,151	\$12,861	\$15,000	\$5,000	\$10,000	-\$2,861
19	\$12,861	\$6,722	\$386	\$6,336	\$6,526	\$10,000	\$5,000	\$5,000	-\$1,526
20	\$6,526	\$6,722	\$196	\$6,526	\$0	\$5,000	\$5,000	\$0	\$0
				\$100,000			\$100,000		

*It is anticipated that the capital asset will have no residual value.

Exhibit 2
Effect of Long-term Borrowing: Governmental Funds v. Governmental Activities

Situation	Journal Entry			Effect on Fund Balance/Net Assets
Governmental fund	Cash	\$7,000		Increase <i>fund balance</i> by \$7,000
	Other Financing Source - debt issuance		\$7,000	
Governmental activities	Cash	\$7,000		No effect on <i>net assets</i>
	Bonds Payable		\$7,000	

of the debt as a positive operating statement item (i.e., *other financing source - debt issuance*) that would increase *fund balance*. On the other hand, from a long-term economic perspective, the borrowing would do nothing to eliminate the underlying deficit—hence the borrowing would have no such positive impact on *net assets - governmental activities* in the government-wide statement of activities. This contrast is illustrated in Exhibit 2. By contrasting *changes in fund balances* with *changes in net assets*, a financial statement user can arrive at a more balanced understanding of the impact of the borrowing.

Conversely, assume that the government began construction on a capital project reported in a governmental fund and that the borrowing used to finance the project occurred in a previous period. Consistent with the governmental fund's focus on near-term financing, spending on the project would be reported as *expenditures* that would reduce fund balance. Conversely, from a long-term economic perspective, construction outlays are really no more than the exchange of one type of asset (i.e., cash) for another (i.e., *construction-in progress/capital asset*). That is, a government is only economically worse off when the capital asset that was constructed is consumed. Accordingly, construction would have no adverse impact on *net assets - governmental activities* (see Exhibit 3).

Once again, contrasting *changes in fund balances* with *changes in net assets* allows a financial statement user to understand that the decrease in fund balance reported in the governmental fund financial statements does *not* represent a deterioration in the government's overall financial position.

Functional cost data. Another important benefit of the government-wide statement of activities is that it provides an accrual-based measure of the cost of a government's various functions and programs. Such information is clearly of value for appreciating the impact of individual functions and programs on a government's overall financial position. Still, care

must be taken to avoid certain misunderstandings that can easily arise in connection with the use of accrual-based cost data.

Budgeting. The accrual basis of accounting, by definition, divorces the recognition of transactions and events from the timing of related cash flows. Accordingly, such data must be used with caution in the context of the operating budget, which normally must ensure that projected cash inflows are sufficient to cover anticipated cash outflows.

Assume for example, that a government borrows \$30 million to finance the construction of a building with an expected useful life of 30 years. Further assume that the government plans to repay the principal of the debt evenly over the next 15 years (i.e., to reduce interest expense). For budgetary purposes, the government would need to raise at least \$2 million each year for the next 15 years to fund its repayment of debt principal (i.e., \$30 million debt principal/15-year debt life = \$2 million per year). Related depreciation expense in the statement of activities, however, would amount to just \$1 million per year (i.e., \$30 million cost/30-year estimated useful life = \$1 million per year) during that same period. Thus, if the government chose to budget the activity on a pure accrual basis, it could face a significant cash shortfall, as illustrated in Exhibit 4. In short, the question "How much will it cost?" so often posed by elected officials and others involved with the budget process, normally is best interpreted as "How much will the government need to raise in this year's budget and in subsequent years' budgets to cover related payments?" The accrual basis data provided in the government-wide statement of activities are *not* designed to answer this question and so should not be used for this purpose.

Contracting decisions. In recent years, local governments have increasingly turned to contracts with outside vendors (i.e., "outsourcing") as a potential cost-saving alternative to directly providing certain types of services (e.g., refuse collection).

Exhibit 3
Effect of Construction Outlays: Governmental Funds v. Governmental Activities

Situation	Journal Entry			Effect on Fund Balance/Net Assets
Governmental fund	Expenditures - capital outlays	\$5,000		Decrease <i>fund balance</i> by \$5,000
	Cash		\$5,000	
Governmental activities	Construction-in-progress	\$5,000		No effect on <i>net assets</i>
	Cash		\$5,000	

Exhibit 4 Budgeting v. Accrual - Debt Service v. Depreciation Expense			
Year	Annual Debt Service Principal Payments	Depreciation Expense	Difference
1-15	\$2,000,000	\$1,000,000	+ \$1,000,000
16-30	\$0	\$1,000,000	- \$1,000,000

The decision to outsource a service involves, among other things, comparing prices quoted by vendors with the cost to the government itself of providing the same service directly. It is intuitively appealing to use the functional cost data provided in the government-wide statement of activities as a measure of the government's cost for this purpose. Such a use of the data, however, would be mistaken for two reasons.

First, the amount reported as functional expense typically does *not* include sometimes substantial amounts of indirect cost (i.e., overhead) related to a given function (often reported in the *general government* function). A sound contracting decision, however, must take into account the *full cost* of providing services (i.e., both direct and indirect costs).

Second, rarely can the full cost of a given function be completely eliminated through outsourcing. A portion of the indirect costs assigned to a given function as part of the calculation of full cost typically will reflect costs that are relatively inflexible to changes in demand (i.e., "fixed costs" or "sunken costs"). Thus, the elimination of one tenth of a government's employees, for instance, ordinarily would *not* result in a proportionate decrease in the cost of the personnel department. Accordingly, contracting decisions should focus exclusively on the avoidable (or incremental) portion of full cost.

Assume, for example, that the *general government* function incurs \$100,000 of indirect costs on behalf of five different functions with total direct costs that amount to \$2,075,000. These indirect costs are allocated on a pro rata basis to the government's various functions to calculate the full cost of each. Half of the indirect costs would not be affected by the elimination of any given function (i.e., fixed costs). The other half would disappear proportionately if a given function were eliminated (i.e., incremental costs). The net result would be as shown in Exhibit 5. The amount of expense reported for

Exhibit 6 Analysis of Potential Vendor Bids			
Functional Costs	Vendor A	Vendor B	
Direct cost	\$600,000		
Indirect cost	<u>28,916</u>		
Full cost	\$628,916		
Less:			
Unavoidable cost	<u>(14,458)</u>		
Avoidable cost	\$614,458		
Less vendor bids:	<u>\$620,000</u>	<u>\$605,000</u>	
Savings/(extra cost)	\$ (5,542)	\$ 9,458	
Comparing Bids to Potential Measures of Cost			
	Vendor A	Vendor B	
Direct cost:	\$600,000	\$600,000	
Bids	<u>620,000</u>	<u>605,000</u>	
Apparent savings/(extra cost)	\$ (20,000)	\$ (5,000)	
Full cost:	\$628,916	\$628,916	
Bids	<u>620,000</u>	<u>605,000</u>	
Apparent savings/(extra cost)	\$ 8,916	\$ 23,916	
Avoidable cost:	\$614,458	\$614,458	
Bids	<u>620,000</u>	<u>605,000</u>	
Real savings/(extra cost)	\$ (5,542)	\$ 9,458	

Function A in the government-wide statement of activities (i.e., direct costs = \$600,000) is *understated* for purposes of making a contracting decision because it excludes avoidable indirect costs. Conversely, the full cost of Function A (i.e., \$628,916) is *overstated* for this purpose because it includes a portion of indirect costs that could not be avoided by outsourcing the function. Instead, it is the avoidable cost (i.e., \$614,458) that is relevant for a contracting decision (see Exhibit 6).

In short, the use of functional cost data taken from the government-wide statement of activities is inappropriate for contracting decisions unless appropriate adjustments are made to ensure that *all* and *only* the avoidable costs associated with a given function are considered.

Intergovernmental comparisons. Financial statement users commonly wish to compare the functional costs of one gov-

Exhibit 5 Calculation of Avoidable Cost for Contracting Decision						
Function	Direct Costs	Indirect Costs	Indirect Cost Allocation	Full Cost	Less: Unavoidable Cost	Relevant Cost for Contracting Decision
General government		\$100,000	(\$100,000)			
Function A	\$600,000		\$28,916	\$628,916	(\$14,458)	\$614,458
Function B	\$500,000		\$24,096	\$524,096	(\$12,048)	\$512,048
Function C	\$450,000		\$21,687	\$471,687	(\$10,843)	\$460,843
Function D	\$325,000		\$15,663	\$340,663	(\$7,831)	\$332,831
Function E	\$200,000		\$9,639	\$209,639	(\$4,819)	\$204,819
Total	\$2,075,000	\$100,000	\$0	\$2,175,000	(\$50,000)	\$2,125,000



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Exhibit 7

Comparison of Functional Costs - Different Construction Dates for the Same Capital Asset

	<u>Date of Construction</u>	<u>Historical Cost</u>	<u>Useful Life in Years</u>	<u>Annual Depreciation</u>	<u>Other Costs</u>	<u>Functional Cost</u>
Government A	1980	\$2,000,000	50	\$40,000	\$230,000	\$270,000
Government B	2000	\$4,300,000	50	\$86,000	\$230,000	\$316,000

ernment with those of another. Such comparisons can pose special challenges in the case of functions that utilize significant capital assets.

When capital assets are “consumed” as part of the process of providing a service, that fact must be reflected in the cost of the service. Accountants generally do so by allocating the historical cost of a capital asset (i.e., price of acquisition) over its estimated useful life. Thus, a government that acquired a \$25 million building with an estimated useful life of 50 years

would increase its operating costs by \$.5 million each year for each of the next 50 years (i.e., \$25 million cost/50 years = \$.5 million/year depreciation expense).

The cost to acquire a particular type of capital asset naturally will change over time. For example, a building constructed in 1980 for \$2 million might cost \$4.3 million to replicate in 2000. Naturally, related amounts of depreciation expense would reflect this price difference. As a result, capital assets that provide essentially the same service can generate significantly different amounts of depreciation expense. This phenomenon creates a challenge when comparisons among governments are motivated by considerations of economy and efficiency, because governments with older capital assets could easily be mistaken for being more efficient than governments with newer assets, as illustrated in Exhibit 7. For this reason, it is important when comparing capital-intensive functions that depreciation expense be removed from consideration if capital assets were acquired at substantially different times. The information needed to make such an adjustment can be found in the notes to the financial statements, which disclose the amount of depreciation expense included as part of the direct expense reported for each function.

Next month’s article will conclude the series by exploring some considerations in evaluating economic condition. **SJG**

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