GAAFR REVIEW

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REPORT FROM GASB

Two members of the Governmental Accounting Standards Board (GASB) completed their term at the end of June 2005. William M. Holder, Ernst & Young Professor of Accounting at the University of Southern California, was reappointed by the Financial Accounting Foundation to a second five-year term. Paul Reilly, former finance director of the City of Madison, Wisconsin, who had served the maximum allowable period of ten years, was replaced by Ms. Marcia Taylor, Assistant Manager of Mt. Lebanon, Pennsylvania. Ms. Taylor's term will run through June 2010.

Sales of future revenues

The GASB previously had agreed that intra-entity sales of future revenues should be "neutral" from the perspective of the overall financial reporting entity, but had not determined precisely how that objective was to be accomplished. At a recent meeting, the board came to the tentative conclusion that just as the transferor should defer revenue recognition, so too should the transferee treat the related outflow of resources as a deferred charge to be amortized over the duration of the agreement. The board plans to review a preballot draft of a proposed statement at its September meeting.

Pollution remediation

The board considered the responses it received to its preliminary views (PV) document on *Accounting and Financial Reporting for Pollution Remediation Obligations*. In the discussion that ensued, the board reached the following tentative conclusions:

- The exposure draft (ED) will clarify that a government that retains risk for pollution remediation liabilities should follow the guidance proposed in the ED rather than the guidance offered in GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues;*
- The ED will specifically address changes in estimates that *decrease* the pollution remediation liability;
- The ED will include a glossary of relevant terms; and
- The flowchart will be amended to include recognition in governmental funds.

The ED will also indicate that retroactive application need occur only when a government has sufficient objective and verifiable information to apply the expected cash flows technique to measurements in prior periods. In addition, the board plans to clarify that measurement of the pollution remediation liability should take place at the *beginning* of the period in which the standard is first implemented to allow for the restatement of beginning net assets.

Derivatives and hedging

Previously, the board tentatively concluded that fair value with hedge accounting was the appropriate method for reporting derivatives. That decision left the board free to identify at its most recent meeting the types of arrangements that ought to be considered "hedgeable:"

- Firm commitments and forecasted transactions that meet the criteria for hedge accounting (still to be developed), including transactions between a primary government and a discretely presented component unit, but *not* interfund activity, and
- Risks associated with a portion of the cash flows or fair value of an existing or potential financial asset or liability (possible hedging of nonfinancial assets and liabilities will be the subject of a future discussion).

The board agreed that when a hedge terminates at a time other than when expected payments have been made or at the expiration of the derivative's term, previously deferred amounts should be recognized as a gain or loss, as appropriate, upon dissolution of the hedge accounting relationship.◗JWL

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Focus on Governmental Accounting

HELPING USERS TO INTERPRET LOCAL GOVERNMENT FINANCIAL STATEMENTS

Published financial reports provide a wealth of information to those seeking to assess a local government's finances. A variety of factors, however, can easily conspire to prevent interested parties from profiting fully from the data contained in those reports. This article is the first in a series that will suggest how accounting and auditing professionals can help those without such expertise to properly interpret the data contained in local government financial reports.

The public-sector challenge

The primary goal of a private-sector business is economic--to make a profit. While local governments also have economic goals, their principal objective is social rather than economic--to provide services to citizens. Stated differently, economic goals in the public sector are a means to an end, rather than an end in themselves. Thus, while it is hard to imagine private-sector investors complaining of "excessive" income, it is easy to envision taxpayers upset by tax revenues significantly in excess of related expenditures. Therefore, the approach taken to interpreting financial statements in the public sector must necessarily differ in important respects from the approach taken in the private sector.

Ratio analysis provides a good illustration of this point. It is common in the private sector to combine various financial statement elements into ratios to serve as a point of reference for analysis. Yet few of the most commonly used private-sector ratios can be applied meaningfully to local governments. A number of them, in fact, cannot even be calculated for a typical local government because they presume the ownership of stock and a primary focus on the sales of goods and services to customers (e.g., earnings per share, book value per share, rate of return on common stock equity, price earnings ratio, profit margin on sales, inventory turnover).

Consequently, even when local government financial statements most closely resemble those of a private-sector business (e.g., the accrual-basis government-wide financial statements), it is not possible simply to apply private-sector analytical techniques. A fundamentally different approach is needed, consistent with the unique objectives and circumstances of local governments.

Focal points for analysis

It is common in the private sector to speak of a "bottom line" in the context of evaluating financial performance (i.e., *net income*). Local government financial statements offer no equivalent single measure suitable for this purpose. Instead, users of local government financial statements must assess a local government's financial health from three different perspectives.

One particularly pressing concern is a local government's *near-term financing situation*. Will the government be able to meet its short-term financial obligations in a timely manner? Are its operating inflows adequate to cover its operating outflows? Is the government financially prepared for contingencies (e.g., budgetary shortfalls and natural catastrophes)?

It would be shortsighted, of course, to focus exclusively on the near term. An equally important concern is a government's overall *financial position* as represented by the totality of its assets and liabilities, as well as the difference between them (i.e., *net assets*). Financial position is an essential point of reference for determining whether a government's overall financial situation is improving or deteriorating over time.

Needless to say, a local government's finances do not exist in a vacuum. Inevitably its financial position will be affected by a variety of external factors and circumstances (e.g., the vitality and diversification of the local economy, the breadth and depth of the government's tax base). When financial statement users consider a local government's financial position in the light of such external factors, they are said to be concerned with its *economic condition*. Viewed another way, economic condition focuses on the likelihood that today's financial position will improve or deteriorate in the future. These three perspectives are summarized in Exhibit 1.

A comparison drawn from personal finance may be instructive for clarifying the relationships that exist among these three items. An individual typically is most immediately and directly concerned with having adequate resources to pay bills on time (i.e., the near-term financing situation). Nonetheless, it is an individual's *net worth* that ultimately measures whether he or she is actually getting richer or poorer (i.e., financial position). Still, it is not possible to focus exclusively on financial position because a significant portion of an individual's net worth could be "tied up" in relatively illiquid assets (e.g., house and car), which could pose an obstacle to making timely payments (i.e., the individual could be "cash poor"). Furthermore, the most crucial factors affecting a person's future economic well being (e.g., education and professional experience) need to be taken into account, even though

Exhibit 1
Perspectives for Analyzing Local Government Financial Statements

Perspective	Significance
Near-term financing situation	Will the government be able to pay its bills (both expected and unexpected) on time?
Financial position	Is the government's financial health improving or deteriorating?
Economic condition	Is it likely that today's financial position will improve or deteriorate?

they are not reflected in a set of financial statements (i.e., economic condition).

Assessing the near-term financing situation

Fund accounting reflects the fact that local governments segregate their financial resources for specific purposes based on "special regulations, restrictions, or limitations" (e.g., the appropriated budget, grant contracts, and state law). Such restrictions naturally have an important effect on near-term financing. Consequently, assessments of a local government's near-term financing situation tend to focus on the fund financial statements rather than on the government-wide financial statements.

Governmental funds - balance sheet

Not all assets and liabilities are directly relevant to near-term financing. Some assets, for example, cannot be used to pay bills (e.g., assets used in operations, such as land, buildings, improvements, equipment, and infrastructure). Likewise, some liabilities will not come due for some time (e.g., long-term debt) and therefore will not require the use of financial resources in the near term. Such assets and liabilities are excluded from governmental funds in accordance with their unique *current financial resources measurement focus*. Consequently, governmental funds are especially well suited for evaluating near-term financing needs.

The difference between a governmental fund's assets and liabilities is described as *fund balance*. As a practical matter, despite their special measurement focus, governmental funds still commonly include a few assets that are not actually available for near-term financing purposes (e.g., supplies inventories, long-term loan receivables, amounts needed to cover prior year encumbrances, debt service "reserves"). Accordingly, an equivalent portion of fund balance is reported as *reserved fund balance* to direct users' attention to the remaining component of fund balance, which is, in fact, available for near-term financing needs: *unreserved fund balance*. It is important that the amount of unreserved fund balance in a government's chief operating fund (i.e., *general fund*) be large enough to serve as a cushion against unanticipated budgetary shortfalls, disasters, and other contingencies, thereby mitigating risk and helping to ensure stable tax rates.

A point of reference is needed for assessing the adequacy of the level of unreserved fund balance maintained in the general fund. For many, this point of reference is regular revenues (i.e., revenues adjusted to remove the effect of any items that would distort trends). For others, it is regular expenditures. As a rule, the choice between the two will depend upon which is considered more predictable in a given government's specific circumstances. Thus, a government that relies heavily on property taxes typically would focus on revenues, whereas a government with a less predictable revenue stream might choose to focus instead on expenditures.

Perhaps the most common question posed in connection with local government financial statements is "How much unreserved fund balance is enough?" Although there is no single right answer to this question, it is possible, nonetheless, to offer some practical guidance. The Government Finance Officers Association (GFOA) has formally recommended that the *minimum* level of unreserved fund balance in the general fund be no less than 5 to 15 percent of general fund regular revenues, or one to two months of general fund regular expenditures, depending upon the point of reference selected.

The guidance just described addresses only the *minimum* amount of unreserved fund balance that should be maintained in the general fund. Prudent financial management often will suggest that higher than minimum levels be maintained, especially in the case of smaller governments, which may not enjoy the economic depth and breadth of revenue diversification of their larger counterparts. GFOA advises that governments consider the following factors when making such a determination:

- Higher levels of unreserved fund balance may be needed if significant revenue sources are subject to unpredictable fluctuations, or if regular expenditures are highly volatile;
- The availability of resources in other funds may reduce the amount of unreserved fund balance needed in the general fund, just as deficits in other funds may require that a higher level of unreserved fund balance be maintained in the general fund;
- A larger amount of unreserved fund balance may be needed to avoid cash flow problems if the average maturity of receivables significantly exceeds the average maturity of payables;
- Governments sometimes designate a portion of unreserved fund balance to reflect tentative plans of management or the governing board. In that case, a government may wish to focus on unreserved, undesignated fund balance rather than on total unreserved fund balance;
- A larger amount of unreserved fund balance may be necessary to compensate for the added risk faced by local governments that must rely heavily upon a single corporate taxpayer or upon a group of corporate taxpayers in the same industry. The same holds true for local governments in regions prone to natural disasters such as hurricanes and tornadoes; and
- Rapidly growing budgets are also an indicator that greater than normal levels of unreserved fund balance may be needed in the general fund.

No government is able to control precisely the level of unreserved fund balance in the general fund. Levels of unreserved fund balance will naturally vary with fluctuations in revenues and expenditures. Furthermore, it is only to be expected that a budgetary cushion will temporarily diminish when the contingencies being planned for actually occur. It would

be a mistake, therefore, to place undue emphasis on the level of unreserved fund balance at any given moment. What is really important is the pattern of unreserved fund balance over time (e.g., ten years). Is fund balance normally in excess of minimum levels? How rapidly has unreserved fund balance been replenished in the wake of events requiring its use? (See GFOA's 2002 recommended practice on "Appropriate Level of Unreserved Fund Balance in the General Fund.")

It is important to note that the approach just described typically would *not* be appropriate for governmental funds other than the general fund for a variety of reasons, including the following:

- ***Special revenue funds.*** Special revenue funds are used to account for resources that are legally restricted for specific purposes (e.g., grants). Since the purpose of a special revenue fund is simply to demonstrate that restricted resources have been spent for their intended purpose, there is no need to maintain a budgetary cushion.
- ***Debt service funds.*** Debt service funds normally do not report the debt that their resources will be used to repay, making any analysis of fund balance problematical.
- ***Capital projects funds.*** The main purpose of capital projects funds is to track spending on major capital projects. It is presumed that all of the resources in the fund eventually will be expended. Furthermore, project financing often is ultimately guaranteed by the general fund.
- ***Permanent funds.*** Permanent funds are essentially endowments. It is expected that the entire unreserved portion of fund balance (i.e., earnings) will be expended for the fund's intended purpose.

Governmental funds - operating statement

The key item on the statement of revenues, expenditures, and changes in fund balances, from a near-term financing perspective, is the *excess of revenues over expenditures.*

As a rule, it is reasonable to expect that a government's regular revenues will be sufficient to cover its regular expenditures. Therefore, it is to be expected that revenues of the general fund normally will equal or exceed fund expenditures. What is true in general, however, is not necessarily true of any particular year. Thus, a local government that had revenues in excess of budgetary projections in one year might deliberately choose (or even be required) to reduce its revenues the following year to bring fund balance back to a level consistent with the government's fund balance policy (a practice sometimes known as "budgeting fund balance"). Thus, any sound analysis of the excess of revenues over expenditures needs to consider patterns in this amount *over time* (e.g., ten years). Do revenues *normally* equal or exceed expenditures in the general fund? Are operating deficits preceded or followed by equivalent surpluses?

Given the importance of fund balance, as described earlier, it might be asked why any attention at all needs to be paid to the excess of revenues over expenditures. Would not an operating deficit automatically be reflected in fund balance, making additional analysis superfluous?

While it is true that the difference between revenues and expenditures automatically affects fund balance, it is not the only item to do so. Other financing sources and uses also affect fund balance. Thus, a general fund facing an ongoing operating deficit could maintain targeted levels of fund balance, at least temporarily, by obtaining resources from other funds (i.e., transfers) or by issuing long-term debt (much like an individual attempting to "make ends meet" by withdrawing funds from a retirement account or taking out a home equity loan). Therefore, an analysis of the excess of revenues over expenditures in the general fund is needed to support the conclusions drawn from the analysis of unreserved fund balance described earlier.

Once again, what is true for the general fund may not be true for other types of governmental funds:

- ***Special revenue funds.*** Restricted resources may be obtained in one fiscal year but spent in another, producing an imbalance between revenues and expenditures. Such a situation is perfectly normal and no cause for concern.
- ***Debt service funds.*** Frequently debt service funds are supported, in whole or in part, by transfers from the general fund, which are reported as an other financing source rather than as revenue. In that case, debt service expenditures in the fund may exceed revenues.
- ***Capital projects funds.*** Much of the financing for capital project funds comes from other financing sources (e.g., borrowings, transfers from the general fund) rather than from revenues. Furthermore, it is common in the public sector to accumulate the resources needed for a given project prior to construction, producing a potential mismatch in timing between revenues (received upfront) and expenditures (incurred over several years of construction).
- ***Permanent funds.*** It is common for endowment income to be earned in one period and spent in another, creating the possibility of an operating deficit in the period when spending actually occurs.

Proprietary fund statement of net assets

Proprietary funds, unlike governmental funds, report both capital assets and long-term debt, even though neither is directly relevant to near-term financing. Therefore, the difference between proprietary fund assets and liabilities (described as either *net assets* or *equity)* is not equivalent to the fund balance reported in governmental funds.

Proprietary funds, however, do distinguish *current assets* and *current liabilities* from noncurrent items. It is possible to take advantage of this distinction to calculate *working capital* (i.e., current assets less current liabilities), which Accounting

Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins,* describes as "the relatively liquid portion of total enterprise capital which constitutes a margin or buffer for meeting obligations within the ordinary operating cycle of the business" (chapter 3, paragraph 3). Working capital bears important similarities to fund balance, although there also are important differences (e.g., fund balance does not reflect long-term debt until it is actually due, whereas working capital normally is affected by any portion of long-term debt payable in the subsequent twelve months).

Users of financial statements typically choose to focus on the relationship between the two components of working capital rather than on the actual number itself. That is, they tend to focus on the *working capital ratio* (i.e., current assets/current liabilities), commonly known as the *current ratio*. For example, a proprietary fund with current assets of $30,000 and current liabilities of $20,000 could be described as having a current ratio of 1.5. There is no single accepted rule of thumb concerning how large the current ratio ought to be. Absent such a rule, the adequacy of a given proprietary fund's current ratio is probably best assessed by comparing it to that of other funds involved in similar operations.

Proprietary fund operating statement

The objective of the quintessential private-sector business is to make a profit. Consistent with that objective, a business enterprise that routinely proved incapable of recovering its operating costs from customers would eventually be expected to go out of business. In the public sector, however, it is service, rather than profit, that provides the motivation for sponsoring the various business-type activities reported in enterprise funds. Indeed, public policy considerations often cause governments to deliberately set fees and charges for selected activities at levels lower than what is needed to recover operating costs. Mass transit could serve as a good example of this common phenomenon.

In the United States, fares for mass transit typically could not be set at levels high enough to recover cost without significantly reducing utilization. At the same time, the indirect benefits of mass transit (e.g., lower traffic volume, decreased demand for parking, less air pollution, greater access to employment opportunities for low-income workers) extend well beyond the ridership of the system. Consequently, governments frequently choose, as a matter of public policy, to subsidize mass transit to maintain fares at a level intended to maximize utilization.

Thus, the issue of cost recovery is more complicated for enterprise funds than it is for private-sector businesses. While some enterprise funds have cost-recovery goals quite similar to those of a private-sector business (e.g., an electrical utility), others aim at only partial cost recovery.

Cost-recovery goals legitimately vary from fund to fund and from government to government. Still, cost recovery should be the result of choice rather than of chance. Therefore, GFOA recommends that local governments adopt a formal policy on the degree to which specific fees and charges are intended to recover related costs (See GFOA's 1996 recommended practice on "Setting of Government Charges and Fees").

The format of the proprietary fund operating statement highlights the extent to which an enterprise fund has been successful at meeting its cost-recovery target. It does so by juxtaposing *operating revenues* (i.e., amounts received from customers) and *operating expenses* (i.e., the cost of the goods or services provided to customers) to calculate *operating income*.

Familiarity with an enterprise fund's cost-recovery policy is essential to a sound analysis of the fund's operations. Assume, for example, that it is the policy of a particular enterprise fund to recover 90 percent of its operating expenses through fees and charges to customers. Further assume that operating expenses and revenues for the most recent period were $100,000 and $95,000, respectively. In that case, the enterprise fund would, in fact, be meeting its cost-recovery policy goals (i.e., $95,000/$100,000 = 95% > 90% target), despite a deficit in operating income.

Special considerations for internal service funds

Internal service funds are classified as proprietary funds, just like enterprise funds. All the same, there are significant differences between the two types of funds that affect how the financial data reported in an internal service fund should be interpreted.

An internal service fund is designed to function as a cost-allocation mechanism within the government. Stated differently, the role of an internal service fund is to isolate and accumulate the costs of certain operations (e.g., motor pool) so those costs can subsequently be assigned to the appropriate fund based on actual usage. Ideally, an internal service fund should operate on a break-even basis (i.e., revenues = expenses) *over time*.

Because an internal service fund's revenues and expenses are expected to balance *over time*, a surplus or deficit at any given moment need not be a cause for alarm. A significant, ongoing surplus or deficit, however, ought to raise concerns, because it could obscure what otherwise would be reported as a surplus or deficit in some other fund.

Assume, for example, that an internal service fund provides all of its services to various departments of the general fund. If that internal service fund reported an ongoing deficit of $1 million, it would be because the general fund had been undercharged by this same amount, thereby increasing fund balance in the general fund by $1 million. Conversely, a significant ongoing surplus could indicate that other funds had been overcharged, thus lowering the amount of fund balance they otherwise would have reported.

There are two important exceptions to the general rule just

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described that internal service funds should not report significant ongoing surpluses and deficits. First, it is widely acknowledged to be good management practice, especially in the case of motor pools, for an internal service fund to set fees and charges based on the estimated replacement cost of its capital assets rather than based on their historical cost as reflected in depreciation expense. Assume, for example, that an internal service fund acquired a vehicle for $30,000 with an estimated useful life of three years. Further assume that the replacement cost for that vehicle at the end of its three-year estimated useful life is expected to be $33,000. In that situation, many internal service fund managers would prefer to charge $11,000 per year (i.e., $33,000 replacement cost/3 years) rather than $10,000 per year (i.e., $30,000 historical cost/3 years), to ensure that sufficient resources will be available to replace the vehicle at the end of its useful life. As a result, however, the fund would report an ongoing surplus (i.e., the difference between charges based on estimated replacement cost and depreciation expense) until the replacement actually took place and the cycle started all over again for the newly acquired replacement asset. Such a surplus is perfectly acceptable.

A second exception is associated with self-insurance. Some types of losses (i.e., catastrophe losses) are not reasonably predictable for any given year. It is established practice to accumulate resources over time as "reserves" in anticipation of such contingencies. In that case, the internal service fund would report an ongoing surplus equal to its provision for anticipated catastrophe losses until the loss actually occurred and the cycle recommenced. In this instance, generally accepted accounting principles expressly accept the propriety of such an approach, provided that the provision for anticipated catastrophe losses is reasonable (GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, paragraph 66c).

Notes to the financial statements

This article will continue in the next issue with an examination of what the notes offer users to help in assessing a local government's near-term financing situation. SJG