BLUE BOOK

The Practitioner's Choice
75
for 75 Years

GAAFR

Governmental Accounting, Auditing, and Financial Reporting

Stephen J. Gauthier

Government Finance Officers Association

203 N. LaSalle Street
Suite 2700
Chicago, IL 60601-1210
www.gfoa.org

Library of Congress Control Number: 2013938545
ISBN 978-0-89125-308-2
Printed in the United States of America.

Part 1:

BACKGROUND AND FRAMEWORK

Section A: Basic Background

Chapter 1: Accounting, Financial Reporting, and the Financial Statement Audit: An Overview

Public finance encompasses a broad range of professional activities, including budgeting, capital planning, debt management, fiscal policy, economic development, investment and treasury management, and retirement and benefits administration. [The Government Finance Officers Association has established standing committees to advise its Executive Board on all of these activities.] Parties both inside and outside a government must make important decisions in connection with these and similar finance-related activities. The soundness of these decisions depends on the quality of the information upon which they are based. Furthermore, it is the duty of all those who manage financial resources on behalf of others to provide a full accounting of that stewardship. The purpose of accounting, financial reporting, and the financial statement audit is to provide the information needed for both financial decision making and the assessment of financial stewardship. Thus, accounting, financial reporting, and the financial statement audit might be described as providing the informational infrastructure of public finance.

Accounting

Many different types of transactions and events can affect a government's finances. A government must *assemble* relevant data on all of these transactions and events.

It is important not to let the form of a transaction obscure its economic substance. For example, the "purchase" of a valuable piece of land from a developer for a nominal amount is really a donation from the developer rather than a purchase. Likewise, some leases are merely rental arrangements (*operating leases*), whereas others are substantially equivalent to a sale of the leased asset inasmuch as the risks and benefits of ownership are effectively transferred from the lessor to the lessee (*capital leases*). Accordingly, a government must also *analyze* the economic substance of events and transactions.

It is important, too, that a government be in a position to group like items. Accordingly, governments must adopt a comprehensive chart of accounts and then *classify* all of the various components of a given transaction or event into one of those accounts. Thus, for example, the purchase of land would be identified with at least two [In accordance with the accounting practice known as double-entry bookkeeping.] specific accounts (*land* and *cash*).

Finally, a government needs to make a journal entry to *record* the identified effect of transactions and events on specific accounts. The effect on each account, in turn, is then posted to the general ledger (a list of the balances in each of the individual accounts in the chart of accounts).

The term *accounting* is used, in a technical sense, to describe this process of assembling, analyzing, classifying, and recording data relevant to transactions and events that affect a government's finances.

Since those who manage resources have a duty to give an accounting of their stewardship of the resources entrusted to their care, *accounting is primarily the responsibility of management*.

Financial reporting

The terms *accounting* and *financial reporting* often are employed as though they were interchangeable. In fact, the two concepts are quite distinct, although they complement one another. [Sometimes, the term *accounting* is used to describe both *accounting* and *financial reporting*. In that case, the term *bookkeeping* is used to describe *accounting* in the more limited sense.]

Accounting, as just described, is the process of assembling, analyzing, classifying, and recording data relevant to a government's finances. *Financial reporting* is the process of taking the information thus assembled, analyzed, classified, and recorded and providing it in usable form to those who need it.

A sound accounting system will collect and maintain detailed data on each individual transaction and event. The goal of financial reporting, on the other hand, is to aggregate and summarize detailed data so the data can be put to practical use for decision making. Thus, for example, an accounting system must maintain data on individual accounts payable, whereas a financial report typically will provide information only on aggregated totals.

Once again, since those who manage resources must give an accounting of their stewardship, *it is managers who are primarily responsible for financial reporting.*

Financial reporting can take one of three forms: *internal financial reporting*, *special purpose external financial reporting*, and *general purpose external financial reporting*.

Internal financial reporting

Management uses financial data for a variety of purposes. Since managers control the accounting system, they are free to design reports to meet their specific managerial needs and preferences. That is, the content, format, and timing of such reports remain at the discretion of management. The term *internal financial reporting* is sometimes used to distinguish managerially focused reporting from reporting aimed at outside users. Internal financial reports for state and local governments typically present data in a manner consistent with the annual (or biennial) appropriated budget to help management monitor budgetary compliance. Internal financial reporting often provides more detail on individual departments than does general purpose external financial reporting and is not subject to the same level of review and audit.

Special purpose external financial reporting

Not infrequently, parties outside the government (a state regulatory agency or a grantor) will be in a position to require financial reports for which they themselves set the content, format, and timing. The technical term used to describe such tailor- made financial reports to outside parties is *special purpose external financial reporting*.

General purpose external financial reporting

Those who rely on internal financial reporting and special purpose external financial reporting are in the enviable position of being able to decide for themselves the content and format of the financial reports they will receive. Most interested parties, however, have no choice but to rely upon financial reports designed to serve a broad range of potential users. Accountants describe financial reports intended to meet the needs of those who do *not* have direct access to financial information as *general purpose external financial reporting*. General purpose external financial reporting typically is governed by generally accepted accounting principles (GAAP), which may or may not be consistent with the approach taken to calculating and presenting data for budgetary purposes.

GAAP direct that different types of information be presented in different ways. Specifically, there are three different *communications methods* [Governmental Accounting Standards Board (GASB) Concepts Statement No. 3, *Communication Methods in General Purpose External Financial Reports That Contain Basic Financial Statements*.] that are used to present information in general purpose external financial reports:

- Display (inclusion in one of the basic financial statements);
- Disclosure (inclusion in the notes to the basic financial statements); and
- Supporting information.

Display. Items are reported as dollar amounts on the face of the financial statements if they *both* meet the definition of one of the seven financial statement elements *and* can be adequately measured. The seven financial statement elements for state and local governments are: *assets*, *liabilities*, *inflows of resources*, *outflows of resources*, *deferred inflows of resources*, *deferred outflows of resources*, and *net position*. Exhibit 1-1 provides a description of each of these elements. [GASB Concepts Statement No. 4, *Elements of Financial Statements*.]

Exhibit 1-1.

Elements of financial statements

Assets: *resources with present service capacity that the government presently controls*

The term *control* refers to a government's ability:

- To utilize a resource's present service capacity; and
- To determine the nature and manner of its use.

Control does *not* have to be absolute for this purpose. For example, grant-acquired equipment that must be used for a particular program could still be classified as an asset, despite the restriction.

Control normally results from *legal ownership* (title to land) or from *contractual rights* (easement).

Control must result from a *past event* (tax levy) *rather than an inherent power* (ability to tax).

Liabilities: *present obligations to sacrifice resources that the government has little or no discretion to avoid*

The concept of *avoidability* is crucial -- an obligation that can be avoided is *not* a liability. Normally an obligation will be deemed unavoidable because it is legally enforceable:

- Either pursuant to a contract (payables); or
- As a result of third-party legislation (environmental regulations).

Still, legal enforceability is not essential to liability recognition.

Furthermore, an obligation may need to be recognized as a *constructive (inferred) liability* if "social, moral, or economic consequences leave the government little or no discretion to avoid the sacrifice of resources."

At the same time, it is essential to differentiate *commitments* from liabilities. An obligation to provide a particular service (public education) or a particular level of service, for instance, would not, of itself, constitute a liability.

In addition, a liability also must involve an *external party,* although that party need not necessarily be identified (tax refunds).

Inflow of resources: *an acquisition of net position by the government that is applicable to the reporting period*

Acquisition involves either:

- New resources coming under the government's control (occurrence of a taxable sale); or
- Resources already under the government's control becoming newly available (meeting eligibility requirements for a grant that provided cash in advance).

Either way, acquisition will always result in either a *net increase in assets* or a *net decrease in liabilities.*

Outflow of resources: *consumption of net position by the government that is applicable to a reporting period*

Consumption may involve either:

- Using up an existing resource (cash); or
- Using up a resource as it is acquired (employee labor).

Either way, the result of consumption will always be a *net decrease in assets* or a *net increase in liabilities.*

Deferred inflow of resources: *acquisition of net position by the government that is applicable to a future reporting period*

A given item that meets the definition of an inflow of resources, but relates to a future period, is a *deferred* inflow of resources (property taxes levied in the current year to finance the subsequent year's budget).

Deferred inflows are *not* to be confused with *liabilities.* For example, a grant received prior to meeting eligibility requirements (other than time requirements) does *not* meet the definition of a deferred inflow of resources because:

- It involves no acquisition of resources resulting in either a net increase in assets or a net decrease in liabilities (the asset cash received from the grantor is counterbalanced by a related liability to the grantor); and
- It also meets the definition of a liability because it represents a present obligation to sacrifice resources that the government has little or no discretion to avoid.

Deferred outflow of resources: *consumption of net position by the government that is applicable to a future reporting period*

A given item that meets the definition of an *outflow of resources,* but relates to a future period, is a deferred outflow of resources (resources provided to a grantee before the grantee has met related time requirements, but after all other eligibility criteria have been met).

Deferred outflows are *not* to be confused with *assets.* For example, prepaid rent does *not* meet the definition of a deferred outflow of resources because:

- It involves no consumption of resources that results in either a net decrease in assets or a net increase in liabilities (the asset *prepaid rent* simply replaces the asset *cash*); and

- It does meet the definition of an asset because it represents access to present service capacity that is under the government's control.

Net position: *the residual of all other elements presented in a statement of financial position*

The difference between *assets* + *deferred outflows of resources*, on the one hand, and *liabilities* + *deferred inflows of resources,* on the other, constitutes the last of the financial statement elements, *net position*.

Disclosure. Three types of information are properly included within the notes to the basic financial statements:

- *Descriptions* of the policy underlying amounts presented in the basic financial statements;
- *Detail or explanations* concerning amounts presented in the basic financial statements; and
- *Information about potential financial statement elements* that do *not* qualify for recognition.

Such information needs to possess a clear and demonstrable link to the basic financial statements. Furthermore, it needs to be *essential* (*indispensable*) to the user's understanding of the financial statements (the user being presumed to have a reasonable understanding of public finance and governmental financial reporting and to be willing to study the information with reasonable diligence). It also should be free of predictions or subjective assessments of the future effect of reported items.

Supporting information. This third method of communicating financial information is used for information designed to provide *operational, economic, or historical context* for the financial statements themselves or for the notes to the basic financial statements.

Sometimes the presentation of supporting information is mandated by the GASB, in which case it is referred to as *required supplementary information* (RSI). Otherwise the appropriate term is other *supplementary information* (SI).

Both RSI and SI need to possess a clear and demonstrable link to either the basic financial statements or the notes to the basic financial statements. The key difference is that the GASB must consider it *essential* that certain information accompany the basic financial statements for its presentation to qualify as RSI. In addition, RSI cannot contain either subjective assessments of the future effect of reported items or predictions.

SI commonly includes more detailed presentations of information included in the financial statements, as well as presentations mandated by law or regulation. The presentation of SI is optional. However, any relevant authoritative standards for the presentation of such information should be followed if it is presented in connection with GAAP financial statements. [For example, governments that voluntarily present a statistical section in connection with GAAP financial statements must follow the guidance set forth in GASB Statement No. 44, *Economic Condition Reporting: The Statistical Section*.]

Essential characteristics of accounting data. Regardless of whether information is presented in the financial statements, in the notes to the basic financial statements, or in supplementary information, it must possess certain essential characteristics for inclusion in general purpose external financial reporting: understandability, reliability, relevance, timeliness, consistency, and comparability. [GASB Concepts Statement No. 1, *Objectives of Financial Reporting*, paragraph 62-68.]

In a perfect world, the information in financial statements would be readily *understandable* to anyone with an interest in the information. More realistically, the stated objective of general purpose external financial reporting is to provide information that will be understandable to someone with "a reasonable understanding of government and public finance activities and of the fundamentals of governmental financial reporting," who is both willing to study a financial report "with reasonable diligence," and to apply "relevant analytical skills." [GASB Concepts Statement No. 3, paragraph 21.]

Users of financial statements should not be offered information to be used in making financial decisions unless that information is *reliable*. Information does *not* have to be precise to be reliable (estimates are acceptable); it must, however, faithfully represent what it purports to represent (economic substance v. legal form).

Accounting information also needs to be *relevant*. That is, the information should be able to make a difference in how users assess a problem, condition, or event. Irrelevant data obscure rather than enhance more relevant data.

Financial information, for most purposes, becomes less valuable with the passage of time. Data must be *timely* to be of value to decision makers. That is, financial reports should be issued soon enough after the close of a period to affect decision making.

Many financial decisions involve the analysis of financial trends over time. Data must be *consistent* from period to period to be useful for this purpose. Thus, an accounting principle, once adopted, should be applied consistently over time.

Finally, financial data should be *comparable*. Simply put, similar events, transactions, and activity should be treated similarly. Conversely, different financial treatment of transactions, events, or activity should result from underlying differences in substance.

The financial statement audit

As already noted, both accounting and financial reporting are primarily the responsibility of management. Unfortunately, in a variety of circumstances, there is the very real possibility that management might be tempted to be less than forthcoming (*or worse!*) in its financial reporting. Consequently, users of general purpose external financial reporting have long insisted that an independent third party vouch for the reliability of financial reports. That third party is the independent auditor. The process used to provide reasonable (not absolute) assurance that the financial statements are fairly presented (in all material respects) is the *financial statement audit*.

Even when management seeks outside help to prepare the financial statements, it still remains responsible for their contents, just as taxpayers remain responsible for their tax return, even if the return is prepared by a paid tax professional. Thus, managers must take complete ownership of their financial reporting. However, it hardly would be meaningful for management to assume responsibility for the data presented in financial statements if it did not have some reasonable basis for doing so. That reasonable basis can be provided only by a *comprehensive framework of internal control*.

While management is *primarily* responsible for financial reporting (including the comprehensive framework of internal control used to generate the financial statements), the governing body remains *ultimately* responsible for ensuring that management meets its responsibilities in this regard. Typically an audit committee, ideally composed of members of the governing body, provides the necessary oversight.

The independent auditors are responsible for the opinion they express concerning the fair presentation of the financial statements. Their responsibility in that regard, however, in no way diminishes either management's primary responsibility or the governing body's ultimate responsibility for the government's financial reporting.

Chapter in brief

Accounting, financial reporting, and the financial statement audit provide the informational infrastructure of public finance. *Accounting* and *financial reporting* are complementary rather than identical.

- *Accounting* is the process of assembling, analyzing, classifying, and

recording data relevant to transactions and events that affect the government's finances.
- *Financial reporting* is the process of taking the information thus assembled, analyzed, classified, and recorded and providing it in usable form to those who need it.

Both accounting and financial reporting are primarily the responsibility of management.

¶

Financial reporting can take one of three forms: *internal financial reporting*, *special purpose external financial reporting*, and *general purpose external financial reporting*.

The content, format, and timing of internal financial reports are set by management. Typically data in those reports are presented in a manner consistent with the budget.

The content, format, and timing of special purpose external financial reports are set by outside parties (a state regulatory agency or grantor).

General purpose external financial reporting is designed to serve a broad range of potential users and typically is governed by GAAP, which may not be consistent with budgeting.

¶

Information in general purpose external financial reporting can be communicated in one of three ways: *display* (inclusion in one of the basic financial statements), *disclosure* (inclusion in the notes to the basic financial statements), or *supporting information*.

Items are displayed in the financial statements only if they meet the definition of one of the seven financial statement elements (*assets*, *liabilities*, *inflows of resources*, *outflows of resources*, *deferred inflows of resources*, *deferred outflows of resources*, and *net position*) and can also be reliably measured.

Disclosure is used for *descriptions* of the policy underlying amounts presented in the basic financial statements, *detail or explanations* concerning amounts presented in the basic financial statements, and *information about potential financial statement elements* that do *not* qualify for recognition.

Supporting information is designed to provide *operational, economic, or historical context*. Sometimes the presentation of supporting information is mandated, in which case it is referred to as *required supplementary information*.

¶

Accounting data must possess certain essential characteristics for inclusion in general purpose external financial reporting: *understandability*, *reliability*, *relevance*, *timeliness*, *consistency*, and *comparability*.

¶

The financial statement audit is designed to provide independent assurance that the financial statements are fairly presented.

A comprehensive framework of internal control is necessary to provide management a reasonable basis for assuming responsibility for the financial statements.

¶

While management is *primarily* responsible for financial reporting (including the comprehensive framework of internal control used to generate the financial statements), the governing body remains *ultimately* responsible for ensuring that management meets its responsibilities in this regard. Typically, an *audit committee* assists in providing the necessary oversight.

The independent auditor's responsibility to offer an opinion on the fair presentation of the financial statements in no way diminishes the responsibility of management and the governing body.

Exercises

1. Which of the following best describes the role that accounting, financial reporting, and the financial statement audit play for state and local governments?
   A. They comprise a comprehensive framework of internal control.
   B. They provide the informational infrastructure of public finance.
   C. They serve as a public-sector performance management system.

2. Who is *primarily* responsible for *accounting*?
   A. The governing body
   B. The independent auditor
   C. Management

3. Who is *primarily* responsible for *financial reporting*?
   A. The governing body
   B. The independent auditor
   C. Management

4. Which of the following best describes the relationship between *accounting* and *financial reporting*?
   A. The two terms are essentially interchangeable.
   B. The two terms are complementary but distinct.
   C. The two terms are unrelated.

5. What determines the content and format of *internal financial reports*?
   A. Generally accepted accounting principles
   B. Management's needs and preferences
   C. Both A and B

6. What typically determines the content and format of *general purpose external financial reports*?
   A. Generally accepted accounting principles
   B. Management's needs and preferences
   C. Both A and B

7. Which of the following methods of communication would require that a given item meet the definition of a financial statement element?
   A. Display
   B. Disclosure
   C. Both A and B

8. Which of the following methods of communication focuses on providing an operational, economic, or historical context?
   A. Disclosure
   B. Supporting information
   C. Both A and B

9. Which of the following is an *essential characteristic* of accounting data?
   A. Precision
   B. Comparability
   C. Both A and B

10. Who is *ultimately* responsible for a government's *financial reporting*?
   A. The independent auditor
   B. Management
   C. The governing body

Answers

1. B 2. C 3. C 4. B 5. B 6. A 7. A 8. B 9.B 10.C