Basic Public Accounting

2011 Midwest Regional Public Finance Conference
February 17, 2011

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Objectives

- Current issues and challenges
- Government accounting and financial reporting – why is it different?
- Government accounting and financial reporting – the basics
- Financial best practices
- Fiscal sustainability

Current Issues and Challenges

Current headlines: pensions

Underfunded pension plans

- Many local governments, and states in particular, are underfunded on their defined benefit pension plans.
- KPERS: 64% funded -- $7.7 billion short of the actuarial liability
- San Francisco is spending $400 million a year on pensions, up from $175 million in 2005
- Impact on bond ratings – rating agencies evaluate the size of the resource base, % of entity’s budget needed to make payments, and officials’ willingness and ability to make hard choices

Pension plans: The good news

- From 2001-2009, pension plan sponsors nationwide funded 91% of their required contributions[1].
- Since 2006, nearly two-thirds of states have made changes to benefit levels, contribution structures or both[2].

Sources: [1]Public Fund Survey
[2]NASRA

Current headlines: debt burden

- Increasing debt levels jeopardize fiscal sustainability and transfer wealth across generations
- Most of increase has been in advanced economies, not emerging markets
- Debt-to-aggregate GDP is approx. 71% for advanced economies in 2010, and projected to be more than 80% by 2015
- Debt per capita in 2007 was $19K, up to $29K in 2010, and projected at $41K in 2015
- Debt burden more likely to fall on the working-age population than the population as a whole

Source: Brookings Institution

Debt burden

- States and local governments issue bonds almost exclusively to fund infrastructure projects, not operating costs
- Interest payments on state and local bonds are generally 4-5% of current expenditures – no more than in the 1970s
- State and local government outstanding debt stood at 16.7% of GDP in the 2nd quarter of 2010, up from 12% in 2000, but similar to the average levels from the mid-1980 to mid-1990s
- Rating agencies calculate municipal bond default rate at less than one-third of 1%. Between 1970 and 2009, only four defaults were from cities and counties.

Source: Center on Budget and Policy Priorities

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Current headlines: Health costs

- Unfunded benefits for retiree health coverage
- Kansas statutes provide for retiree health costs to be covered until Medicare at age 65.
- Current estimates are that state and local unfunded liabilities for retiree coverage are $500 billion.
- The GAO projects that the cost of retiree health benefits is expected to increase at an annual rate of 6.7% between now and 2050.

Source: Center on Budget and Policy Priorities

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Retiree health care

- Such benefits are not legally binding – provisions more easily changed than pension benefits
- How much of premium is paid by the retiree?
- Benefit provisions likely to change

Government Accounting and Financial Reporting – Why is it Different?

“Why can’t government operate like a business?”

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Government vs. Business

Government	Business
Service-driven	Profit-driven
Taxpayers	Customers
Taxes paid / services	Price / product
Cash flow	Cost of service
Legal budget	Operating budget
Restricted resources	Common resources
Elected officials	Hired officers

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Government vs. Business

- Taxes often bear little direct relationship to services received by the taxpayer (unless a customer paying for goods / services)
  - Result: focus on how public resources are acquired and used; are current resources meeting current service costs?
- Governments do not have owners, measures of net income have no meaning.
  - Result: focus on stewardship of public resources, how resources are devoted to specific services and costs of providing those services

Government vs. Business

- Creditors of both are interested in information on the ability to repay debt.
  - Government creditors focus more on the government's ongoing ability to raise taxes and costs of activities that could compete for those resources.
- Return on investment (business) vs. sustainability of the level of services and ability to meet future levels of demand for services (government)

Government financial-statement users

- Management
  - Planning purposes
  - Ensure / demonstrate compliance
  - Internal budgetary restrictions
  - External restrictions (grantors)
- Legislative and oversight bodies
  - Allocation of scarce resources
  - Monitor management's compliance
- Investors and creditors
  - Evaluate creditworthiness of government
  - Evaluate compliance with contractual provisions (debt covenants)
- Citizens
  - Evaluate financial stewardship

Result of difference: Are we making money?

- Were current-year taxes and other revenues sufficient to cover cost of current-year services?
- What resources support programs?
- What are the spending priorities?
- Did the government's ability to provide services improve or deteriorate from the previous year?
- Does the government have capacity to meet future obligations?
- What resources are available for future expenditures?

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Government Accounting and Financial Reporting – The Basics

- Financial reporting

- Accounting basics

- Budgeting

Government reporting options

In Kansas, there are 2 options for reporting:

1. GAAP: generally accepted accounting principles
   - Guidance issued by the Governmental Accounting Standards Board (GASB)
2. KMAG: Kansas Municipal Audit Guide
   - Mandated under K.S.A. 75-1123, prescribed by the Division of Accounts and Reports
   - Follow provisions of Kansas statues, including cash basis and budget laws
   - Governing body must pass an annual resolution to waive GAAP requirements

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Government reporting options

- KMAG applies to all Kansas municipal audits to be conducted under KSAs 75-1112 (most municipalities), and 10-1208 or 12-866 (utilities w/ revenue bonds).
- KMAG audit required if the municipality has:
  1) Annual gross receipts > $275,000
  2) GO bonds outstanding > $275,000, or
  3) Revenue bonds outstanding > $275,000
- KMAG audit required for utilities if they have *any* outstanding revenue bonds.

Government reporting: Financial reporting entity

- What entities are included in the financial statements?
  - Government itself (primary government)
    - All state and general-purpose local governments
  - Legally separate units for which the primary government is financially accountable or whose exclusion would make the primary government's financial statements misleading (component units)
  - Certain special purpose governments may be separate primary governments, and not included

Government reporting: Special-purpose governments

Special-purpose governments meet these criteria:

- Elected governing body
  - General, popular election
- Separate legal status
- Fiscal independence
  - Ability to *arbitrarily* override financial decisions, such as those related to budgets, tax levies or setting of rates / charges, and the issuance of bonded debt

Government reporting: Component units

- Legally separate organization that must be included as part of the primary government's financial statements
- Three tests
  - Appointment of the unit's governing board
  - Fiscal dependence
  - Exclusion potentially misleading

Government reporting: Component units

Board appointment:

- Must be substantive, and not an approval of a list of candidates or selection from narrow list of candidates
- Voting majority
- Evidence that relationship is continuing
  - Ability to impose will
  - Financial benefit or burden

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Government reporting: Component units

Ability to impose will:

- Ability to significantly influence programs, projects, activities or level of services
  - Removal of board members at will
  - Modification or approval of budget
  - Modification or approval of changes in rates or fees
  - Veto, overruling or modification of decisions
  - Hiring, reassignment or dismissal of management

Government reporting: Component units

Financial benefit / burden:

- Access to assets
- Obligation to finance deficits or provide financial support
- Obligation in some manner to support debt
- Tax-increment financing is always evidence of a financial burden

Government reporting: Component units

Fiscal dependence:

- Criteria same as for fiscal independence

Potentially misleading to exclude:

- Foundations and similarly affiliated organizations (legally separate tax-exempt organizations)
- Closely related

Government accounting basics

- Standards set by Governmental Accounting Standards Board (GASB)
- Certain standards set by the Financial Accounting Standards Board (FASB) may apply to proprietary fund types
- Kansas Municipal Audit Guide (KMAG) for statutory-basis financial statements

Government accounting: The basics

- Governments use fund accounting
- Governments have required budgetary reporting
- Governments use different bases of accounting / measurement focuses within a single set of financial statements

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Kansas cash basis law (K.S.A. 10-1101 et. seq.)

Municipalities are prohibited from creating any financial obligation (indebtedness) unless there is money on hand to pay for it. If there is no cash, there can be no financial obligation.

- Exceptions:
  - When there is a favorable vote of electors
  - Matters for which bonds will be issued
  - When no-fund warrants have been authorized
  - Lease-purchase agreements

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Kansas budget law (K.S.A. 79-2925-2937)

- The annual budget provides legal expenditure authority by fund.
- The annual budget is used to make annual property tax levies.
- All money belonging to the entity must be included in the annual budget.
- A separate financial statement for each fund must be included.
- Forms prescribed by the Director of Accounts and Reports
- A balanced budget for the proposed budget year must be presented for each tax levy fund; the law permits, but does not require, a 5% non-appropriated fund balance in each fund.
- Budgeted transfers from one fund to another must be authorized by statute.

Statutory vs. GAAP reporting

Statutory –

- Focus is on current year, cash received and spent / obligated
  - Ensure and demonstrate accountability
- Reflects current public policy priorities
- Are current resources sufficient to meet current service costs?
- Revenues: recognized when received
- Expenditures: recognized when paid or encumbered

Statutory vs. GAAP reporting

GAAP (generally accepted accounting principles):

- Greater focus on economic resources – resources available for future expenditures and capacity to meet future obligations (longer-term focus)
- Revenues: recognized when earned
- Expenditures: recognized when incurred
- Capital assets and long-term debt recognized as well

Fund accounting

- Governmental funds:
  - General fund
  - Special revenue funds
  - Capital-project funds
  - Debt-service fund
  - Permanent funds
- Proprietary / business-type funds:
  - Enterprise funds
  - Internal service funds
- Fiduciary funds

Fund accounting

- General fund: chief operating fund, used to account for all financial resources other than those required to be accounted for in another fund
- Special-revenue funds: account for the proceeds of specific revenue sources, for specific purposes
  - Grants, enabling legislation, etc.
  - Use is *permitted* rather than *required*

Fund accounting

- Capital-project funds: account for resources to be used for the acquisition or construction of capital assets other than those financed by proprietary funds

- Debt-service fund: accounts for the accumulation of resources for and the payment of general long-term debt principal and interest

Fund accounting

- Permanent funds: report resources legally restricted to the extent that only earnings, and not principal, may be used for purposes that support the government's programs or its citizenry
- Enterprise funds: may be used to report any activity for which a fee is charged to external users for goods and services (required in certain situations)
  - Not required to recover full cost of operations (for example – Transit operations)

Fund accounting

- Internal service funds: may be used to report any activity that provides goods or services to other funds, departments, or agencies of the primary government and its component units, or to other governments, on a cost-reimbursement basis
  - Example: fleet pools, IT systems, self-insurance or other risk financing
  - Use is *never* required

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Fund accounting

- Fiduciary funds: used for pension or other employee benefit trust funds, investment trust funds, private-purpose trust funds or agency funds
  - Gov't is acting in a fiduciary or custodial capacity.
  - Trust funds are created as official legal "trusts."
  - Private purpose trusts – principal and income can benefit individuals, private organizations or other governments (for example, escheat assets)
  - Agency funds – role is purely custodial; all assets offset by liabilities (no net assets)

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Financial statements

- Budgetary statements
- Fund financial statements
- Government-wide financial statements
- Notes to the financial statements

Budgetary statements

- Reported for each individual fund, with focus on compliance with legal budget and cash-basis laws
- Cash basis, modified for encumbrances
- Comparison of:
  - Original budget vs. final budget
  - Actual results vs. final budget

Fund financial statements

- Reported by fund type (governmental, proprietary, fiduciary)
  - Focus on “major” funds
  - Demonstrates fiscal accountability
- Current financial resources focus / modified accrual basis of accounting
  - Principal & interest payments on long-term debt are recorded as expenditures
  - Costs of construction or other capital outlay are recorded as expenditures
  - Proceeds from bond issues are recorded as revenues

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Fund financial statements

Governmental funds:

- Balance sheet
- Statement of revenues, expenditures and changes in fund balance

Proprietary funds:

- Statement of net assets
- Statement of revenues, expenses and changes in net assets
- Statement of cash flows

Government-wide financial statements

- Report governmental activities and business type activities in total
- Excludes fiduciary funds
- Economic resources focus / full accrual basis of accounting
  - Includes all long-term assets and liabilities

Statement of net assets

- What does the government own, and what does it owe?
- What are the government's short-term financial needs, and what are its available resources?
- What are its liquid assets?
- What's left over after all liabilities are paid? (net assets)
  - Is this money the government can spend?

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Statement of net assets (cont'd.)

- What does the statement really tell me about the government?
  - Overall financial condition: ability to meet obligations as they come due and finance the services its constituency requires
  - Current assets vs. current liabilities (liquidity)
  - Long-term viability (solvency): degree to which assets are financed through borrowing – i.e., extent to which assets will be needed to satisfy debts rather than be available for providing public services
  - Trend data from prior years: see the MD&A or the Statistical Section

Statement of activities

- Starting point: total cost of governmental services by function (i.e., expenses)
- What program revenues does the entity generate to support its services?
  - Charges for services
  - Grants and contributions
- Net cost of services = taxpayer burden
- Change in net assets (equivalent of net income in a for-profit entity)

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Statement of activities

- What does this statement tell me?
  - The cost of providing services
  - The tax burden on citizens to finance services
  - Degree to which each functional area requires taxes or general revenues for financing
  - Whether the government is raising enough resources to finance its operations
  - Diversity of revenues and trends over past years – can demonstrate exposure to financial difficulty if a source of revenue dries up
  - Did the government finance that year's services with revenues from that year (intergenerational equity)?
  - See MD&A and Statistical Section for trend data.

Basic financial statements – other info

- Reconciliation between fund statements and government-wide statements
- Notes to the financial statements
- GAAP financial statements:
  - Required supplementary information
    - Budget vs. GAAP explanation
    - Funded status of pension plans
  - Management's discussion and analysis
- Comprehensive Annual Financial Report
  - Transmittal letter
  - Statistical section

Statistical section (CAFRs only)

- Debt per capita
- Debt to assessed value
- Legal debt margin
- Debt service as a % of total expenditures
- Major industries and employers – now vs. 10 years ago

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GAAP: pros / cons if not required

<u>Pros</u>:

- Provides data on long-term asset needs, and long-term obligations
- Presents a full economic picture of the entity
- May result in better interest rates and easier access to capital, if bond market participants have access to more data

<u>Cons</u>:

- Cost of producing GAAP financial statements is higher
  - Need for internal processes, expertise, and expanded IT systems
  - Higher audit costs
- Information on long-term obligations and assets may be available for decision-making purposes already, without need to prepare GAAP statements.
- If not going to bond market frequently, GAAP statements may not result in a significant enough benefit from lower interest rates compared to the cost incurred to produce them.

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Budgeting: The basics

- Role shared with the private sector
  - Financial-planning tool
- Role unique to the public sector
  - Set public policy
  - Control on taxing and spending

Classifying budgets

- Period
  - Annual
  - Biennial
  - Project-length
- Character
  - Operating
  - Capital

Capital budgets

- Replacement schedules should anticipate the inevitable aging and obsolescence of facilities and equipment. Depreciable assets should be financed through internal funds whenever possible.
- Realistically assess future revenues and avoid commitments for projects that lack economic feasibility.
- Disciplined borrowing – appropriate as a means of matching facilities' costs with the benefits enjoyed by future residents
- Capital expenses usually add operating costs. Capital plans should include projected changes in operating and maintenance costs, workforce requirements and risk-management considerations.

Legally adopted budgets

- Legally adopted budgets are required in Kansas, unless exempted by statute.
  - Generally exempt:
    - Capital-project funds – project-length instead
    - Federal and state assistance funds
    - Certain other special-revenue funds (depends on nature of fund)
    - Airports, transit, golf courses
    - Internal-service funds
    - Trust and agency funds

Budgetary integration

- Automatic access to information on:
  - Uncommitted balance of appropriations
  - Unrealized revenue

- Integration:
  - Now automated with IT system
  - At one time, was done via journal entry

Unrealized revenues

Estimated revenue account (budget)

Less: Actual account (amount realized)

Equals: Unrealized revenues

Encumbrances and uncommitted appropriations

	Appropriations (budget)
Less:	Actual account (expenditures paid)
Less:	Encumbrances (commitments)
Equals:	Uncommitted appropriation

Encumbrances outstanding at year-end

Two approaches:

- Reappropriation
  - Would need to be reappropriated as part of the subsequent year's budget
- Extension of budget period for encumbrances (lapse period)
  - When the encumbrance is finally liquidated, it is charged against the prior year's budget, rather than against the budget of the current year.

Legal level of budgetary control

The lowest level at which a government's management may not reallocate resources without special approval from the governing body. Most common:

- Fund level
- Department level
- Object-code level (personnel, contractual, materials and supplies)

Financial Best Practices

Financial policies

- Investment policy
  - Types of securities, liquidity, maturity, default risk, investment return, etc.
  - Use of brokers / bankers in a competitive program with reputable financial institutions
- Cash-management policy
  - Designed to facilitate maximum cash flow, and investment income
  - Safety first: security of public deposits should be assured through proper collateralization

Financial policies

- Debt management plan
  - Assess the government's long-term capacity to absorb and repay debt
  - Ensure appropriate bond counsel and financial advisors assist on bond issues
  - Competitive vs. negotiated underwriting: competitive sales should be used whenever feasible. In negotiated underwritings, ensure that underwriter profits are reasonable and that costs are truly minimized. Interest rates, fees and fee structure should be part of negotiations.

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Financial policies

- Procurement policy
  - Should promote maximum value and economy through a competitive process
  - Minimize opportunities for favoritism
  - Set specific dollar amounts for competitive bidding, and authorization limits for others.
  - Consider special procedures for selecting service providers such as financial advisors, auditors, consultants.
  - Consider procurement cards for smaller items (need separate policy).

Financial policies

- Reserves policy / fund balance policy
  - Essential for mitigating current and future risks, revenue shortfalls and unanticipated expenditures. Also helps ensure stable tax rates.
  - GFOA recommended practice is to have no less than two months of regular general-fund operating revenues or expenditures (depending on which is more predictable).
  - Consider: predictability of revenues and volatility of expenditures, exposure to one-time outlays (disasters, immediate capital needs), liquidity, previous commitments

Fiscal Sustainability

Fiscal sustainability

- Fiscal capacity: the government's ability and willingness to meet its financial obligations as they come due on an ongoing basis

- Service capacity: the government's ability and willingness to meet its commitments to provide services on an ongoing basis

Source: GASB staff discussion paper

Fiscal sustainability (cont'd)

- 2008 Census Bureau reported that on average, more than 34% of revenues for non-state governments came from states or the federal government – this was before federal stimulus actions of the last 2 years.
- States received about 25% from feds, but that increased to one-third of budgets with the stimulus monies.
- Only 3 ways to cure deficits:
  - 1) raise revenues
  - 2) cut spending, or
  - 3) sell assets
- Rainy-day funds / reserves have been drained
- Issues resulting from aging population
- Failure to maintain long-term financial health can lead to lower bond ratings

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Debate over selling assets

- Both Arizona and California have put significant assets up for sale. Arizona sold state office buildings, prisons, fairgrounds, and even the State House in 2010, raising $700 million. However, deficit was $4.5 billion. The state leases such facilities back for use, and estimates that it will pay $1.5 billion over term of lease.
- Leaseback terms are often more expensive over the long-term.
- Selling income-producing assets such as toll roads, lotteries or parking meters eliminates a future revenue stream.

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Using debt to fund operations

In Kansas, generally not allowed.

However:

- Refinancing debt to take advantage of lower interest rates, but debt payments may be extended over longer period of time
- Pension obligation bonds used to fund the unfunded pension liability – this is an “arbitrage play” (gamble) that earnings on invested bond proceeds will exceed the interest cost of the bonds

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Balancing act

How to balance current fiscal problems stemming from the recession, with longer-term issues relating to debt, pension obligations, health care costs

- Current issues: lower income tax, sales taxes, and property taxes due to the recession, and increases in demand for public services (Medicaid, social services, job training, etc.)
- Long-term issue: matching revenue systems with cost of services
  - Health care costs are an example of costs increasing faster than revenue streams.

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State structural deficits

- Revenue systems not modernized / obsolete tax structure
  - Impact of Internet commerce, telecommunications, and the role of services has changed the economy.
  - Few states adequately tax the sales of services on an equal basis to tangible goods.
  - Majority of states focus taxes on moderate- and middle-income residents, failing to maintain progressive tax systems that adequately tax incomes of top 1-5% of earners.
  - Tax exemptions often provided for elderly and retirement income, regardless of income of the taxpayer

- Budget and revenue projections
  - Multi-year budgeting would allow policymakers to have greater understanding of the long-term impact of changes they are making.

Source: Center on Budget and Policy Priorities

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What is the answer?

- Adopt a long-term financial plan.
  - Longer term budgeting / forecasting
  - Factoring in operating and maintenance costs for capital projects
- Modernize revenue systems.
- Analysis of estimated savings vs. actual savings achieved from cost cutting measures.

- Set the priorities of government
- Set the price of each priority
- Develop a plan for each priority

involve elected officials

- Measure outcomes

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Long-term planning: diversity

Long-term view not limited to revenues and expenditures

- Land-use patterns
- Demographic trends
- Long-term unfunded liabilities

Source: GFOA "Building a Financially Resilient Government through Long-Term Financial Planning"

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Long-term planning: redundancy

- Maintain a reserve policy – prevent use for recurring expenditures, specify purpose of reserves.
- Institutionalize financial planning through governance practices like financial policies and citizen management.
- Have a combination of strategies, not just one.

Source: GFOA "Building a Financially Resilient Government through Long-Term Financial Planning"

Long-term planning: Decentralization

- Make managers manage their cost and revenue structures.
- Engage departments in identifying issues, analyzing them, and developing strategies.
- Engage departments in financial modeling and forecasting.

Source: GFOA "Building a Financially Resilient Government through Long-Term Financial Planning"

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Long-term planning: Transparency

- Promote transparency in key areas like goals and objectives, forecast assumptions, and reserves.
  - Makes it easier to figure out where problems are.
  - Share plans and listen when people point out flaws.
- Include all direct and indirect costs in accounting for programs.

Source: GFOA "Building a Financially Resilient Government through Long-Term Financial Planning"

Long-term planning: Use key indicators

- Key indicators help keep elected officials and citizens abreast of financial condition and progress toward meeting goals.
- % of budget spent on personnel
- Recurring revenues vs. expenditures
- Enrollment trends vs. staffing
- Include service efforts and accomplishments (outcomes)
  - Cost per lane mile of road maintained
  - Cost per ton of trash collected
  - Cost per student reading at grade level by grade 4

Source: GFOA "Building a Financially Resilient Government through Long-Term Financial Planning"

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Long-term planning: flexibility

- Constantly monitor the environment.
- Create financial models to show the impact of changes.
  - How does deferred maintenance affect the life cycle of capital assets?
- Adapt the planning process itself.

Source: GFOA "Building a Financially Resilient Government through Long-Term Financial Planning"

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Questions?

Thank you!

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