policyprofiles

VOL. 3, NO. 1 FEBRUARY 2003

CENTER FOR GOVERNMENTAL STUDIES
Northern Illinois University

- ***Efforts are ongoing to assure integrity in government accounting practices***
- ***New accounting standards are now being instituted to make government reports more understandable***
- ***Government annual financial reports will abandon reports by funds in favor of two new government-wide reports***
- ***Governments will now be required to issue annually a Statement of New Assets and a Statement of Activities***
- ***In the new format, budgetary comparisons must be made on the basis of originally passed appropriations***

NORTHERN ILLINOIS UNIVERSITY

issue: *Can Government Accounting Be Trusted? An Experiment in Accounting and Accountability*

John W. Swain, Lloyd G. Sage, and Susan L. Gaffney

Editor's Note: The U.S. economy was rocked in 2002 by disclosure after disclosure of accounting fraud in some of the nation's largest companies. ***A reasonable question to ask in the light of these scandals is: what about government accounting?*** Can it be trusted any more, or even less, than private business accounting? This issue of *Policy Profiles* seeks to provide an answer to such questions.

Now that the integrity of corporate accounting has been opened to question, it is only reasonable that the public should ask if government accounting can be trusted. This was a major concern at the turn of the twentieth century, but the evolution of professional local government management and the implementation of rigorous accounting standards have produced a high level of accountability in most state and local government agencies. Still, the question is timely: do governmental accounting practices need the same kind of review that is now reportedly ongoing in the private sector?

Is anybody watching government accounting practices?

Two agencies, the Government Finance Officers Association (GFOA) and the Governmental Accounting Standards Board (GASB), have established financial management and accounting procedures designed to assure integrity in financial management and reporting. Although there have been no recent public sector scandals comparable to those in the private sector, the efforts of GFOA and GASB to assure integrity in governmental accounting and reporting are ongoing.

Without much attention, governmental accounting is now undergoing a major reform, known by the name of the document presenting new accounting standards: *Statement Number 34 of the Governmental Accounting Standards Board* (hereafter GASB No. 34).

That reform is intended to increase accountability by requiring that governments provide more and different information than they have previously provided in their annual financial reports. Whether that reform succeeds in improving accountability is an important concern.

What is the goal of GASB No. 34?

The primary goal of GASB No. 34 is implementing a new model of accountability in governmental financial reporting, and especially in the annual financial reports of counties, municipalities, school districts, and other local government agencies.

What kinds of information are contained in annual financial reports?

Annual financial reports show two kinds of information. First, certain reports show the financial position of a government at the end of a fiscal year with respect to assets and liabilities, that is, what is owned and what is owed. Second, certain other reports show the flows of resources over the course of a fiscal year (e.g., revenues and expenditures).

Financial reports that show more assets and fewer liabilities than the previous year and more revenues than expenditures signify an improving financial picture with regard to available resources; reports that show the opposite signify a declining financial picture.

What was wrong with the old model of accountability?

Critics argue that the old model of accountability represented in the previous standards did not result in adequate annual financial reports. The criticisms are that the financial reports were too fragmented, inadequately oriented toward the degree to which particular activities are self-financing, insufficiently focused on major portions of a government's finances, insufficiently comprehensive, overly focused on the current use of resources, and short on meaningful information.

How were the annual financial reports too fragmented?

Pre-GASB No. 34 annual financial reports showed financial information divided into various parts: funds, groupings of funds, and account groups. The primary parts were funds and groupings of funds. Funds are segments or parts of a government's finances that are used to account for particular monies apart from the rest of a government's finances. For example, a village might have a library fund to keep track of its library's revenues and expenditures. The purpose of using funds is to enable a government to show compliance with a variety of legal requirements and constraints placed on the way monies are spent (e.g., certain monies can be used only for certain purposes).

The three types of funds are governmental, proprietary, and fiduciary. Governmental funds are used to account for governmental operations (traditional government services mostly supported by taxes). Specific kinds of governmental funds include a general fund, special revenue funds (e.g., Motor Fuel Tax Fund), capital projects funds, permanent funds, and debt service funds.

Proprietary funds are used to account for businesslike operations, such as the production and sale of water (similar to the private sector in that fees are charged for services). Specific kinds of proprietary funds include enterprise funds (e.g., Water and Sewer Fund) and internal service funds (e.g., Motor Pool).

Fiduciary funds are used to account for monies that are held or used for another party (e.g., Illinois Municipal Retirement Fund). The old reports showed individual funds separately and funds grouped together (added together) by kinds and types (e.g., all special revenue funds and all governmental funds).

Although very small governments might have only one fund, a general fund, most governments have multiple funds; more than 10 funds is not uncommon. For example, Will County's Comprehensive Annual Financial Report for the fiscal year ending in 2000 shows 55 funds on 150 pages. So, a person looking at annual financial reports for a local government in Illinois would have to look at several funds, or totals for various types and kinds of funds, to figure out the government's finances.

In addition to funds, many pre-GASB No. 34 annual reports included two account groups called the General Fixed Assets Account Group and the General Long-Term Debt Account Group. Because of peculiarities of governmental accounting under the previous standards, the fixed assets (e.g., land, land improvements, buildings, and heavy equipment) and the long-term debt associated with general governmental operations were recorded in lists and shown in the annual financial reports as account groups. Annual financial reports displayed a list of items and associated values for each account group (e.g., Village Hall at $500,000 and bonds issued to resurface Main Street outstanding at $300,000).

By way of contrast, neither funds nor account groups are found in private sector financial accounting and reporting. Each private organization is treated in its financial accounts as a single unit with all financial information divided into accounts.

How does GASB No. 34 make annual financial reports less fragmented?

The new requirements for annual financial reports reduce fragmentation in three ways. First, two government-wide reports are required to show the overall financial situation of a government. Second, information formerly reported in the account groups is incorporated into the two government-wide reports. Third, the new standards no longer require specific fund reports for many funds, specifically ones not deemed "major."

In regard to the first way of reducing fragmentation, the two government-wide reports that show the overall financial situation of a government are called Statement of Net Assets and Statement of Activities (Tables 1 and 2). The Statement of Net Assets displays data on assets (things owned) and liabilities (things owed). The Statement of Activities displays data on flows of resources (e.g., revenues and expenses). The reports display financial information aggregated for all the individual government's governmental and proprietary funds. The information reported in the "Governmental Activities" column of the reports comes from governmental funds and internal service funds. Data in the "Business-type Activities" column comes from the enterprise funds. Fiduciary funds are excluded from the two reports because governments cannot use those resources as they desire. Besides, few fiduciary funds contain a very large percentage of a government's finances, with pension funds being the primary exception.

The key figures in the Statement of Net Assets (Table 1) are the Total Net Assets (total assets minus total liabilities) for Governmental Activities, Business-type Activities, and Total. Those figures are found on the last line of all three columns in Table 1.

The key figures in the Statement of Activities (Table 2 on the next page) are the Change in Net Assets (revenues minus expenses) for Governmental Activities, Business-type Activities, and Total. Those figures are found on the third line from the bottom, labeled "Change in Net Assets" in the three columns to the far right of Table 2. The calculations leading to those figures in Table 2 are more difficult to follow because they read left to right for the top portion of the Table and then top to bottom from the top right to the bottom right.

The left to right calculations involve Program Expenses and Program Revenues (column headings) for the "Functions/Programs," which are the Governmental Activities and Business-type Activities (row headings). The left-to-right calculation sequence is Expenses (second column from the left side) minus Program Revenues (the next three columns to the right) equals Net (Expenses) or Revenue figures for the Functions/Programs (three far-right columns). These figures show the degree to which particular activities are supported by program specific revenues.

The purpose of the top right to bottom right calculation sequence is to calculate the Change in Net Assets, which basically involves adding General Revenues to the Net (Expenses) or Net Revenue figures for the activities. The calculation sequence is the Net (Expenses) or Revenue figures for the Functions/Programs (three far-right columns) plus Total General Revenues (a row in the lower portion of the three far-right columns that is a sum of

table*one* **Statement of Net Assets (Example)**

Assets	Governmental Activities	Business-type Activities	Total
Cash	$ 5	$ 6	$ 11
Receivables	2	3	5
Capital Assets, net of accumulated depreciation	50	60	110
Total Assets	$ 57	$ 69	$ 126
Liabilities			
Accounts Payable	$ 3	$ 4	$ 7
Noncurrent Liabilities	27	40	67
Total Liabilities	$ 30	$ 44	$ 74
Net Assets			
Invested in capital assets, net of related debt	$ 23	$ 6	$ 11
Unrestricted	4	3	5
Total Net Assets	$ 27	$ 25	$ 52

all the general revenues) equals the Change in Net Assets.

How else do the new procedures reduce fragmentation?

In the second way of reducing fragmentation, information formerly associated with the two account groups is reported in the Governmental Activities portion of the Statement of Net Assets (Table 1). The specific entries are "Capital Assets, net of accumulated depreciation," which includes general fixed assets; "Noncurrent Liabilities," which includes general long-term debt; and "Invested in capital assets, net of related debt." Similar information was previously reported only in internal service and enterprise funds.

Third, to further reduce fragmentation, the new model no longer requires separate reports for all funds. Governments do not have to provide separate reports for any governmental or enterprise fund that is not deemed "major." This change allows governments to exclude much of the details found in financial reports under the old model.

The new model is designed to help readers understand the financial reports.

How does the new model report self-financing activities?

The degree to which particular activities are self-financing is presented in the Statement of Activities (Table 2). The heading for particular activities is "Functions/Programs," in the far-left column. The next column to the right is titled "Expenses," which shows the amount of resources used for each function/program. The heading for monies earned (either collected or shown as an accrued asset) in particular functions/programs is "Program Revenues," with the subheadings of "Charges for Services," "Operating Grants and Contributions," and "Capital Grants and Contributions." The "Net (Expenses) Revenue and Changes in Net Assets" columns show the net figures as the expenses minus the program revenues for the functions/programs and the totals for governmental activities, business-type activities, and the overall government. For example, the general government function/program expense is $90, the program revenues are $10, and the net

table*two* **Statement of Activities (Example)**

		Program Revenues			Net (Expenses) Revenue and Changes in Net Assets		
Functions/Programs	Expenses	Charges for Services	Operating Grants and Contributions	Grants and Contributions	Governmental Activities	Business-type Activities	Total
Governmental activities							
General gov.	$ 90	$ 6	$ 4	—	$ (80)	—	$ (80)
Public safety	260	7	5	1	(247)	—	(247)
Public works	119	3	12	30	(74)	—	(74)
Total gov. activities	$ 469	$ 16	$ 21	$ 31	$ (401)	—	$ (401)
Business-type activities:							
Water	$ 120	$ 119	—	$ 2	—	$ 1	$ 1
Sewer	180	178	—	3	—	1	1
Total business-type act.:	$ 300	$ 297	—	$ 5	—	$ 2	$ 2
Total	$ 769	$ 313	$ 21	$ 36	$ (401)	$ 2	$ (399)
General Revenues:							
Taxes:							
Specific Tax:					$ 398	—	$ 398
Total general revenues (and other inflows)					$ 398	—	$ 398
Changes in net assets				$ (3)	$ 2	$ (1)	
Net assets - beginning					30	23	53
Net assets - ending					$ 27	$ 25	$ 52

expense and negative change in net assets is $80. General revenue amounts, which mostly finance governmental activities, appear in the bottom portion of the report.

How were annual financial reports insufficiently focused in the old model?

Critics pointed out that the large number of funds contained in annual reports under the old model obscured the relatively few funds that involved large amounts of money. Even attempts to provide a report for all funds of a particular kind could involve multiple pages. They argued that large dollar funds should be the center of attention rather than making them equivalent to needles in a financial-reporting haystack.

How does the new model correct this problem?

As discussed above, the new model focuses attention on the two groups of funds in the two government-wide reports.

Table 3 (on page 6) provides examples of the headings for the three separate fund type reports, which begin on separate pages. The specific reports in each column display the same sort of information as shown in Tables 1 and 2, either a government's financial position at a point in time as expressed in assets and liabilities, or a government's flow of resources over a fiscal year expressed as revenues, transfers, and expenditures or expenses for specific funds or groups of funds. Headings or indications of those categories would appear in the far-left column as they do in Tables 1 and 2.

As shown in Table 3, the general heading information appears at the top of each report along with what fund type is being reported. The three reports vary in specific ways.

In the governmental and proprietary fund reports, certain funds are reported as "major." Major funds are usually governmental or enterprise funds used for a relatively large portion of the government's finances. In Table 3, the governmental funds heading includes two specific major funds (general and capital projects), the "other" heading for the funds not deemed "major," and a "total" heading for the sum of all governmental funds.

The proprietary fund report is divided into two parts to make it easier to relate this report to the two government-wide reports. The enterprise funds comprise the business-type activities portion of those reports, and the internal service funds comprise the governmental activities portion of those reports.

The fiduciary report headings show "specific fund" and "kind of fund" headings separately without an overall total, again because the funds are completely independent of each other.

In addition to the fund type reports, a detailed supplemental report for internal service funds is required. Supplemental reports for governmental and enterprise funds of smaller dollar value are optional.

How were annual financial reports insufficiently comprehensive?

Criticisms regarding comprehensiveness mostly overlap with those regarding fragmentation and insufficient focus. An additional, separate criticism concerning comprehensiveness is that different scoring rules were used to arrive at the numbers for the different parts of the old reports. For that reason, the various parts of the old model could not be added together to produce meaningful total figures for a government.

In government accounting, historically, some funds used the accrual basis, some funds used the modified accrual basis, and the general fixed assets account group used historical cost as a basis. Under the old model, judging how changes in different parts of the reports compared to one another was nearly impossible.

How does the new reporting model correct this confusion?

The two new government-wide reports *both use the accrual basis of accounting*. The two reports show the overwhelming majority of a government's assets, liabilities, revenues, and expenses on one basis. People will now see figures for most of a government's finances reported in one place, using one basis.

How was the old model overly focused on the current use of resources?

In the old model, proprietary and fiduciary funds were reported using the accrual basis and governmental funds, which generally involve the majority of a government's monies, were reported using the modified accrual basis. The long-term financial condition of governmental funds was not clear from annual reports because of the modified accrual reporting basis.

tablethree Heading for Three Fund Type Reports

I. [General Heading Information for Each Report (Jurisdiction, Name of Report, and Point or Period in Time)]

Government Funds			
General	Capital Projects	Other	Total

II. [General Heading Information for Each Report (Jurisdiction, Name of Report, and Point or Period in Time)]

Proprietary Funds				
Business-type Activities Funds (Enterprise)				Governmental Activities Funds (Internal Service)
Water	Sewer	Other	Total	Total

III. [General Heading Information for Each Report (Jurisdiction, Name of Report, and Point or Period in Time)]

Fiduciary Funds
Specific Fund/Kind of Fund

How does the new model correct this problem?

The two new government-wide reports show the financial situation for a government wholly on an accrual basis. All assets and liabilities are included in the reported categories. Those assets include earned but not collected revenues, and those liabilities include unpaid bills. The total assets and liabilities and the net assets provide a clear representation of the financial position of a government from an economic resources perspective.

How were the old annual reports short on information?

The old financial reports primarily contained page after page of numbers with a letter containing an audit report and a group of footnotes about accounting policies. Those reports seldom provided explanations of the financial situation of governments in ways that were meaningful, or even decipherable, by regular citizens.

How does GASB No. 34 treat budgetary information?

Budgetary information, and especially information comparing appropriations with actual figures, is reported in notes to the financial statements. Under the new model, these comparisons will be more accurate.

The new budgetary comparison requires the inclusion of the *originally passed appropriations* for the general fund and each major special revenue fund that has an adopted budget. The original appropriations information prevents governments from manipulating a budget late in the year to create budget figures that closely approximate actual spending.

The budgetary comparisons are not reflected in the tables included herein because GASB No. 34 allows a variety of options for reporting this information, but requires that, at the least, it should be incorporated into the presentation of required supplementary information.

Does the new model contain other important improvements?

Two major enhancements in the new model are the inclusion of information on general infrastructure and a required section called management's discussion and analysis (MD&A).

The general infrastructure enhancement is the new requirement that general infrastructure will be reported and depreciated as a part of the capital assets. General infrastructure refers to especially long-lived capital assets (e.g., roads and bridges). Relatively small governments have to report general infrastructure only prospectively. Relatively larger ones have to report retrospectively, which has been a cause of consternation in some quarters because many governments have not recorded that information previously.

The requirement for the MD&A is the most visible information enhancement to annual financial reports. GASB No. 34 requires that an MD&A section precede the financial statements in annual reports. The underlying idea for the MD&A requirements is that government officials will provide a written explanation of the financial performance and condition of a government in a manner that is easy to read, objective, detailed, and comprehensive. The requirements are general so as to encourage understandable explanations rather than technical ones.

One requirement is that the discussion be "easily readable." The highlights of the required MD&A topics include a discussion of the current-year results that includes comparison with the previous year's results, a comprehensive discussion of the government's financial reports, an analysis of the government's financial position in respect to whether it is improving or deteriorating, an analysis of the balances and transactions of individual funds, an analysis of the budget with respect to the original and the final budget figures and the actual budget results, a description of activities with respect to capital assets and long-term liabilities, and a description of anything that can be expected to have a significant financial impact on the government.

When do these changes take effect?

The implementation dates for the new standards vary according to the financial size of local governments. Also, the requirement for retroactively reporting major infrastructure assets is phased in later.

The general requirements apply to governments with total annual revenues of $100 million or more starting with the fiscal year ending after June 15, 2002, with the retroactive infrastructure requirement beginning in fiscal year 2006. The general requirements apply to governments with total annual revenues between $10 million and $100 million starting with the fiscal year ending after June 15, 2003, with the retroactive major infrastructure reporting requirement beginning in fiscal year 2007. The general requirements apply to governments with total annual revenues of less than $10 million starting with the fiscal year ending after June 15, 2004, and GASB 34 only encourages these governments to report major infrastructure assets retroactively.

Will this experiment in governmental accounting succeed or require further reforms?

The GASB No. 34 accounting reforms have been made in the name of increased accountability. Their success will ultimately be judged in light of that standard.

Initially, the predictions by proponents and opponents were essentially diametrically opposed. Proponents suggested that the public would be much more enlightened by the government-wide annual financial reports and thereby more able to hold their governments and government officials accountable. Opponents suggested that the costs of the reforms would be fruitless and that the new reports would be as confusing, if not more confusing, than the ones they replaced.

Time will have to pass before this experiment can be fairly judged.

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