How to Read Governmental Financial Statements, Part 1

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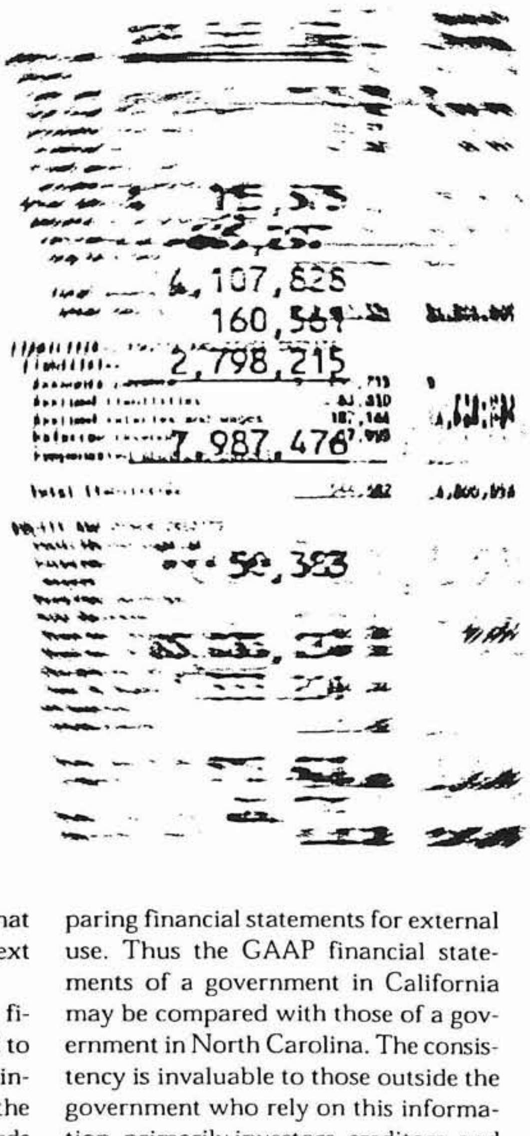

Management and elected officials of governmental entities receive an often overwhelming supply of financial data. This information takes various forms—budgetary reports, internally generated financial statements, schedules and summaries, and audited annual financial statements. Usually, internally generated information comes in a format that is comprehensible to accountants and nonaccountants alike. Comprehending the audited financial statements, however, requires at least a minimal understanding of the principles of governmental financial reporting. This article, the first of two parts, is designed to make the audited financial statements more user-friendly and to provide a key to unlocking the basic information they contain. The article focuses on current reporting requirements. Part 2, scheduled for a future issue of *Popular Government*, will introduce readers to new governmental financial reporting requirements that will be implemented over the next three to five years.

Governmental accounting and financial reporting standards, referred to as generally accepted accounting principles, or GAAP, are established by the Governmental Accounting Standards Board. GAAP provide consistency in financial reporting. In other words, they offer rules and formats for all governments in the country to follow in preparing financial statements for external use. Thus the GAAP financial statements of a government in California may be compared with those of a government in North Carolina. The consistency is invaluable to those outside the government who rely on this information, primarily investors, creditors, and bond rating agents, as well as to federal and state agency personnel.

Management must have timely access to financial information in order to make decisions, evaluate compliance issues, and obtain an overall "feel" for an entity's fiscal status. Reports prepared for internal use serve this need. Budget-to-actual financial statements (that is, statements comparing budgeted amounts with actual results); brief analyses of tax billings and collections, as well as general revenue collections; and investment summaries—these are a few examples of the internal information that should be available to management and elected officials on a continuing basis. In most cases the format of these presentations is left to the discretion of management, elected officials, and staff responsible for preparing the information. Some governing bodies may desire a summary of revenues by category (property taxes, utility billings and collections, other taxes, and so forth). Others may focus on key ratios on a monthly basis (for example, tax collection rates and expenditures to date compared with budget projections).

Governments typically operate purely from a cash perspective: revenue is recognized when cash is collected, and expenditures are recognized as cash is disbursed. This is consistent with how they budget their operations. The balanced budget requirement in North Carolina presumes that all expenditures, or uses of financial resources, will be funded either by revenue sources (taxes, grants, utility fees, and so forth) or by uncommitted cash on hand (for example, available fund balance). Internal financial statements most often stay consistent with this type of reporting. However, external financial statements, such as the "official" financial statements prepared in conjunction with the annual audit, are prepared with the intention of

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"providing a single financial report tailored to meet the *basic* information needs of a broad range of potential users."[1] These audited financial statements are in a format that is useful for those with an understanding of governmental accounting—for example, accountants, investors, lenders, and rating agents—and they provide an excellent summary of the fiscal year's financial events. Ironically the preparation of these GAAP financial statements is the specific responsibility of management, but they often are confusing and of little practical use to management and elected officials on a day-to-day basis. Nevertheless, management and elected officials can easily obtain useful information from these statements.

Table 1. Fund Types

General fund	Accounts for general operations of government (e.g., legislative, administrative, public safety, sanitation, and recreation)
Special revenue fund	Accounts for legally restricted revenue sources, those that must be used for particular activities (e.g., E-911 taxes and community development block grants)
Debt service fund	Accounts for resources that governments are *required* to accumulate to pay debt service in *future* years
Capital projects fund	Accounts for major capital activities or construction that is being financed by governmental resources (e.g., taxes) or by bonds that will be repaid by governmental resources
Enterprise fund	Accounts for activities that are usually supported by user fees (e.g., water, wastewater, electricity, and natural gas services)
Internal service fund	Accounts for internal activities that provide service to other departments (e.g., government motor pools, in-house print shops, and warehousing for utility activities)
Trust and agency funds	Account for various activities for which government acts as fiduciary (e.g., pension plans, execution of trust and bequest agreements, and taxes collected on behalf of other governments)

Overview of GAAP Reporting Requirements

GAAP require that state and local governmental entities use *fund accounting*, a concept unique to the government environment. Unlike agencies in the private sector, governmental entities provide a tremendous variety of services. Some services are "public purpose" in nature (for example, public safety, public works, and social services). Others are "business-like" (for example, public utilities). The public-purpose services are primarily financed by taxation (property taxes, sales taxes, income taxes, and so forth), whereas most business-like services are primarily financed by user fees (that is, payments by those using the services). In most cases the various revenue sources for the services each have restrictions on how they may be used. Fund accounting is an accounting and reporting vehicle that allows segregation of these services and their revenue sources.

Fund accounting uses three basic categories of funds: governmental, proprietary, and fiduciary. Within each category, several fund types are available to account for all the government's activities and services (see Table 1).

To present the minimum information required by GAAP, governmental entities must prepare up to six basic financial statements and a comprehensive set of related "note disclosures" (footnotes that communicate essential information not disclosed in the body of the financial statements themselves; see the sidebar, page 25). North Carolina statutes require that all local governmental entities prepare these GAAP financial statements for the end of each fiscal year and have them audited by an independent certified public accountant.[2] These basic financial statements present aggregated information for each fund *type*. For example, a government may have three special revenue funds, such as a community development block grant fund, a capital reserve fund, and an E-911 fund. For the basic audited financial statements (often referred to as the combined financial statements), that government combines these three special revenue funds into one column and identifies that column as the special revenue funds. Some argue that this aggregation diminishes the usefulness of the financial information. Most users of the information, however, are assessing the government's financial situation as a whole. They do not necessarily need all the supporting detail. In contrast, internal reporting almost always has a focus on the activities of individual funds, which is necessary from an internal decision-making perspective.

The Combined Balance Sheet—All Funds

The combined balance sheet reports the assets, the liabilities, and the equity for each of the government's fund types (for a sample, see Exhibit 1, page 26). The balance sheet is actually a "snapshot" of the assets, the liabilities, and the equities—that is, the net worth—of the fund types as of the end of the fiscal year (June 30 for most North Carolina governments, such as municipalities and counties). "Assets" is simply defined as items owned by the government (cash, investments, receivables fixed assets, and the like), and "liabilities" is defined as obligations of the government (for example, accounts payable, salaries payable, and bonds payable). "Equity" is the net worth of each of the fund types, which is simply the fund's assets minus its liabilities. This balance sheet is a visual representation of the standard "accounting equation":

Assets = Liabilities + Equity

Each fund *type* is reported in a separate column. Assets equal liabilities plus equity for each column.

Unlike the operating statements, the balance sheet does not represent an accumulation of transactions across the year. Instead, it answers the following questions:

- What does each fund type *own* as of June 30?
- What does each fund type *owe* as of June 30?
- What is each fund type's *net worth* as of June 30?

Management and elected officials make decisions at the individual-fund

Note Disclosures

In addition to requiring the basic financial statements, GAAP require a comprehensive set of note disclosures. Because of their obvious limitations, the basic financial statements cannot provide details about every number reported. The note disclosures provide critical details about financial issues that are of importance to users of the financial statements. Some of the more significant types of disclosures are the following:

- Significant accounting policies
- Compliance issues
- Deposit and investment detail
- Fixed-asset information
- Information on outstanding long-term debt
- Pension plan information

These categories of note disclosures are very broad, and a complete discussion of each one is beyond the scope of this article. However, together with the brief descriptions that follow, they provide a basic overview of the types of disclosures that are typically of most interest to management and elected officials.

Significant accounting policies. This category encompasses various accounting and financial reporting policies of the government. Examples include a complete identification of the governmental entity and its fund structure, budget practices, calendar, and investment and fixed-asset policies. Although much of this information is standard from government to government, the overall accounting and reporting policies are unique to each entity.

Compliance issues. Governmental entities have extensive concerns with legal compliance related to the budget, bonds, investment policies, and more. GAAP require disclosure of any violations of these legal requirements. For example, if a government exceeds its budget appropriation in any department, it must disclose this violation of the budget ordinance. Likewise, if a government makes investments that violate its adopted investment policy, it must disclose that fact.

Deposit and investment detail. This information is of paramount importance to readers of the financial statements. North Carolina statutes require investment of all idle public funds to maximize their earnings potential. State statutes also require insurance of all deposits and all investment securities, to limit the risk to which public funds are exposed. (Depositories and investment dealers usually insure government deposits and investments by "collateralizing" them—that is, by setting aside collateral as insurance.) GAAP require disclosures about the types of deposits and investments held by the government at the end of the fiscal year, as well as the collateral for those deposits and investments.

Fixed-asset information. In most cases, the fixed assets reported on the combined balance sheet represent the majority of the assets owned by the government. However, space limitations do not allow detail on the *types* of assets owned (land, buildings, equipment, and so forth), their original cost value, and, if applicable, the accumulated depreciation on the asset. The note disclosures provide this detail. GAAP also require a summary, by type of asset, of the *additions* to fixed assets that occurred during the fiscal year and the *retirements* (the assets taken out of use).

Information on outstanding long-term debt. This is critical information to anyone assessing the government's financial situation. Although all the government's liabilities are reported on the combined balance sheet, it is impossible to provide detail on the *types* of indebtedness and the specifics for each liability. GAAP require disclosure of the outstanding debt issuances, the interest rate being paid, and the repayment terms. They also require inclusion of a schedule that shows the amounts of principal and interest due each year for five years, and in five-year increments thereafter, until maturity. The requirements for repayment of principal and payment of interest must be reported separately.

Pension plan information. Pension plans are significant operations and represent significant costs for most governments. Many governments participate in the North Carolina Local Governmental Employees' Retirement System; others sponsor their own plans. Also, some governments supplement the state's plan or their own plan with a deferred compensation plan. If the government participates in the state plan, then it must make disclosures about the nature of the plan and the annual costs that it incurs to participate. If the government sponsors its own plan, then it must identify the assets and the liabilities of that plan, as well as the funding requirements, in the disclosures.

level, not at the fund-type or total level. For example, if a government is assessing its ability to finance expansion of a water plant, either with cash on hand or through issuance of debt (such as bonds), it does not look at its cash position as a whole. Instead, it looks at the water fund and that fund's cash position, asking, Is cash available in the fund to finance the project? The broad perspective represented in the total columns of the balance sheet does not serve this kind of purpose.

GAAP have specific rules for the types of assets and liabilities that may be reported for certain funds. Exploring all the theoretical reasons for these requirements is beyond the scope of this article. Suffice it to say that governmental funds (that is, general, special revenue, capital projects, and debt service) focus on *financial* assets and *financial* liabilities, whereas proprietary funds (that is, enterprise and internal service) focus on *all* assets and *all* liabilities. A financial asset is an asset that either is in cash form or will convert to cash in its natural course. Cash, investments, and receivables are the most common examples. A financial liability is a very

CRAVEN COUNTY BOARD OF EDUCATION
COMBINED BALANCE SHEET - ALL FUND TYPES AND ACCOUNT GROUPS
June 30, 1997

	Governmental Fund Types		Proprietary Fund Types	Fiduciary Fund Types	Account Groups	
	General Fund	Capital Projects	Enterprise	General Trust Funds	General Fixed Assets	General Long-Term Debt
ASSETS AND OTHER DEBITS						
Assets						
Cash and investments	$ 3,002,558	$ 678,813	$ 654,113	$ 1,368,735	$	$
Due from other governments	53,002	4,210	36,513			
Accounts receivable	126,511		7,573	438,722		
Inventories	421,263		63,037			
Fixed assets, net of accumulated depreciation			812,445		100,781,038	
Other debits						
Amounts to be provided for retirement of general long-term debt						3,180,926
Total assets and other debits	$ 3,603,334	$ 683,023	$1,573,681	$ 1,807,457	$100,781,038	$3,180,926
LIABILITIES, EQUITY AND OTHER CREDITS						
Liabilities						
Accounts payable	$ 255,715	$ 388,995	$ 298	$	$	$
Accrued liabilities	83,810		9,823			
Accrued salaries and wages	187,164		56,858			
Deferred revenues	17,993		26,875			
Compensated absences payable			97,687			3,180,926
Total liabilities	544,682	388,995	191,541			3,180,926
EQUITY AND OTHER CREDITS						
Contributed capital			30,960			
Investment in general fixed assets					100,781,038	
Retained earnings			1,351,180			
Fund balances:						
Reserved for inventories	421,263					
Reserved by State Statute	179,513	4,210				
Designated for subsequent year's budget	641,474					
Unreserved:						
Undesignated	1,816,402	289,818		1,807,457		
Total equity and other credits	3,058,652	294,028	1,382,140	1,807,457	100,781,038	
Total liabilities, equity, and other credits	$ 3,603,334	$ 683,023	$1,573,681	$ 1,807,457	$100,781,038	$3,180,926

Exhibit 1. This is an example of a combined balance sheet for a local school district, in this case the Craven County Board of Education. This governmental entity has a general fund, a capital projects fund, an enterprise fund, and several trust funds. Note the account group columns, which report the fixed assets and the long-term debt associated with the *governmental* funds.

short-term liability, to be paid off soon, presumably with cash that is on hand or will be received in the near future. The most common examples are vendor accounts payable and accrued payroll.

Governmental funds report only financial assets and liabilities. Nonfinancial assets, such as fixed assets (land, buildings, equipment, and so forth) and long-term liabilities (for example, bonds payable that will be paid off over many years) are not recorded in the governmental fund columns themselves. Of course, governmental funds purchase such assets and incur such long-term liabilities. However, these items are included on the balance sheet in the columns for the general fixed-asset account group and the general long-term debt account group, respectively. Thus a user can determine the types of fixed assets a governmental fund owns, or the types of liabilities a governmental fund will be repaying over the long term, by reviewing the information included in these columns. This GAAP reporting approach, in fact, is consistent with how governmental funds are budgeted and managed. The budget for one year is designed to provide the resources to deliver services for that year.

Proprietary funds, on the other hand, are managed with a long-terr perspective. They operate more like a private-sector business, in which the focus is on net income. Water rates, for example, are structured not only to provide resources for the current year's operations but also to generate the necessary capital to maintain the systems in perpetuity. Therefore the GAAP balance sheet presentation for the proprietary funds reflects *all* their assets and liabilities—both financial and nonfinancial assets, and both current and long-term liabilities.

Many of the account captions on the balance sheet are relatively self-explanatory (for example, cash, investments, taxes receivable, accounts payable, and bonds payable). However, other account captions that may be of particular interest to management and elected officials merit additional description.

Due from/to other funds. Often, funds within a government provide services for one another. For example, the general fund pays for the water provided to city hall by the water department, which is accounted for in the water fund (a proprietary fund type). Suppose the water fund has billed the general fund for the most recent month's water usage, but the fiscal year ends before the bill is settled. The water fund reports a "due from other fund," which is a receivable, and the general fund reports a "due to other fund," which is a payable. This terminology is used in lieu of the usual "accounts payable/ accounts receivable" to reflect that the underlying transaction is between funds within the government, not between the government and outside parties (for example, customers and vendors).

Interfund receivables/payables and advances to/from other funds. Occasionally one fund may lend money to another fund. For example, the general fund may borrow money from an electric fund to purchase a computer system. The transaction is reported as a loan between funds, using terminology that reflects the repayment terms.[3] The current portion of the loan (for example, the amount to be repaid within the next year) is reported as an "interfund receivable" in the fund that is to be repaid, and as an "interfund payable" in the fund that is repaying the loan. The long-term portion of the loan is reported as an "advance to other fund" (a receivable account) in the fund that is to be repaid, and as an "advance from other fund" (a liability account) in the fund that is repaying the loan.

Intergovernmental receivables/payables. State monies paid to local governments in North Carolina are a common example of an intergovernmental transaction, as are subsidies paid by municipalities to local housing authorities. If any of these receivables or payables are outstanding at the end of a fiscal year, they are captioned "intergovernmental" to reflect the underlying nature of the transaction.

Compensated absences payable. As of the end of each fiscal year, the government has incurred a liability to its employees for earned vacation and similar types of compensation time. This kind of liability is reported in several sections of the balance sheet. The amount owed to general fund employees is most commonly reported in the general long-term debt account group. Likewise, the amount owed to employees in the proprietary operations is reported directly in those fund-type columns. These amounts do not represent liabilities that the government will pay out in total at one time. GAAP require a presentation of the full liability, but in practice the government pays the amounts to employees incrementally as they use their vacation or similar compensation time.

Deferred revenue. In governmental funds, revenue is recognized as it is available (that is, as it is received in cash or becomes receivable in cash in a very short period).[4] In proprietary funds, revenue is recognized as it is earned, regardless of when it is actually collected in cash.

In governmental funds, such as the general fund, tax revenue is recognized not as it is billed but as it is collected. When property taxes have been billed but not paid as of the end of the fiscal year, and are not collected within sixty days after the end of the fiscal year, both GAAP and North Carolina statutes require that the amount of the tax receivable on the balance sheet be reported not as revenue but as "deferred revenue," which is reported similar to a liability. Deferred revenue does not increase fund balance because it is not available for appropriation (that is, the cash it represents is not available).

Another common example of the creation of deferred revenue is associated with grants. This situation might occur in either a governmental or a proprietary fund. Assume that a local government receives a federal grant. The grant is paid to the government in advance, but the government does not earn the right to keep it until certain criteria have been met (for example, the grant must be actually spent for its particular purpose to become revenue; until that time it is technically refundable to the grantor). Until the government meets the grant requirements, it must report the amount as deferred revenue. As the grant provisions are met, the deferred revenue is reclassified as revenue on the appropriate operating statement.

Equity. As stated earlier, equity is the net worth of a fund. Governmental financial reporting uses different terminology for equity in the different fund types. Following is a summary of the various equity accounts.

Fund balance. This term describes equity for the governmental fund types. Because the assets in a governmental fund are all financial ones and the liabilities are all current ones, fund balance actually represents the net financial resources potentially available in that fund.

However, North Carolina state statutes include a formula that identifies how much of fund balance is actually available for appropriation. Governments may not appropriate more than "the sum of cash and investments minus the sum of liabilities, encumbrances, and deferred revenues arising from cash receipts."[5] (An "encumbrance" is an outstanding commitment of funds usually documented by a purchase order or a contract.)

In addition to that statutory limitation, there are restrictions on portions of fund balance. "Reserved fund balance" reflects legal restrictions placed by independent third parties. Management or elected officials may not use reserved fund balance for any purpose other than that to which it is restricted. In North Carolina some common examples of reservations are the following:

Reserved by state statute. Fund balance is a close approximation of resources that will eventually be available in a governmental fund. North Carolina statutes prohibit a government from considering receivables as resources that it may appropriate in its calculation of available fund balance. "Reserved by state statute" generally reflects the amount of fund balance that is attributable to receivables that the applicable governmental fund has recognized as revenue under GAAP but may not yet appropriate under North Carolina law.

Reserved for encumbrances. Often there will be outstanding encumbrances (that is, outstanding purchase orders or contracts) at the end of the fiscal year. A reservation for encumbrances indicates that a portion of fund balance is dedicated to pay for the encumbered items once the goods or the services have been received, presumably early in the next fiscal year. Technically the vendor with whom the purchase was made is the independent third party who has a claim on these resources.

Reserved for Powell Bill. Municipalities in North Carolina receive annual allotments of Powell Bill money from the state. Powell Bill money may be used only for specific street construction and maintenance projects. Usually, municipalities have unspent portions of the distribution in their fund balance at the end of each fiscal year. Although they may use it in future fiscal years, the state legally restricts how they may use it. Thus portions of unspent Powell Bill money as of the end of the fiscal year must be reported as reserved fund balance.

Portions of fund balance that are not reserved are considered to be unreserved. This classification may be further categorized as "designated" or "undesignated." The primary difference between a reservation and a designation is the role that the governing body plays in the latter's determination. Elected officials may designate portions of available fund balance for any number of purposes—future capital needs, operating-budget resources for the following year, special projects, or purchases. A designation is internally created, is not legally binding, and may be modified as the elected officials desire. Obviously, undesignated fund balance reflects the portion of fund balance that is not legally reserved or designated by the governing board for future use.

Retained earnings. Equity in the proprietary funds is referred to as "retained earnings." Unlike equity in the governmental funds, equity in the proprietary funds reflects the total assets minus the total liabilities of the fund. Therefore, retained earnings reflect not only financial assets (minus financial liabilities) of the fund but all other assets, such as fixed assets (minus long-term liabilities). Total retained earnings do not represent spendable resources. As in the private sector, they reflect total net worth of the fund, which includes assets that are not convertible to cash for spending.

Contributed capital. Sometimes a proprietary fund receives capital contributions from outside third parties. For example, a developer may pay for the installation of water lines in a new subdivision. When the water lines are connected to the local government's water system, they become the property of the government. The water fund has received an asset at no cost. Contributed capital simply represents the equity that a proprietary fund has built with outside contributions. The total net worth of a proprietary fund is retained earnings plus contributed capital.

The Combined Operating Statement: Governmental Funds

There are two main types of operating statements for governments, one for the governmental funds[6] and another for the proprietary funds. (As discussed later, some governments may have a third type of operating statement, for their pension trust funds.) Because governmental funds focus on current financial resources, the operating statement of a governmental fund is similar to a checkbook register (for a sample, see Exhibit 2). The revenues and the other financing sources are like deposits; the expenditures and the other financing uses are like withdrawals. The net result of these "deposits" and "withdrawals" is an increase or a decrease in the checkbook balance (that is, the fund balance).

Revenues and expenditures. Most of the account categories under these captions are self-explanatory. Examples of common revenue resources are property taxes, licenses and permits, charges for services (that is, user fees), interest and receipts from other government entities (that is, intergovernmental revenues, such as sales taxes, grants, and other types of state-shared monies). Expenditures are typically categorized by "character" and "function." "Character" identifies the nature of an expenditure: current, intergovernmental, debt service, and capital outlay. "Current character" expenditures are typically identified by function. The most common types of functions are general government, public safety, public works, sanitation, and recreation.

Governmental funds use the term "expenditure" as opposed to "expense." An expenditure is an actual outflow of cash resources. Because the governmental funds' operating statement focuses on the cash perspective, this term is more appropriate for it. In contrast, the term expense is used for the proprietary funds' operating statement because it focuses on all transactions of the operation, regardless of their effect on cash. An expense is an outflow of cash resources or the recognition of noncash transactions such as depreciation of capital assets and write-off of bad debts. Broadly stated, an expense is an allocation of all the costs of an operation.

Other financing sources/uses. Following revenues and expenditures, there usually is another category of transactions, referred to as "other financing sources (uses)." These are resources or uses that do not meet the basic criteria of a revenue or an expenditure. This category is *not* for miscellaneous revenues and expenditures. In fact, only a few kinds of transactions may be reported in this category, as follows:

Operating transfers in/out. Funds often transfer money to other funds. For example, a proprietary fund may routinely transfer money to the general fund. The receiving fund reports the transaction as an "operating transfer in," the contributing fund as an "operating transfer out." In contrast, revenues and expenditures reflect transactions with third parties. Given that operating transfers are internal in na-

COMBINED STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES

FORSYTH COUNTY, NORTH CAROLINA

Year Ended June 30, 1999

		General Fund
REVENUES:		
Taxes:		
Property	$	129,635,212
Occupancy		-
Sales		40,800,486
Total taxes		170,435,698
Intergovernmental		45,661,051
Charges for services		12,254,516
Investment earnings		2,880,881
Other		4,639,017
Total revenues		235,871,163
EXPENDITURES:		
Current:		
General government		31,731,295
Public safety		32,397,921
Health		21,870,079
Welfare		45,495,351
Culture and recreation		8,961,210
Community and economic development		1,058,763
Education		80,263,999
Capital outlay		
Debt service: (notes 6, 7, and 8)		
General obligation bonds:		
Principal		10,990,000
Interest and fiscal charges		9,233,880
Capital leases, installment purchases and certificates of participation:		
Principal		5,144,983
Interest and fiscal charges		642,847
Total expenditures		247,790,328
Excess (deficiency) of revenues over expenditures		(11,919,165)
OTHER FINANCING SOURCES (USES):		
Proceeds of refunding bonds (note 8)		16,480,000
Proceeds of general obligation bonds (note 8)		-
Proceeds of installment purchases (notes 6 and 7)		7,675,808
Operating transfers in (note 12)		4,285,813
Payment to refunded bond escrow agent (note 8)		(16,480,000)
Payment to refunded installment purchase escrow agent (note 6)		(3,321,714)
Operating transfers out (note 12)		(1,042,819)
Total other financing sources (uses)		7,597,088
Excess (deficiency) of revenues and other sources over expenditures and other uses		(4,322,077)
Fund balances - June 30, 1998		44,751,668
Residual equity transfers from (to) (note 13):		
Capital Project Funds		422,226
General Fund		-
Fund balances - June 30, 1999	$	40,851,817

Exhibit 2. This excerpt from Forsyth County's combined governmental fund operating statement shows information about the county's general fund.

ture, it is more appropriate to consider them other financing transactions.

Proceeds of debt issuances. Obviously a common resource for governmental entities is the issuance of bonds or similar financing instruments. When such debt is issued by a governmental fund, receipt of the debt proceeds increases the financial resources of the fund. Given that the operating statement of the governmental funds is similar to a checkbook, the proceeds of the debt issuance must be reflected. Categorizing them as a revenue source is inappropriate; they are simply a resource that was borrowed. Thus they are reported as an other financing source.

Payments to bond escrow agents. Governments often refinance existing debt to take advantage of better interest rates or more favorable debt-service requirements. This type of transaction is referred to as a "refunding." The actual transaction is rather simple. The government issues refunding bonds, and it uses the proceeds to pay off the existing debt. However, just as homeowners often may not prepay mortgages without penalties, governments may not prematurely liquidate many bonds until the maturity date or a predetermined "callable" date. Yet there are legal ways to effectively eliminate the government's liability and satisfy the terms of the outstanding bonds at the same time.

When the proceeds of the refunding bonds are received, they are paid to an independent escrow agent. That agent pays off the old indebtedness. Once these funds are placed with the escrow agent, they are no longer accessible to the government, and the government's liability for the old bonds has effectively been satisfied. In the year this transaction takes place, the proceeds of the refunding bonds are reported as an other financing source, and the subsequent payment to the escrow agent is reported as an other financing use.

Sale of fixed assets. Occasionally, governments dispose of fixed assets purchased by the governmental funds. Any proceeds of the sale obviously add to the cash balance of the fund making the sale. These proceeds are reported as an other financing source.

The net effect of revenues and other financing sources minus expenditures

WAKE COUNTY, NORTH CAROLINA

COMBINED STATEMENT OF REVENUES, EXPENDITURES AND CHANGES IN FUND BALANCES
BUDGET AND ACTUAL
For the Year Ended June 30, 1999

	General Fund			Special
	Budget		Actual	Budget
REVENUES:				
Taxes	$ 335,181,840	$	338,435,442	$ 7,527,9
Licenses and permits	1,979,900		2,611,967	-
Intergovernmental	74,634,565		70,939,121	-
Charges for services	33,635,659		30,579,672	-
Investment earnings	8,000,000		8,275,790	-
Miscellaneous	2,334,958		1,897,553	-
Total Revenues	455,766,922		452,739,545	7,527,9
EXPENDITURES:				
Current:				
General administration	39,891,803		34,261,117	-
Human services	135,694,144		126,342,499	-
Education	141,385,552		140,329,349	-
Community development and cultural	15,818,781		14,950,364	39,7
Environmental services	5,136,762		4,733,541	-
Public safety	41,135,601		38,475,915	7,488,1
Debt service	63,675,431		63,457,823	-
Total Expenditures	442,738,074		422,550,608	7,527,9

Exhibit 3. This is a portion of Wake County's budget-to-actual presentation, which shows the budgeted *and* actual revenues and expenditures of the general fund.

and other financing uses of any governmental fund is an increase or a decrease in fund balance. Occasionally, other transactions may be reported on the governmental fund operating statement as direct adjustments to fund balance:

Residual equity transfer in/out. Unlike an operating transfer, a residual equity transfer is an unusual and infrequent transfer of resources between funds. For example, the general fund may make a one-time contribution to a proprietary fund to help finance a capital project. The funds are not to be repaid, and the contribution is a one-time event. These transfers are reported as a "residual equity transfer in" to the receiving fund and as a "residual equity transfer out" of the contributing fund.

Prior period adjustments. Occasionally, errors made in previous years need to be corrected. Also, adjustments may be necessary to reflect the implementation of a new accounting and financial reporting standard. Either of these events would be reported as a direct adjustment to fund balance and identified as a "prior period adjustment." Such adjustments do not necessarily reflect a problem.

The ending fund balances for each of the governmental fund types should agree with the fund balances reported on the combined balance sheet. In summary, the balance sheet is a snapshot of the assets, the liabilities, and the equity (fund balance or retained earnings, as appropriate) at the end of the fiscal year (June 30 for North Carolina governments). The governmental fund's operating statement reports the transactions *throughout the year* that either increase or decrease the applicable fund's fund balance.

The Combined Budget-to-Actual Statement: Governmental Funds

GAAP require that the combined financial statements include a budget-to-actual statement[7] for *governmental* fund types that legally adopt an *annual* budget (for a sample, see Exhibit 3). The primary purpose of this statement is to demonstrate compliance with the budget. The statement has little practical use, for the fund-type columns still are aggregated. For example, if a government has more than one special revenue fund, the budget-to-actual presentation includes all of them in one column.

For North Carolina governments, the formats of the combined governmental fund operating statement and the budget-to-actual statement are practically identical. The same account captions—revenues, expenditures, and other financing sources and uses—are used. GAAP simply limit this combined budget-to-actual statement to *governmental funds that legally adopt an annual budget.* Therefore, if multiyear (or project-length) budget are adopted for special revenue or cap tal projects funds, they would *not* b included on the statement.

The Combined Operating Statement: Proprietary Funds

A governmental entity's financial statements may include two types of operating statements if the entity has both governmental and proprietary funds. The operating statement for the proprietary funds[8] is formatted differently from the operating statement for the governmental funds. The primary reason is that the statements are designed for different purposes. The governmental funds' operating statement can be used like a checkbook register. Proprietary funds are reported from a perspective of total economic resources: all revenues *earned*, not just those that are *available* (as is the case with the governmental funds). Accordingly the expenses reflect all events that affect the equity of the fund—cash outflows for operations, purchase of capital assets, payment of debt service, and noncash transactions such as depreciation and write-off of bad debts.

Operating revenues. This category on the proprietary funds' operating statement identifies the revenues generated by the operation itself—for example, in the case of a water fund, fees earned for providing water. Also, revenues are recorded as they are *earned*, regardless of their availability (unlike the governmental funds' operating statement). Otherwise, the account captions themselves are relatively self-explanatory.

Operating expenses. This category identifies the expenses generated by providing particular operations. In the preceding example of the water fund, all the direct costs of providing water service are considered operating expenses. Some common types of operating expenses are salaries and wages, employee benefits, materials, and supplies.

Expenses incurred as part of the operation but not resulting in a cash outlay are included in the operating expense category. Two common examples are depreciation and bad debt expense. "Depreciation" is the allocation of the cost of an asset over its useful life. In the governmental funds, the full cost of acquiring a capital asset is recognized when the transaction occurs (for example, capital outlay expenditure). Therefore the financial reporting theory of depreciation does not apply. This is consistent with the focus of the governmental funds' operating statement on transactions that affect cash. However, with the proprietary funds' focus being much broader, the cost of a capital asset is allocated over its useful life, not simply expensed when it is purchased. Depreciation expense does not result in a cash outflow but systematically reduces the fund's equity in an asset as it is being used.

Town of Garner, North Carolina
Combined Statement of Revenues, Expenses, and Changes in Retained Earnings—Proprietary Fund Type
For the Year Ended June 30, 1998

	Enterprise Fund 1998
OPERATING REVENUES	
Charges for services	$4,470,742
Other operating revenues	884,378
Total operating revenues	5,355,120
OPERATING EXPENSES	
Administration	508,853
Water supply and distribution	2,004,300
Waste collection and disposal	913,363
Sewer plant operation	345,974
Depreciation and amortization	698,642
Total operating expenses	4,471,132
Operating income	883,988

Exhibit 4. This is the first half of a proprietary fund operating statement—the revenues, the expenses, and the net income of Garner's enterprise fund (a type of proprietary fund).

Bad debt expense occurs when service billings are not collected. Often, such accounts receivable are "written off" as a loss when it is determined that they will not be collected. Such losses are considered operating expenses.

Operating income. The net of operating revenues and operating expenses is known as "operating income." This amount simply identifies the income (or loss) generated by the operation itself.

(For an excerpt of a statement showing operating revenues, operating expenses, and operating income, see Exhibit 4.)

Nonoperating revenues and expenses. Many proprietary operations are subsidized by resources that are not generated by the operation itself. Common examples are taxes, grants, interest revenue, and intergovernmental revenue. In many cases these are substantial amounts. They are classified as "nonoperating" activities simply to indicate that they are not generated by the operation itself but are the result of external events (for example, taxation). Likewise, expenses are incurred that are not a *direct* result of the operation. The most common example is interest expense associated with a fund's long-term debt.

Transfers to/from other funds. Proprietary funds often receive operating transfers from other funds or provide transfers to other funds. For example, the electric fund may routinely transfer money to the general fund to keep property tax rates down (property taxes being the primary source of revenue for the general fund). When this occurs, the transactions are reported as gross amounts (that is, transfers in and transfers out are *not* combined into one sum) on the operating statement in a

Town of Garner, North Carolina Combined Statement of Revenues, Expenses, and Changes in Retained Earnings—Proprietary Fund Type For the Year Ended June 30, 1998	Enterprise Fund
	1998
NONOPERATING REVENUES (EXPENSES)	
Interest earned on investments	304,832
Interest earned on assessments	6,608
Local option sales tax	-
Sale of assets	10,758
Interest on long-term debt	(372,221)
Total nonoperating revenues (expenses)	(50,023)
Net income	833,965

Exhibit 5. This is the second half of Garner's proprietary fund operating statement. This portion of the statement's column *follows* the revenue, expense, and net income portion shown in Exhibit 4.

separate category immediately following the nonoperating category.

Net income. Operating income minus nonoperating revenue and expenses, as well as transfers in and out of the fund, is captioned "net income." This amount either increases the fund's equity (that is, retained earnings), resulting in a net income, or decreases it, resulting in a net loss.

(For an excerpt of a statement showing nonoperating revenues and expenses, and net income, see Exhibit 5.)

The ending retained earnings should agree with the retained earnings reported on the combined balance sheet. Events such as residual equity transfers or prior period adjustments are reported as direct adjustments to the retained earnings balance.

The Combined Statement of Cash Flows: Proprietary Funds

As explained earlier, the governmental funds' operating statement basically gauges the cash inflows and outflows of the governmental funds. In contrast, the proprietary funds' operating statement includes cash and noncash transactions. Therefore the proprietary funds' operating statement *cannot* be used effectively to identify cash flows. GAAP require that governments with proprietary and nonexpendable trust funds include a statement of cash flows in their external financial statements (for an excerpt, see Exhibit 6).[9]

The statement of cash flows focuses on transactions that directly affect the fund's cash balance. Governments have the option of focusing on cash alone or including cash equivalents. A "cash equivalent" is defined as a highly liquid, short-term investment that has an *original* maturity (maturity at the time of purchase) of no more than ninety days. Each of the cash flows is reported at gross amounts. Simply put, cash inflows are reported separately from cash outflows. For example, operating transfers in are reported separately from operating transfers out.

This statement focuses on four categories of cash flows, as follows. The transactions identified within each category are relatively self-explanatory.

Cash flows from operating activities. Any proprietary fund has cash inflows and outflows associated with the operation of the activity itself. The most common example of a cash inflow is collections on utility billings. Examples of cash outflows are payments to vendors and employees. GAAP also require that miscellaneous cash inflows or outflows that do not fit the criteria of the other cash-flow categories be reported as operating activities.

Cash flows from non-capital-financing activities. Often a proprietary fund will receive cash inflows or incur cash outflows that are indirectly related to the operation itself but not related to capital acquisitions. (This category is similar to nonoperating revenues and expenses, discussed earlier.) Common examples are tax revenues, grant revenues, and operating transfers from other funds. Examples of non-capital-financing cash outflows are operating transfers to other funds or grants made to other governmental entities.

Cash flows from capital financing activities. Especially in proprietary funds, cash flows related to capital acquisitions can be very significant. Examples of cash inflows related to capital financing are debt proceeds associated with capital financing, grants restricted to acquisition of capital items, and transfers from other funds restricted for capital purposes. Also, cash generated by the sale of any fixed assets is reported as a cash flow from capital financing activity. Examples of cash outflows are purchase of capital items and debt-service payments when the debt is capital related.

Cash flows from investing activities. The statement of cash flows segregates all activity associated with the fund's investing activities. Sales or maturities of investments, as well as interest earned and collected on those investments, are reported as cash inflows in this category. Purchase of investments is the most common cash outflow associated with investing.

The net result of all the identified cash inflows and outflows per proprietary fund type represents how cash[10] changed from the beginning of the year to the end. The ending cash amount should agree with the cash amounts reported by fund type on the combined balance sheet.

GAAP recognize that some transactions do not result in actual cash inflows or outflows but are *not* obvious

Carolina County, North Carolina
Combined Statement of Cash Flows

For the Year Ended June 30, 19X1

	Enterprise Fund	Carol Cour Hospita
Cash flows from operating activities:		
Cash received from customers	$1,020,892	$40,98
Cash paid for goods and services	(175,166)	(16,97
Cash paid to employees for services	(195,893)	(21,13
Customer deposits received	1,800	
Customer deposits returned	(4,983)	
Other operating revenues	630	
Taxes paid to other governments	—	
Net cash provided by operating activities	647,280	2,87
Cash flows from noncapital financing activities:		
Gifts and donations	—	97
Alcohol education	—	
Operating transfers from primary government	—	1,24
Operating transfers to primary government	—	
Net cash provided by noncapital financing activities	—	2,21
Cash flows from capital and related financing activities:		
Proceeds of bond anticipation notes	675,000	
Acquisition and construction of capital assets	(1,319,536)	(4,75
Principal paid on bond maturities and equipment contracts	(250,000)	(30
Interest paid on bond maturities and equipment contracts	(99,144)	(14
Residual equity transfer	100,000	
Federal grant	225,348	
Net cash used by capital and related financing activities	(668,332)	(5,21
Cash flows from investing activities:		
Interest on investments	38,122	63
Net cash provided by investing activities	38,122	63
Net increase in cash and cash equivalents	17,070	51
Cash and cash equivalents, July 1	1,945,325	9,89
Cash and cash equivalents, June 30	$1,962,395	$10,41

Exhibit 6. This is an excerpt from fictional Carolina County's more extensive statement of cash flows. There is a column for each fund type; the information shown here is for the enterprise fund.

on the proprietary funds' operating statements. "Noncash" transactions that affect the assets and the liabilities of a fund, *and would have been* reported in the operating, non-capital-financing, or capital financing categories if cash had actually exchanged hands, must be disclosed in a separate noncash activities section of the statement of cash flows. Two of the most prevalent examples of this type of transaction are acquisition of a capital asset through a capital lease agreement (that is, acquisition of an asset and incurrence of a liability without any initial cash flow) and receipt of a capital asset by donation, such as water and sewer lines from a developer.

The Statement of Changes in Net Assets: Pension Trust Funds

Most local governmental entities participate in pension plans for their employees that are under the fiduciary care of another entity. The most common example of this in North Carolina is the Local Governmental Employees' Retirement System. The state is the fiduciary of a pension plan that benefits participating local governmental employers and employees in North Carolina.

However, some local governments either sponsor an additional plan for their employees only or provide a plan in lieu of participation in the state-sponsored plan. The most common example is the Law Enforcement Officers' Special Separation Allowance. In these cases the local government acts as the fiduciary of a pension plan, and GAAP require the inclusion of a separate operating statement for that plan (for a sample, see Exhibit 7) because the required format of the statement is so different from that of a proprietary fund. (The assets, the liabilities, and the equity of such a plan are included on the combined balance sheet.)

The resources of a pension plan are categorized as "additions to net assets," and the uses of those resources are categorized as "deductions from net assets." Additions include contributions from employers, contributions from participating employees, and net investment income.[11] Deductions include benefits (and refunds) paid to participants in the plan, as well as administrative

Carolina County, North Carolina
Statement of Changes in Plan Net Assets
Pension Trust Fund
For the Year Ended June 30, 19X1

	Pension Trust
Additions:	
Employer contributions	$101,424
Investment income:	
Net appreciation (depreciation) in fair value of investments	12,417
Interest	38,984
	51,131
Less investment expense	438
Net investment income	50,693
Total additions	152,117
Deductions:	
Benefits	16,585
Administrative expense	941
Total deductions	17,526
Net increase	134,591
Fund balance reserved for employees' pension benefits:	
Beginning of year	893,676
End of year	$1,028,267

Exhibit 7. This sample operating statement for Carolina County's pension trust fund is typical for a government required to report such information.

expenses incurred in the operation of the plan.

As with the operating statements of both the governmental and the proprietary funds, the net of these additions and deductions is the increase or the decrease in the pension plan's equity for the year.

Conclusion

Financial statements for local governmental entities can be very complex. Those with at least limited knowledge of governmental accounting and financial reporting principles may have the edge in interpreting the information, but any interested party certainly can glean useful information from these statements. External financial reporting is the specific responsibility of management. Management and elected officials must make every effort to understand the landscape of these financial statements. This article is designed not to teach the principles of governmental GAAP but to highlight for management and elected officials the fundamental information included in the combined financial statements. By understanding the basic logic of financial presentation, and the terminology unique to governmental accounting, management and elected officials can better fulfill their fiduciary duties.

Notes

1. Stephen J. Gauthier, An Elected Official's Guide to Financial Reporting at 8 (Chicago: Government Finance Officers Association, 1995).

2. N.C. Gen. Stat. § 159-34. Hereinafter the General Statutes will be cited as G.S.

3. Governmental financial statements sometimes report these interfund loan arrangements with the "due to/due from" terminology discussed earlier. Although this is technically not prohibited, the use of the different language is designed to identify clearly the underlying nature of the transaction.

4. GAAP define "availability" as revenue collected in cash as of the end of the fiscal year, or within a short period following the end of the fiscal year. The North Carolina Local Government Commission recommends that the availability period be no more than sixty days. In practice the short period is usually sixty to ninety days following the balance sheet date.

5. G.S. 159-13(b)(16).

6. If a government also has expendable trust funds, they will be included in a separate column on this statement. The technical title of a governmental fund operating statement is Combined Statement of Revenues, Expenditures and Changes in Fund Balances.

7. The technical title of this statement is Combined Statement of Revenues, Expenditures and Changes in Fund Balances—Budget and Actual. Most governments prepare additional statements and schedules that exhibit budgetary compliance for individual funds. For example, if a government prepares a comprehensive annual financial report, such information is included therein.

8. The technical title of the proprietary fund operating statement is Combined Statement of Revenues, Expenses and Changes in Retained Earnings. If a government also has a nonexpendable trust fund, it will be included in a separate column on this statement.

9. The technical title of the statement of cash flows is Combined Statement of Cash Flows.

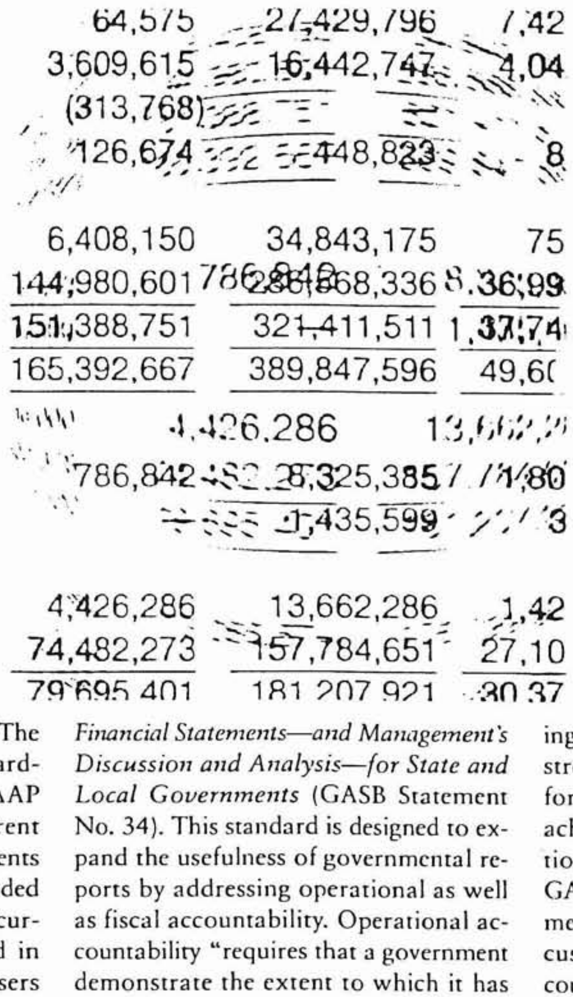
10. Governments also may include cash equivalents.

11. Investment income is reported minus appreciation or depreciation of the fair value of investments, as well as administrative costs and costs associated with investment management (for example, an investment adviser's fees).

How to Read Governmental Financial Statements, Part 2

Gregory S. Allison

In its Spring 2000 issue, *Popular Government* published "How to Read Governmental Financial Statements, Part 1." That article described the general format and meaning of governmental financial statements for elected officials, managers, and others without an accounting or financial reporting background. It also described generally accepted accounting principles, or GAAP, and their role in establishing consistency in financial reporting among governmental entities across the country.[1] The article noted that GAAP reporting requirements for governments would be changing in future years. This article introduces readers to the new governmental financial reporting requirements.[2]



Governmental GAAP are promulgated by the Governmental Accounting Standards Board, or GASB. The GASB has been the primary standard-setting body for governmental GAAP since its inception in 1984. Current reporting requirements for governments have been in place for decades, amended in various ways by the GASB. The current reporting model, as described in Part 1 of this article, has served users well, but early on, the GASB indicated its intention to thoroughly research ways to improve the usefulness of governmental reports. The new reporting standards summarized in this article are the culmination of a fifteen-year project.

In June 1999 the GASB issued *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments* (GASB Statement No. 34). This standard is designed to expand the usefulness of governmental reports by addressing operational as well as fiscal accountability. Operational accountability "requires that a government demonstrate the extent to which it has met its operating objectives efficiently and effectively . . . and whether it can continue to do so."[3] Fiscal accountability "requires that governments demonstrate compliance with public decisions concerning the raising and spending of public monies in the short term (usually on budgetary cycle or one year)."[4] Current financial reporting requirements always have focused on fiscal accountability, with an emphasis on various compliance issues, such as budgetary and statutory requirements. In truth, that is the focus of most governmental entities, as the adoption of annual budgets and the evaluation and establishment of tax rates on an annual basis confirm. Although most users of governmental financial statements agree that this focus is very important in the government environment, there has long been a consensus that users also need to assess operational accountability.

Operational accountability is obviously the focus in the private sector. Again, although most users agree that the vast differences in objectives between the public and private sectors prohibit a one-size-fits-all model of financial reporting, the GASB does believe that governmental financial reporting also should include elements of operational accountability. The challenge is to include them without compromising or diminishing the usefulness of the current model's strengths, specifically its fund-based information. The GASB has attempted to achieve this balance by adding an additional level of financial reporting to the GAAP-mandated external financial statements that is specifically designed to focus on a government's operational accountability.

Even though the GASB released the pronouncement establishing the new standards in June 1999, it readily recognized that the changes in external financial reporting requirements would be time-consuming to implement and, in some cases, costly. Therefore it established a schedule that takes into account the perceived readiness of governmental entities to implement the new standards. The GASB generally believed that large governments would be in a better position to implement the standards earlier

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than the small entities, and the schedule reflects this belief. Thus, depending on the size of their revenue base,[5] governments in North Carolina must implement the new standards as follows:

Phase 1—Revenue base of $100 million or more
Financial reports for fiscal years ended June 30, 2002

Phase 2—Revenue base of between $10 million and $100 million
Financial reports for fiscal years ended June 30, 2003

Phase 3—Revenue base under $10 million
Financial reports for fiscal years ended June 30, 2004

Financial Reporting Requirements

The combined financial statements and note disclosures discussed in Part 1 of this series make up what is currently known as the general purpose financial statements. These financial statements represent the minimum necessary to be in accordance with GAAP. The new financial reporting model replaces the concept of general purpose financial statements with a somewhat different reporting structure, as follows:

- Management's Discussion and Analysis (MD&A)
- Basic Financial Statements
  - Government-wide Financial Statements
    - Statement of Net Assets
    - Statement of Activities
  - Fund Financial Statements
  - Note Disclosures
- Other Required Supplementary Information

In general, the fund financial statements, note disclosures, and other required supplementary information are very similar to what is currently required, and accordingly they are the focus of Part 1 of this series. This article focuses on the MD&A and the government-wide financial statements, which basically are new reporting requirements. Notable changes to the fund financial statements and the note disclosures are highlighted.

Management's Discussion and Analysis

The MD&A has its roots in private-sector reporting. Its primary purpose is to "provide the narrative introduction and overview that users need to interpret the basic financial statements."[6] Considered required supplementary information, the MD&A should prove to be a useful document to accountants and nonaccountants alike for a summary of key data reported in the financial statements themselves.[7] This document represents management's opportunity to present both a short- and a long-term analysis of its entity's activities and financial condition. The MD&A is not the proper forum for subjective information, such as goals, objectives, forecasts, and the like. Rather, it is a summary and analysis of currently known facts and financial data.

The general information required to be reported in the MD&A is as follows:

- A brief discussion of the basic financial statements of the government, highlighting their relationship to one another and the information that each is intended to provide
- Condensed financial information based on the government-wide financial statements, as well as the fund financial statements
- An analysis that informs users whether the government's financial situation has improved or deteriorated
- A discussion of relevant budgetary events, such as significant amendments to the original budget and significant differences between budgeted and actual amounts
- Any currently known facts or other information that would or could have a direct bearing on the government's financial condition

The MD&A focuses on the current year and generally provides a comparison with the previous year's operations. Although relevant charts, graphs, or other visual aids are not required, enhancing the narrative with them is useful.

Most managers and elected officials are familiar with a comprehensive annual financial report (CAFR). Entities that prepare CAFRs include a letter of transmittal in its introductory section. A letter of transmittal is not the same as an MD&A, nor is the MD&A designed to replicate or replace the letter of transmittal. A letter of transmittal is generally a formal transmission of the CAFR to the users and describes the format of the document, the broad policies of the government, and any other subjective information (for example, goals, objectives, and forecasts) deemed useful by management. Governmental entities that prepare CAFRs must continue to include a letter of transmittal, in addition to an MD&A. Governmental entities that do not prepare CAFRs still will be required to prepare an MD&A. The two documents should not duplicate information. The limited financial analysis that currently appears in many letters of transmittal will be moved to the MD&A when the new reporting standards are implemented. Otherwise, the general information included in the letter will remain the same.

Basic Financial Statements

Governmental entities report their financial information in three broad categories of funds: governmental, proprietary, and fiduciary. Within each category, several fund types are available to account for all the government's activities and services (see Table 1). The basic financial statements provide two different perspectives on the government's financial situation: government-wide information and fund financial information, both of which are supported by a single set of note disclosures (notes containing critical details about important financial issues—for example, significant accounting policies, components of investment portfolios, capital assets information, and specifics about the types of long-term indebtedness the government has incurred). Government-wide information basically represents the new reporting requirements, whereas the fund financial information represents information similar to what is currently required by GAAP. In broad terms the government-wide financial information presents a picture of the government as a whole, focusing on the governmental funds and enterprise funds only, and including all their respective assets and liabilities. In contrast, the fund financial

Table 1. **Fund Types**

General fund	Accounts for general operations of government (e.g., legislative, administrative, public safety, sanitation, and recreation)
Special revenue fund	Accounts for legally restricted revenue sources, those that must be used for particular activities (e.g., E-911 taxes and community development block grants)
Debt service fund	Accounts for resources that governments are required to accumulate to pay debt service in future years
Capital projects fund	Accounts for major capital activities or construction that is being financed by governmental resources (e.g., taxes) or by bonds that will be repaid by governmental resources
Permanent fund	Accounts for resources that are legally restricted by a trust agreement according to which the earnings, but not the principal, are to be used for services or activities that benefit the government or its citizenry as a whole (e.g., perpetual care funds for government-owned cemeteries)
Enterprise fund	Accounts for activities that are usually supported by user fees (e.g., water, wastewater, electricity, and natural gas services)
Internal service fund	Accounts for internal activities that provide service to other departments (e.g., government motor pools, in-house print shops, and warehousing for utility activities)
Fiduciary funds	Account for various activities for which government acts as fiduciary (e.g., pension plans, execution of private-purpose trusts, and taxes collected on behalf of other governments)

information focuses on all the major funds of a government, including the fiduciary funds, and it retains the traditional measurement focuses (that is, current financial resources for governmental funds and total economic resources for proprietary funds, described in more detail later in this article) required by current GAAP.

Government-wide Financial Statements

The primary feature of the new reporting requirements is the government-wide financial statements. These statements are similar to private-sector financial information in that they are designed to present a picture of an entity as a whole, as opposed to by fund. These statements focus on two broad types of activities: governmental and business-type.

Under current GAAP, balance sheets of governmental funds (that is, general, special revenue, capital projects, debt service, and permanent funds) focus on financial assets and financial liabilities.[8] A "financial asset" is an asset that either is in cash form or will convert to cash in its natural course. A "financial liability" is a very short-term liability, to be paid off soon, presumably with cash that is on hand or will be received in the near future. This focus is consistent with the budgetary approach to management that is characteristic of the governmental environment. Also, for assessing the short-term financial liquidity of a government (for example, the resources available to finance current activities), this limited focus serves a useful purpose.

However, governmental funds also own "nonfinancial assets," assets that cannot be spent but are used by the government for their intended purpose. These are capital assets such as land, buildings, equipment, and vehicles. Although not spendable, they are of significant worth and cannot be ignored when assessing an entity's overall net worth. Likewise, governmental funds also have "long-term liabilities," those that are not due immediately but will be paid back in future periods. Although the government is not currently using resources to repay these long-term liabilities, it needs to accumulate resources to do so in the future. Accordingly, all short- and long-term liabilities must be taken into account when assessing the overall net worth of an entity.

Operating statements of governmental funds report their revenues and expenditures. Per current GAAP, governmental funds focus on current financial resources. Thus, revenues are recognized only when they are considered available, as opposed to when they are earned. Governmental fund operating statements are similar to a checkbook register. Revenues are like deposits; expenditures are like withdrawals. Again, this is useful information when focusing on spendable resources only, but it falls short when assessing the overall earnings (that is, revenue earned but not necessarily available) of the fund and thus its total economic picture.

The government-wide statements provide the total economic picture for governmental activities and business-type activities. Specifically, governmental funds are aggregated. The financial and nonfinancial assets of the funds are reported, as are the financial liabilities and long-term liabilities. Revenues for the aggregated funds are reported when earned, not just when available in cash. The aggregation results in a single columnar presentation known as "governmental activities."

Proprietary funds, which include enterprise and internal service funds, currently focus on all assets and liabilities in their individual fund presentations, as well as on all revenue that is earned, not just that which is available. However, for purposes of assessing the government as a whole, the activities of an internal service fund should not be considered. Internal service funds are simply an internal accounting and reporting mechanism for internal services (for example, in-house print shops). They do not enhance or limit the government's financial condition as a whole. The business-type activities column therefore represents only the entity's enterprise funds.

The government-wide financial statements do not include the fiduciary activities of a government. This information is reported in the fund financial statements. Since fiduciary activities are controlled by trust agreements and independent parties, they do not enhance or limit the governmental entity's economic picture as a whole.

Statement of Net Assets

The standard accounting equation of "assets = liabilities + equity" also can be stated as "assets – liabilities = net assets." The statement of net assets (see Exhibit 1) reports the total assets, the total liabilities, and, accordingly, the net assets of both the governmental and the business-type activities of a government. The statement can be used to answer the following questions:

- What does each activity (that is, governmental and business-type) of the governmental entity *own* as of June 30?
- What does each activity of the governmental entity *owe* as of June 30?
- What is each activity's *net worth* as of June 30?

Again, the uniqueness of the governmental activities column on the government-wide statement of net assets is that all assets, not just financial assets, are reported, as are all liabilities, not just short-term liabilities. Thus the net worth (that is, the net assets) reflects the total economic picture of the governmental activities, not just the spendable net worth, as the fund balance reflects in the fund

Exhibit 1

Sample City
Statement of Net Assets
December 31, 2002

Alternatively, the internal balances could be reported on separate lines as assets and liabilities. (See Appendix 3, Exhibit 1.)

	Primary Government			
	Governmental Activities	Business-type Activities	Total	Component Units
ASSETS				
Cash and cash equivalents	$ 13,597,899	$ 10,516,820	$ 24,114,719	$ 303,935
Investments	27,365,221	64,575	27,429,796	7,428,952
Receivables (net)	12,833,132	3,609,615	16,442,747	4,042,290
Internal balances	313,768	(313,768)	—	—
Inventories	322,149	126,674	448,823	83,697
Capital assets				
Land, improvements, and construction in progress	28,435,025	6,408,150	34,843,175	751,239
Other capital assets, net of depreciation	141,587,735	144,980,601	286,568,336	36,993,547
Total capital assets	170,022,760	151,388,751	321,411,511	37,744,786
Total assets	224,454,929	165,392,667	389,847,596	49,603,660
LIABILITIES				
Accounts payable and accrued expenses	7,538,543	786,842	8,325,385	1,803,332
Deferred revenue	1,435,599	—	1,435,599	38,911
Long-term liabilities				
Due within one year	9,236,000	4,426,286	13,662,286	1,426,639
Due in more than one year	83,302,378	74,482,273	157,784,651	27,106,151
Total liabilities	101,512,520	79,695,401	181,207,921	30,375,033
NET ASSETS				
Invested in capital assets, net of related debt	103,711,386	73,088,574	176,799,960	15,906,392
Restricted for:				
Capital projects	11,290,079	—	11,290,079	492,445
Debt service	3,076,829	1,451,996	4,528,825	—
Community development projects	6,886,663	—	6,886,663	—
Other purposes	3,874,736	—	3,874,736	—
Unrestricted (deficit)	(5,897,284)	11,156,696	5,259,412	2,829,790
Total net assets	$122,942,409	$ 85,697,266	$208,639,675	$19,228,627

Source: Portions of *GASB's Guide to Implementation of GASB Statement 34 on Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Questions and Answers*, copyrighted by the Governmental Accounting Standards Board, 401 Merritt 7, P.O. Box 5116, Norwalk, Connecticut 06856-5116, are reprinted with permission. Complete copies of this publication are available from the GASB.

financial statements. In contrast, the business-type activities column is basically the same as the total enterprise funds reported in the fund financial statements.

Part 1 of this series provides a detailed overview of the types of assets and liabilities that are common to a balance sheet, as well as the terminology used for equity (that is, "fund balance" for governmental funds and "retained earnings" for proprietary funds). With the exception of the equity terminology, these same types of assets and liabilities are generally found on the statement of net assets. Accordingly, this article focuses on the specific differences between the statement of net assets and the aforementioned balance sheet.

Infrastructure. As stated earlier, the government-wide statement of net assets will include all assets of the governmental and business-type activities. Included, however, for the first time will be infrastructure assets of the governmental activities. These are roads, bridges, sidewalks, and the like—assets that are certainly significant in value but of use only to the government. Heretofore these assets have not been included on the balance sheet of governmental entities. However, the GASB believes that it is important to include this information in order to give users a complete economic picture of the government. Governments will be required to include infrastructure as an asset as it is procured, but they also will have to include infrastructure acquired within approximately the last twenty years.[9]

This requirement will be time-consuming to implement and could be costly in some jurisdictions. Although procuring professional services to help with the identification and the capitalization of these assets is certainly not required, many entities may have to do so. Realizing the difficulties that governments might encounter, the GASB is allowing additional time for implementation of the retroactive portion of infrastructure capitalization. Specifically, Phase 1 and Phase 2 governments have an additional four years from the required implementation date of the new standards to get this piece into place.[10] However, new infrastructure will have to be included when the initial implementation of the standard is required.

Net assets. In the new government-wide financial statements, equity terminology for both the governmental and the business-type activities will be "net assets." This terminology reflects the restatement of the accounting equation:

Assets – Liabilities = Net Assets

As described earlier, both governmental and business-type activities focus on total economic resources. Each activity reports all assets, not just those that are liquid, and all liabilities, not just those that are current. Thus their net worth (that is, assets minus liabilities) results in a net assets figure that includes both expendable and nonexpendable pieces. This may be best illustrated with an example. Assume that a governmental fund has the following financial assets and financial liabilities:

Financial Assets	
Cash	$ 65,000
Investments	576,400
Taxes receivable	243,500
Due from other funds	25,000
Total assets	$909,900
Financial Liabilities	
Accounts payable	$ 46,899
Salaries payable	15,750
Due to other funds	95,000
Due to other governments	188,000
Total liabilities	$345,649

Using the accounting equation, the net assets, or net worth, of this entity would be $564,251. Since all the assets are financial assets (that is, cash or assets that will convert to cash) and all the liabilities are short-term, the net assets of $564,251 reflect an amount that will eventually be available to spend for other items, assuming that there are no specific restrictions on it. Per current governmental GAAP, this reflects how governmental funds are reported: the measurement focus is on current financial resources. Also, the net assets are simply known as the "fund balance."

However, using the same assumptions yet introducing nonfinancial assets (for example, capital assets) and long-term liabilities results in a significant difference in the information being revealed by the net assets amount:

Financial Assets	
Cash	$65,000
Investments	576,400
Taxes receivable	243,500
Due from other funds	25,000
Capital assets	2,250,000
Total assets	$3,159,900
Financial Liabilities	
Accounts payable	$46,899
Salaries payable	15,750
Due to other funds	95,000
Due to other governments	188,000
Bonds payable	2,550,000
Total liabilities	$2,895,649

Although the entity has the same amount of liquid assets and short-term debt, net assets are only $264,251. From a total economic perspective, considering all spendable and nonspendable assets, as well as all liabilities that the entity will eventually have to pay, its net worth is significantly less. The first calculation answers a limited question: What are net spendable resources for the current period? The second calculation answers a much broader question: What is the entity's net worth overall? Each calculation is equally valuable, but the information is used for different purposes. For example, the latter calculation of net worth cannot be used simply to identify what is spendable. Likewise, the former calculation does not assess an entity's total net worth.

The GASB believes that both types of information are useful and should be available to users of governmental financial statements to assess both spendable net worth and total economic net worth. Current GAAP provide only spendable net worth information for governmental funds. The net assets calculated on the new government-wide financial statements for governmental activities provide the total economic perspective.

Net assets are divided into three classifications, as follows:

- *Invested in capital assets, net of related debt*
  This amount is calculated by subtracting any outstanding debt incurred to procure capital assets from the value of the assets themselves. Obviously this category of net assets does not reflect a spendable

Exhibit 2

Sample City
Statement of Activities
For the Year Ended December 31, 2002

		Program Revenues			Net (Expense) Revenue and Changes in Net Assets			
					Primary Government			
Functions/Programs	Expenses	Charges for Services	Operating Grants and Contributions	Capital Grants and Contributions	Governmental Activities	Business-type Activities	Total	Component Units
Primary government:								
Governmental activities:								
General government	$ 9,709,509	$ 3,333,265	$ 843,617	$ —	$ (5,532,627)		$ (5,532,627)	
Public safety	34,782,144	1,198,855	1,307,693	62,300	(32,213,296)		(32,213,296)	
Public works	10,131,928	850,000	—	2,252,615	(7,029,313)		(7,029,313)	
Engineering services	1,299,645	704,793	—	—	(594,852)		(594,852)	
Health and sanitation	6,705,675	5,612,267	575,000	—	(518,408)		(518,408)	
Cemetery	735,866	212,496	72,689	—	(450,681)		(450,681)	
Culture and recreation	11,534,045	3,995,199	2,450,000	—	(5,088,846)		(5,088,846)	
Community development	2,994,389	—	—	2,580,000	(414,389)		(414,389)	
Education (payment to school district)	21,893,273	—	—	—	(21,893,273)		(21,893,273)	
Interest on long-term debt	6,242,893	—	—	—	(6,242,893)		(6,242,893)	
Total governmental activities	106,029,367	15,906,875	5,248,999	4,894,915	(79,978,578)		(79,978,578)	
Business-type activities:								
Water	3,643,315	4,159,350	—	1,159,909	—	$ 1,675,944	1,675,944	
Sewer	4,909,885	7,170,533	—	486,010	—	2,746,658	2,746,658	
Parking facilities	2,824,368	1,449,012	—	—	—	(1,375,356)	(1,375,356)	
Total business-type activities	11,377,568	12,778,895	—	1,645,919	—	3,047,246	3,047,246	
Total primary government	$117,406,935	$28,685,770	$5,248,999	$6,540,834	(79,978,578)	3,047,246	(76,931,332)	
Component units:								
Landfill	$ 3,382,157	$ 3,857,858	$ —	$ 11,397				$ 487,098
Public school system	31,186,498	705,765	3,937,083	—				(26,543,650)
Total component units	$ 34,568,655	$ 4,563,623	$3,937,083	$ 11,397				(26,056,552)
General revenues:								
Taxes:								
Property taxes, levied for general purposes					51,693,573	—	51,693,573	—
Property taxes, levied for debt service					4,726,244	—	4,726,244	—
Franchise taxes					4,055,505	—	4,055,505	—
Public service taxes					8,969,887	—	8,969,887	—
Payment from Sample City					—	—	—	21,893,273
Grants and contributions not restricted to specific programs					1,457,820	—	1,457,820	6,461,708
Unrestricted investment earnings					1,885,455	619,987	2,505,442	884,277
Miscellaneous					884,907	—	884,907	19,950
Special item—gain on sale of park land					2,653,488	—	2,653,488	—
Transfers					501,409	(501,409)	—	—
Total general revenues, special items, and transfers					76,828,288	118,578	76,946,866	29,259,208
Change in net assets					(3,150,290)	3,165,824	15,534	3,202,656
Net assets—beginning					126,092,699	82,531,442	208,624,141	16,025,971
Net assets—ending					$122,942,409	$85,697,266	$208,639,675	$ 19,228,627

portion. For most governmental jurisdictions in North Carolina, this will be a positive amount.

- *Restricted net assets*
  This amount reflects net assets whose use is restricted by independent external third parties. Assets that would be part of this calculation are cash, investments, or receivables related to grants or restricted shared revenues. A common North Carolina example is Powell Bill assets held by a municipality but not yet spent. The state restricts use of those assets to specific street construction and maintenance projects. Again, for most governmental jurisdictions, this will be a positive amount unless there are significant outstanding restricted liabilities.

- *Unrestricted net assets*
  In short, this amount reflects all net assets that were not classified into one of the other two categories. This would typically be all noncapital or unrestricted assets, such as cash, investments, and receivables, minus all noncapital liabilities, such as accounts payable. There are numerous scenarios in which this amount could actually be negative, though that does not necessarily indicate a problem. It could simply mean that at present, certain long-term liabilities exceed the currently available spendable assets. Assets will need to be accumulated to repay these liabilities as they come due in the future. (For a further discussion of potentially negative unrestricted net assets in North Carolina governments, see the sidebar on this page.)

Statement of Activities

The new government-wide operating statement is referred to as the "statement of activities" (see Exhibit 2). This statement reports the changes in a government's net assets during the year. As with the statement of net assets, the focus is on the entity's governmental and business-type activities. The statement of activities reports the revenues earned and the expenses incurred during the year. The terminology used in the statement remains generally consistent with the current reporting model, which is explained in Part 1 of this series. The focus here is on the unique aspects of the new government-wide statement.

Negative Unrestricted Net Assets

Any of the three classifications of net assets (that is, invested in capital assets, restricted net assets, and unrestricted net assets) may be negative amounts. However, negative amounts are going to be most common in the "unrestricted net assets" classification. For North Carolina counties, negative amounts in "unrestricted net assets" will not be unusual because the North Carolina General Statutes require counties to issue debt on behalf of the schools. This debt remains a legal liability of the county, while the assets procured by the proceeds (school buildings, school equipment, and so on) become the property of the school district. In short, the county has debt but no assets to offset it; the schools have assets but no debt to offset them. Even though the debt proceeds will be used for capital procurement, the capital is not that of the county. Therefore the outstanding liability is an offset not in the "invested in capital assets" classification but in the "unrestricted net assets" classification. With no asset offset, the liability often will result in a negative "unrestricted net assets" calculation.

Ironically, counties where explosive growth is occurring will actually be more negatively affected. These counties are issuing more and more debt to keep up with the need for additional school facilities. Managers and elected officials should not interpret these negative amounts as an indication of financial difficulties. Similarly, large positive "invested in capital assets" amounts in the school systems' financial statements should not be considered an indication of spendable net worth.

The most noticeable difference in the new statement is its format. The focus is actually expenses, followed by various types of revenues. This reflects the fact that, in the public sector, "the goal is to provide needed services, not maximize revenue."[11] Information is broken down by functional categories in both the governmental and the business-type activities. For governmental activities these functional categories include, but are not limited to, general governmental services, public safety, public works, recreation, and sanitation. Examples of business-type functional categories are water, wastewater, and electric operations.

Program revenues. The statement of activities is actually read horizontally. An expense column is presented first, followed by three categories of program revenues. Program revenues are defined by GASB Statement No. 34 as revenues derived "directly from the program itself or from parties outside the reporting government's taxpayers or citizenry, as a whole; they reduce the net cost of the function to be financed from the government's general revenues."[12] Program revenues are reported in three categories:

- Charges for services
- Program-specific operating grants and contributions
- Program-specific capital grants and contributions

Charges for services typically include user fees such as garbage collection fees or water charges. Grants and contributions are resources received by the government whose grantors or contributors require use for either operating or capital purposes in specified functional areas. Common examples for North Carolina governments are Powell Bill funds and community development block grants.

These revenues are reported in columns following the expense column. Net columns are then presented for governmental activities or business-type activities. For most of the functional categories, especially for the governmental activities, this net amount will reflect a deficit. This does not indicate financial difficulties or any type of loss. It simply reflects the fact that governmental entities do not fund the majority of their functional services with charges, grants, or contributions intended to cover the full cost of those services. Instead, general, unrestricted revenues such as taxes subsidize these activities.

Below these amounts, the statement of net assets includes all the governmental entity's general revenues. General revenues include, but are not limited to, taxes (for example, property taxes, sales taxes, and income taxes), interest, unrestricted grants and contributions, and transfers between governmental and business-type activities. Again, this format visually represents how governmental entities are generally structured. Taxation and revenue sources of a similar type subsidize public-purpose functions that rarely could be considered self-sufficient.

The net effect of expenses, program revenues, and general revenues is either an increase or a decrease in net assets of both the governmental and the business-type activities. The ending net assets for each activity should agree with the net assets reported on the statement of net assets. In summary, the statement of net assets is a snapshot of all assets, liabilities, and net assets at the end of the fiscal year (June 30 for North Carolina governments). The statement of activities reports all the transactions for the governmental or business-type activities throughout the year that either increase or decrease the applicable activities' net assets.

Fund Financial Statements and Note Disclosures

As noted earlier, the new financial reporting model presents financial information from two different perspectives. The government-wide financial statements provide information on the governmental and business-type activities as a whole, and the fund financial statements focus on the individual funds. Specifically the governmental fund information focuses on current financial resources, while the proprietary and fiduciary fund information focuses on total economic resources. The reporting requirements for the fund financial statements are adequately summarized in Part 1 of this series and thus are not repeated in this article. In short, balance sheets, operating statements, and statements of cash flow (for proprietary funds) for each major fund are included in the fund financial statements.[13]

The new reporting requirements include a reconciliation between the government-wide and the fund financial statements. This reconciliation should prove invaluable for users to understand why certain information is included on one statement but not on another, or how a transaction can be viewed from the perspective of either current financial resources or total economic resources.

Another required element of the basic financial statements is the note disclosures. Obviously, some changes were necessary to incorporate explanations of the new government-wide financial statements (for example, describing the measurement focus used and the inclusion of infrastructure assets). Generally, though, the form and the content of the note disclosures have remained unchanged.

North Carolina governments are required to adopt budgets for each of their funds except internal service and fiduciary. Budgetary comparisons must be presented in the fund financial section. GASB Statement No. 34 gives governmental entities the option to include budgetary information as other required supplementary information. Making budgetary information required supplementary information lessens the audit coverage to which it is subject. However, since this information is critical to exhibiting compliance with state budgetary statutes, North Carolina governments will be required to include these budgetary presentations as basic financial statements.

Conclusion

This article is intended to provide managers and elected officials with an overview of the new financial reporting requirements that will be affecting governments all across the nation. It is impossible to teach governmental GAAP in the context of an article like this. However, Parts 1 and 2 of this series highlight for managers and elected officials the fundamental information included in the new financial reporting model, in the hope that these officials will better understand how to interpret financial information and ultimately better fulfill their fiduciary responsibilities.

Notes

1. For purposes of this article and in terms of the scope of jurisdiction of the Governmental Accounting Standards Board (GASB), "governmental entities" are state and local governmental entities only. They include, but are not limited to, counties, municipalities, public school systems, public authorities, public colleges and universities, and similar entities. The federal government is not subject to the GASB's reporting requirements.

2. This article does not review the current governmental reporting requirements. Refer to the Spring 2000 issue of POPULAR GOVERNMENT, page 23, for that information.

3. STEPHEN J. GAUTHIER, AN ELECTED OFFICIAL'S GUIDE TO THE NEW GOVERNMENTAL FINANCIAL REPORTING MODEL 13 (Chicago: Gov't Finance Officers Ass'n, 2000).

4. GAUTHIER, AN ELECTED OFFICIAL'S GUIDE, at 13.

5. The "revenue base" is defined as total governmental fund revenues (that is, general, special revenue, debt service, and capital projects) and enterprise funds (for example, utility funds). For North Carolina governments, the revenue base is as of June 30, 1999.

6. GAUTHIER, AN ELECTED OFFICIAL'S GUIDE, at 23.

7. "Required supplementary information" is information required to be included in the financial statements to be in accordance with GAAP but not subject to the same level of audit coverage as the basic financial statements.

8. A balance sheet reports the assets, the liabilities, and the equity (that is, the net worth) of a governmental entity. Refer to Part 1 of this series in the Spring 2000 issue of POPULAR GOVERNMENT for a complete description of a balance sheet.

9. The reporting standards actually require governments in Phase 1 or 2 of implementation to include major infrastructure assets acquired in the fiscal years ending after June 30, 1980. For North Carolina governments, this is for infrastructure acquired since July 1, 1980.

10. Phase 1 North Carolina governments will have until the fiscal year ending June 30, 2006, to implement the *retroactive* portion of the infrastructure reporting requirement; Phase 2 North Carolina governments will have until the fiscal year ending June 30, 2007.

11. GAUTHIER, AN ELECTED OFFICIAL'S GUIDE, at 28.

12. General Accounting Standards Board, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, Statement No. 34, ¶ 48 (Norwalk, Conn.: GASB, June 1999).

13. GASB Statement No. 34 requires governments to report by major fund. Government officials can determine major funds by a calculation based on materiality, or they have the discretion to declare any or all of their funds "major."