Back to Basics

An Overview of Governmental Accounting and Financial Reporting

By Michael Genito

Everyone involved in overseeing or managing government operations needs to understand the basics of public-sector accounting and financial reporting.

All those involved in the oversight or management of government operations, and those whose livelihoods and interests rely on the finances of state and local governments, need to have a clear understanding of governmental accounting, auditing, and financial reporting, which are based on a sound set of principles and interrelated practices and procedures.

ACCOUNTING

The term "accounting" is used to describe the process of assembling, analyzing, classifying and recording data that is relevant to transactions and events affecting the government's finances.

Assembling involves gathering together purchase orders, invoices, billing statements, notices, receipts, receiving slips, closing documents, bank statements, correspondence, and other documents that support a transaction.

Accounting

Assembling
(source documents)
↓
Analyzing
↓
Classifying
↓
Recording
(journal entries)

These documents must then be analyzed so someone unfamiliar with the transaction can understand who and what was involved; when, where and why the transaction or event took place; and the value to be assigned to it.

Using a comprehensive chart of accounts, the government can then properly classify the components of the transaction or event and, finally, record it as journal entries. The effect on each account, in turn, is then posted to the general ledger, which contains a list of balances for each of the accounts found in the chart of accounts.

FINANCIAL REPORTING

"Accounting" and "financial reporting" are similar but distinctly different terms that are often used together. Financial reporting is the process of aggregating and summarizing the detailed information that was assembled, analyzed, classified, and recorded in the accounting process, and putting it into a usable form for decision making by those who need it.

Financial reporting can take one of three forms: internal financial reporting, special-purpose external financial reporting, and general-purpose external financial reporting. Internal financial reporting is developed for management to meet specific managerial needs and preferences, with management determining the content, format, and timing of the reports. Special purpose external

Financial Reporting

Financial Report	Users	Access to Information	Content, Format, and Timing
Internal	Management	Yes	Management
Special Purpose External	Grantors, Certain Creditors, Government Agencies	Yes	Third parties
General	Public	No	GAAP

financial reporting is developed for the use of those outside the government to meet certain legal or contractual requirements, such as state regulatory agency or grantor requirements.

General purpose external financial reporting is developed for those who rely on the information contained in the reports and do not have direct access to the jurisdiction's financial information. General purpose external financial reporting typically is governed by generally accepted accounting principles. Three communications methods[1] are used to present information in general purpose external financial reporting: display, disclosure, and supporting information.

Display. The display method of communication provides that items are reported as dollar amounts on the face of the financial statements if they both 1) meet the definition of one of the seven financial statement elements and 2) can be reliably measured. The seven financial statement elements for state and local governments are assets, liabilities, inflows of resources, outflows of resources, deferred inflows of resources, deferred outflows of resources, and net position.[2]

General Purpose External Financial Reporting Communication Methods

Display
Disclosure
Supporting Information

Assets are resources with present service capacity that the government presently controls, meaning that the government is able to use the resource's present service capacity and to determine the nature and manner of its use. Control does not have to be absolute, and is usually associated with either legal ownership or contractual rights. Control must also result from some past event, not an inherent power.

Liabilities are present obligations to sacrifice resources that the government has little or no discretion to avoid, usually because it is legally enforceable, based on a contract or third-party legislation. Liabilities must involve a party external to the government. A constructive (i.e., inferred) liability may need to be recognized if social, moral, or economic consequences leave the government little or no discretion to avoid sacrificing the resources. Commitments (such as the provision of public education) are not liabilities.

Inflows of resources are the government's acquisition of net assets that is applicable to the reporting period. Acquisition involves either new resources coming under the government's control or resources already under the government's control becoming newly available, resulting in either a net increase in assets or a net decrease in liabilities. Outflows of resources are the government's consumption of net assets that is applicable to a reporting period. Consumption involves consuming (using up) an existing resource or consuming a resource as it is acquired, resulting in either a net decrease in assets or a net increase in liabilities. Deferred inflows of resources are the government's acquisition of net assets (inflows of resources) that is applicable to a future reporting period (deferred). Deferred outflows of resources are the government's consumption of net assets (outflows of resources) that is applicable to a future reporting period (deferred).

Net position is the residual of all other elements presented in a statement of financial position. The governmental accounting version of the accounting equation can be defined as (assets + deferred outflows of resources) - (liabilities + deferred inflows of resources) = net position.

Governmental Accounting Equation

Assets
\+ Deferred Outflows of Resources
\- Liabilities
\- Deferred Inflows of Resources
= Net Position

Disclosure. The disclosure method of communication includes three types of information that are properly included within the notes to the financial statements: 1) descriptions of the policy underlying amounts presented in the financial statements; 2) detail or explanations concerning amounts presented in the financial statements; and 3) information about potential financial statement elements that do not qualify for recognition. Such information must be essential (indispensable) to the user's understanding of the financial statements, objective (not subjective, predictive, or prospective), and have a clear and demonstrable link to the financial statements.

Supporting Information. This "supporting information" method of communication is designed to provide operational, economic, or historical context for the financial statements or notes to the financial statements. Required supplementary information is used to present mandated supporting information, while supplementary information is used when the information presented is not mandatory.

Both RSI and SI must possess a clear and demonstrable link to either the financial statements or the notes to the financial statements. While RSI must be essential and objective, SI is useful (but not essential) and may include subjective, predictive, and/or prospective information. RSI is required and SI is optional under GAAP; however, if SI is presented in connection with GAAP financial statements, it must follow any relevant authoritative standards.

Information presented in the financial statements, the notes to the financial statements, or supplementary information must meet the following essential characteristics for inclusion in general purpose external financial reporting: understandability, reliability, relevance, timeliness, consistency, and comparability.[3] Understandability means that a person with "a reasonable understanding of government and public finance activities and of the fundamentals of governmental financial reporting," who is willing to both study a financial report "with reasonable diligence," and to apply "relevant analytical skills" should understand what is being presented. Reliability means that the information presented will be verifiable (reproducible), unbiased, and faithfully reflect the economic substance of transactions and events. Relevance means that the information presented should be able to make a difference in how users assess a problem, condition, or event. Timeliness means that the information must be presented soon enough after the close of a period to affect decision making. Consistency means that once an accounting method is adopted, it should be followed consistently from one accounting period to the next. Comparability means that accounting standards and policies are applied consistently from one period to another and from one state or local government to another, allowing the user to compare a set of financial statements with those of prior periods and those of other governments.

Changes from prior periods that affect the consistency or comparability of the financial information presented should be explained and discussed in the notes and other areas providing detailed information (such as the letter of transmittal).

Characteristics of Information in Financial Reporting

Understandability
Reliability
Relevance
Timeliness
Consistency
Comparability

THE FINANCIAL STATEMENT AUDIT

The Governmental Accounting Standards Board identifies the users of general purpose external financial reporting to "include legislators and their staff, municipal bond insurers, buy- and sell-side analysts, rating agencies, bond holders, citizen and taxpayer groups, community organizations, research institutes, professors and students, among others, and the general public."[4]

The GASB further identifies three groups of primary users of general purpose external financial reporting to include those to whom government is primarily accountable (the citizenry), those who directly represent the citizens (legislative and oversight bodies), and those who lend or who participate in the lending process (investors and creditors).[5] Users of general purpose external financial reporting have long insisted that an independent auditor vouch for the reliability of financial reports. The financial statement audit is the process used by the independent auditor to provide the necessary assurance that the financial statements are fairly presented in conformity with GAAP.

A common misconception by those who are not familiar with the roles and responsibilities of management, the governing board, and the independent auditor is that the auditor is responsible for the information presented in the general purpose external financial report. In fact, while the primary responsibility rests with management, the ultimate responsibility rests with the governing board. The reasonable basis for management's assurance that the information presented in general purpose external financial reporting is complete and reliable can be provided only by a comprehensive framework of internal control. An audit committee, preferably comprising members of the governing board, can provide necessary oversight. The independent auditors are responsible for the opinion they express concerning the fair presentation of the financial statements.

CONCLUSION

Guidance for the government finance officer can be found in the 2012 edition of *Governmental Accounting, Auditing, and Financial Reporting (GAAFR)*, authored by Stephen J. Gauthier and published by the GFOA.

Notes

1. GASB Concepts Statement No. 3, *Communication Methods in General Purpose External Financial Reports that Contain Basic Financial Statements*.
2. GASB Concepts Statement No. 4, *Elements of Financial Statements*.
3. GASB Concepts Statement No. 1, *Objectives of Financial Reporting*, paragraph 62-68.
4. Government Accounting Standards Board, *GASB and the User Community*, http://www.gasb.org/jsp/GASB/Page/GASBSectionPage&cid=1176156741809, accessed October 11, 2012.
5. GASB Concepts Statement No. 1, *Objectives of Financial Reporting*, paragraph 30.

MICHAEL A. GENITO, CPFO, is the commissioner of finance for the City of White Plains, New York. He has served on the GFOA Executive Board and as chair of the GFOA's Committee on Accounting, Auditing, and Financial Reporting, and he participates as a reviewer for the GFOA Certificate of Achievement for Excellence in Financial Reporting program, the Distinguished Budget Presentation Award program, and the Popular Annual Financial Reporting Award programs.