

## Reading and Understanding Financial Statements

Association of Town Finance Committees

Presented By:  
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## Today's Objective

- To review the different reports that are part of the Town's annual audit.
  - ◆ Basic Financial Statements
  - ◆ Management Letter
  - ◆ Schedule of Federal Awards
- To focus on what is important to know
- To discuss what cannot be found in the financial statements

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## Private-Sector versus Governmental Financials

- Private-sector businesses, despite what they sell, share a common goal – **Profit**.
- The primary goal of governments is to provide **Services**.
- Service quality, unlike profit, is not a financial concept.

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## Private-Sector versus Governmental Financials

- Because there is no profit motive, the need exists for defining performance measurement in the public-sector.
- Governmental financial statements have not played the same role in assessing performance as they do in the private-sector.

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## Who Makes the Rules?

- For Private-Sector financial statements the Financial Accounting Standards Board (FASB) is the nation-wide body that establishes the form and content of the statements.
- For Governmental financial statements the Governmental Accounting Standards Board (GASB) is the nation-wide body that establishes the form and content of the statements.

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## Who Makes the Rules?

- The GASB provides the standards on how to prepare financial statements in accordance with Generally Accepted Accounting Principals (GAAP).
- Users such as investors and rating agencies rely on the consistent application of GAAP.
- This is the only way users can assess the financial position of one government compared to another.

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## Who Makes the Rules?

- It is important to remember that the GASB and FASB are independent bodies not associated with either the Federal or State governments.
- The standards are not a Federal or State Mandate.
- Massachusetts General Laws along with the Department of Revenue (DOR) establishes the accounting standards are unique only to Massachusetts governments.

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## Who Makes the Rules?

- The financial statements include budget to actual statements prepared in accordance with accounting standards established by the DOR.
- The DOR accounting standards are known as the Uniform Municipal Accounting System (Umas).
- Umas is different than GAAP and therefore General Fund Unassigned Fund Balance is normally different than Free Cash.

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## Role of an Independent Auditor

- The Financial Statements are not the "Audit Firm's" Statements they are management of the Town.
- The audit firm examines the Town's financial statements for the purpose of rendering an opinion on whether the financial statements are fairly presented in accordance with GAAP.

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## Role of the Audit Committee

- More communities are establishing Audit Committees that are responsible for managing the audit process.
- They have open meetings where the financial statements and management letters are reviewed and discussed.
- They also approve the final products.
- Since these are open meetings you may want to attend them.

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## Independent Auditor's Report

- When you review an audited financial statement this is the first thing I look at.
- This will tell you if there is anything seriously wrong with the financial statements.
- It will also tell you if the statements are OK.
- Look at the DATE of the report as this can be an indication of potential management issues.
- The Independent Auditor's Report is comprised of several sections.

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## Independent Auditor's Report

- Sections of the Auditor's Report
  - Report on the Financial Statements
    - This defines the statements being audited
  - Management's Responsibility for the Financial Statements
    - This tells the reader that management is responsible for the fair presentation in accordance with GAAP; that management is responsible for Internal Controls for preparation of Financial Statements; and free from material misstatement due to error or fraud.

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## Independent Auditor's Report

- Sections of the Auditor's Report
  - ◆ Auditor's Responsibility
    - This section states that the Auditor is responsible for expressing an opinion.
    - That the audit is conducted in accordance with Generally Accepted Auditing Standards (GAAS) and Governmental Auditing Standards.
    - That the audit was planned; risks were assessed; accounting policies evaluated; internal controls were considered; that no opinion will be given on the effectiveness of internal control.

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## Independent Auditor's Report

- Sections of the Auditor's Report
  - ◆ Opinions
    - If the in the auditor's opinion they believe that the financial statements are fairly presented in accordance with GAAP this section will tell you this.
    - If the auditor does not believe the financial statements are fairly presented the opinion will be Modified.
    - Modified Opinions are usually a bad sign and you should understand the reason.

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## Management Letter

- At the conclusion of each audit a management letter may issued by the Independent Auditor.
- It is not required if there are no findings that are considered significant.
- It is a good idea to get a copy of recent management letters before you start reviewing the actual financial statements.

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## Management Letter

- The management letter does not provide an opinion but instead deals with the Auditor's evaluation of the Town's internal control over financial reporting.
- The internal control evaluation is limited and will not identify all weaknesses.
- A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis

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## Management Letter

- A Material Weakness is the most serious finding.
  - ◆ A material weakness is a deficiency or a combination of deficiencies in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.
  - ◆ One common example is that the Town did not reconcile Cash for the entire year.
    - Cash is a material item and an undetected error could lead to a material financial statement misstatement.
    - Since it was not performed at all the IC is not timely.

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## Management Letter

- A Significant Deficiency is a level down from a material weakness but is still serious. Significant deficiencies must also be communicated in writing to management.
  - ◆ A significant deficiency is similar to a material weakness only that the possible financial statement error is a low dollar value.
  - ◆ One example is that the Town did not have an internal control policy and related procedures on the timeliness of the Departmental receipts.

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## Management Letter

- An Other Matter is normally a finding that does not have any significant financial impact but it is a best practice recommendation.
- For example, Cash may be reconciled each month but the process is entirely manual and time consuming. The suggestion may be to automate the process to be more efficient.
- All of these findings will provide insight into how well your community is managed.

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## Before the Annual Audited Financial Statements

- Audited Financial Statements come out once per year and usually between 1 to 7 months after year-end.
- Information received as a Finance Committee member during the year will do more to set expectations of what you will see in the audit.
- The Budgetary Process sets the most important stage for the audited results.

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## Before the Annual Audited Financial Statements

- The General, CPA, Enterprise and Stabilization are budgeted funds that will determine your overall financial position.
- Do you receive Interim Reports?
- How often?
- Is a management narrative attached?
- Are there many significant changes close to year-end?

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## How are the Financial Statements Prepared

- Umas budgetary basis foundation is how the day-to-day accounting is maintained.
- Using the budgetary numbers several adjustments are made to build to the Fund Based Modified Accrual Basis of Accounting GAAP Statements. These are most important to the rating agencies.
- Using the Modified Accrual numbers long-term assets and liabilities are added to get to the Full Accrual Entity-wide Statements.
- Each layer is the foundation for the next level.

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## Financial Statement Components

- Independent Auditor's Report
- Management's Discussion and Analysis
- Entity-wide Financial Statements
- Governmental Fund Based Financial Statements
- Proprietary Financial Statements
- Fiduciary Financial Statements
- Budgetary Financial Statements
- Notes to Financial Statements
- Required Supplementary Information

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## How Do I Start My Review?

- The best place to start the review is the financial statement that is most familiar to you
  - The General Fund Budget to Actual Statement
- The next statement is the General Fund within the Governmental Funds.
- Next is the Major and Nonmajor Governmental Funds

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## How Do I Start My Review?

- Next is the Governmental Activities on the Entity-wide Statements
  - ◆ To understand the changes between the modified accrual and full accrual governmental activities use the Reconciliation Statements.
- Move to the Internal Service Funds which most times is an Self-insured Health Trust fund.

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## How Do I Start My Review?

- The last financial statement to review are the Enterprise funds (Water/Sewer etc.)
- Finally read the MD&A, Notes and Required Supplementary Information.

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## Key Areas of the Budget to Actual Statement

- This statement provides the Original and Final Budget per the RECAP; the actual revenues, expenses and transfers; encumbrances and articles carried forward; and total fund balance.
- The fund balance is the starting point for the calculation of Free cash. However there are a series of fund balance reservations and other items that change fund balance to free cash. This cannot be found in these statements.

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## Key Areas of the Budget to Actual Statement

- Revenues
  - ◆ Review how accurate the estimated revenues are compared to actual results.
  - ◆ Significant surpluses indicate that conservative estimates are used to maintain fiscal stability
  - ◆ Significant deficits indicate that the Town may be stretched to its limit by maximizing revenue estimates to postpone reducing appropriations

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## Key Areas of the Budget to Actual Statement

- Expenditures
  - ◆ Review Original and Final Budget Amounts to see if any significant changes occurred
    - ◆ A significant increase in an appropriation can indicate that the Town under-budgeted the ATM amounts and waited for free cash to be certified to bump it up to the proper level. If free cash came in at a lower level the Town may be forced to cut annual appropriations several months into the year. This is a recipe for disaster.

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## Key Areas of the Budget to Actual Statement

- Expenditures
  - ◆ Look to see if any deficits occurred between the Final Budget and Actual
    - ◆ Normally deficits should only occur for snow and ice or court judgments
    - ◆ If additional deficits are presented you should find out why.
    - ◆ The notes should disclose these deficits.

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## Key Areas of the Budget to Actual Statement

- Transfers In/Out
  - ◆ The notes to the financial statements should describe the amounts and purpose of these transfers.
  - ◆ You should understand the purpose and the corresponding fund.
  - ◆ Many transfers in are recurring annual amounts where the corresponding fund replenishes its fund balance from recurring revenue. This is normal.

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## Key Areas of the Budget to Actual Statement

- Transfers In/Out
  - ◆ Large transfers in from a Stabilization Fund could indicate that a structural deficit may exist. The Stabilization Fund is usually replenished by transfer from the General Fund. This should have been seen during the Budgetary Process and it is then where action should be taken.
    - ◆ Have these transfers been balancing the budget for years?
    - ◆ When will the stabilization fund be depleted?

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## Key Areas of the Budget to Actual Statement

- Transfers In/Out
  - ◆ Review transfers to see if there are transfers out to an enterprise fund. This may indicate that the enterprise fund is not self-supporting but Town Officials are reluctant to raise rates.
- Fund Balance
  - ◆ The amount should be positive and a policy of what the unreserved balance should be as a percentage of budgeted expenditures.

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## Key Areas of the Budget to Actual Statement

- Fund Balance
  - ◆ We audit many Towns that are just concerned with breaking even each year and spending most of their free cash each year or use free cash to reduce the tax rate.
  - ◆ If when reviewing the General Fund budget each year you see the constant use of Free Cash to balance the budget without at least 5% of recurring expenditures of free cash unused each year you are just waiting for a budget crises and cash flow problems.
  - ◆ Reserves and Stabilization funds are good things to have.

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## General Fund Key Areas

- The Fund Based General Fund revenues, expenditures and transfers should be close to the budgetary results. However GAAP throws a couple of curve balls to complicate the comparison.
- Most of the key analysis of this fund was accomplished in the budget/actual statement.

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## General Fund Key Areas

- GAAP requires that most stabilization funds be combined with the General Fund for the fund based presentation.
- The rational is the Stabilization Fund is just a sub-fund of the General Fund since it is usually funded by GF contributions.
- Therefore the Fund Balance will look a lot higher than your free cash calculation. The Notes should detail these amounts.

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## General Fund Key Areas

- **Balance Sheet**
  - ◆ The Balance Sheet should be reviewed with the last few years. The Town services provided is usually pretty consistent year-to-year and therefore the balance sheet amounts should be consistent.
  - ◆ Focus your review on any significant changes.
  - ◆ Recently I completed a forensic audit on a Town that showed outstanding receivable balances increasing by significant amounts over the past several years. This was a red flag that funds were being stolen however it went undetected.

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## Stabilization Funds

- As just stated the Stabilization Funds are combined with the General Fund for financial statement purposes.
- Read the notes and MD&A to determine how these funds are either accumulating or depleting.
- It may be best to receive this information directly from the Town Accountant.

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## Other Governmental Funds

- Within the Governmental Fund Based Statements are Special Revenue, Capital Projects, Debt Service and many Trust Funds.
- The special revenue and trust activity are usually self-supporting and recurring such as school state and federal grants. These should not cause much concern unless there are significant accumulated surpluses or deficits.
- If there are any significant deficits then the notes are required to disclose these amounts. If there is not a future revenue source then the General Fund will have to fund the deficit.
- Any significant surplus will be difficult to find by just reviewing the financial statements so you should request a fund analysis from the Town Accountant.

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## Other Governmental Funds

- The Capital Project Fund is also included within this statement. Capital Projects can carry a temporary deficit at any time during the project based on the timing of borrowing and grants being received. The financial statements may show a deficit if a Bond Anticipation Note is outstanding and the project has not been permanently financed.
- If there is a financial statement deficit you should ask the Town Accountant if there is any projected permanent deficit.

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## Major and Nonmajor Funds

- GAAP requires that any "Major" Fund be presented in its own column based on certain criteria.
- What is normally seen is a Major Capital Project such as a new high school or Community Preservation.
- All other funds are accumulated in the single column for Nonmajor funds. Unless you prepare a CAFR this detail will not be found.
- These funds are not budgeted and most times are not part of a Finance Committee review. You may want to request the detail to see if any other available funds are available.

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## Internal Service Fund

- This is usually a Self-Insured Health Insurance Trust.
- Here is an instance where the Budgetary Basis is the same as full accrual GAAP.
- A liability must be recorded for an estimate of the future payments of benefits commonly referred to as Incurred But Not Reported (IBNR).
- MGL requires that any deficit be raised on the RECAP without exception.
- Revenues are mainly employer and employee contributions at a specific rate (75/25).

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## Internal Service Fund

- The law also requires that the employer/employee split be accounted for and that if it becomes out of balance the fund must be rebalanced.
  - ◆ Most times this requires that the Town increase its contributions
  - ◆ This will be difficult to see as part of the financial statement unless you compare several years contributions to the split known.
- Another issue that is not readily seen is when converting from self-insured to a premium based plan that there may be a employee withholding deficit.

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## Enterprise Funds

- Each Enterprise Fund is required to be Budgeted and recorded on the RECAP.
- Unlike the General Fund, GAAP does not allow a budget-to-actual statement to be presented.
- This makes the analysis of what you are familiar with extremely difficult.
- The main problem is that the budgeted operating activity is commingled with capital activity, long-term liabilities and long-term assets.

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## Enterprise Funds

- The information presented on the financial statements is useful to determine the long-term financial viability of the enterprise similar to a commercial enterprise.
- However for most finance committees the focus is more on the current budget. It is not feasible to try to extract this information back to the budget. The statement of cash flows will show the operating cash results separate from the capital and financing activity but you need to be experienced to analyze the results.
- It may be best to use the Town ledgers and not the financial statements.

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## Enterprise Funds

- The purpose of an Enterprise Fund is to be self-supporting but if it is not you should look to see what the General Fund contribution is.
- This information is best seen by reviewing the RECAP as the amount must be included if there is support.
- On the financial statements you will see this as part of Transfers In.
- The other form of support can be not charging indirect costs or paying debt service on be-half of the enterprise.

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## Pension and OPEB Trusts

- These funds are set aside and can only be spent on retiree's pension and health insurance. The funds cannot be accessed by the General Fund.
- These funds are meant to be measured with a long-term perspective since they are being accumulated for long-term liabilities.
- Investment performance is measured on both a short and long term basis but the actuarial valuations use long-term rates of return.

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## Net Pension Liability

- Starting in FY2014 governments were required to start implementing the Pension Related GASBs.
- GASB 67 – Financial Reporting for Pension Plans required any community with a Pension Plan to report the activity and the statement of net position in accordance with the new standard.
- If your community did not have a Pension Trust Fund you did not have to do anything.
- The Pension Plan receives member assessments, employee pension withholdings and other contributions.
- The Plan paid retiree benefits and administrative expenses

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## Net Pension Liability

- The Assets include cash, long-term investments and miscellaneous receivables.
  - ◆ Most Plans now invest in the state controlled Pension Reserve Investment Trust (PRIT) – they manage their investments to achieve an annual investment return of 7.5%.
  - ◆ Some plans do not invest in PRIT but instead use investment advisors to manage their investments to also achieve an annual investment return of 7.5%.
  - ◆ This expected long-term "Rate of Return" is a major factor the Actuary Uses to calculate the Total Pension Liability.

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## Net Pension Liability

- GASB 68 – Accounting and Reporting for Pensions – relates to how to report the Net Pension Liability on the financial statements of the Employers.
- The underlying process has many factors that require a lot of explanation but for the purposes of this presentation I will highlight the key elements only.
- The ability to have a Net Pension Liability (Unfunded Liability) is unique to governments and really cannot happen in the private sector.
- Why is that? Risk of Payment and Discount Rate.

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## Net Pension Liability

- The actuary uses the census data from the employer and retirement system to project total future benefits for the current employees and retirees.
- They then discount these future payments using a discount rate to the current present value.
- Governments can use a discount rate equal to or less than the expected rate of investment return.
- Private companies must use a "Risk Free Rate" which is a lot lower. The Lower the rate the higher the liability.

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## Net Pension Liability

- It is illegal for Private Companies to have an unfunded liability because it shifts the burden of investment returns to the employee/retiree among other things. They also can go out of business.
- For Massachusetts governments the payment of pensions is law and must be honored by the state and local governments.
- The risk of payments is minimal since in 100 years there still will be a State of Massachusetts and the Town of Andover. It is illegal for a community to go bankrupt
- The Town may have to forego services if the investment returns are insufficient but the retirees will still be paid.

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## Net Pension Liability

- Since the risk of payment is minimal, the discount rate used and be higher and reduce the liability.
- The Net Pension Liability (NPL) is simply the Total Pension Liability less the Total Net Position. The % Funded is just the Net Position divided by the Total Pension Liability.
- What should you look for and where is the information?
- There is a long footnote that describes the NPL. You will see the NPL calculation and % Funded.

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## Net Pension Liability

- There also is a schedule that is called a Sensitivity of the NPL to Changes in the Discount Rate.
- Communities can use a wide range of rates which currently range from 6.0% to 8.0% with most between 7.0% and 7.5%.
- The schedule shows the NPL with the rate used, for Andover 6.25%, and what it would be if the discount rate was 1.00% higher or 1.00% lower.
- The liability increased by 23.4% at 5.25% and decreased by 19.6% at 7.25%.
- If you compare 2 communities make sure you know the Discount Rates.

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## Net Pension Liability

- The next place to review is the Required Supplementary Information Section following the Notes.
- If your Town has a pension trust you will find a 10 year schedule of changes in the NPL and related ratios.
- This is the best way to measure your funding progress. The top section shows the changes in the Total Pension Liability and the bottom sections shows the changes in the Net Position.
- Investment income is volatile year-to-year but over a long-period should come close to that 7.00% range. A 10 year Schedule of Investment Returns is included.
- This can explain wide swings between years.

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## Net Pension Liability

- If you are member of a Regional Retirement System there is not a Pension Trust and schedule to indicate the change in NPL.
- You will see a 10 year Schedule of the Town's Proportionate Share of the NPL.
- This shows your proportionate percentage; your share of the NPL; covered payroll; NPL as a % of covered payroll; and the Plan's % funded.
- Currently there are 104 Retirement Systems and the Funding % range from 30% to 100%. Law requires that each system is fully funded by 2040. The notes should disclose when you system is expected to be funded.

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## Net Other Post Employment Benefit (OPEB) Liability

- Each Town has their own plan and there is no proportionate share allocation.
- Not all Towns have established an OPEB Trust and even the Towns that did have not made a significant dent in Funding the liability.
- The GASB does not allow the Town to use a higher discount rate as their funding plan is not sufficient to eventually pay for all of the future payments.
- They use a risk-free rate equal to the rate on a AA rated 20 year Municipal Bond Index or a blended rate.

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## Net Other Post Employment Benefit (OPEB) Liability

- Therefore the % Funded is extremely low in most cases.
- The Commonwealth does not have legislation mandating a funding schedule so most are currently pay-as-you-go.
- The accounting and disclosures are substantially the same as Pension and you will find the notes and required supplementary information.
- You should ask about the Town's plan to fund or not to fund this liability as the financial statements will show the magnitude of the liability.

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## Debt

- Towns issue debt for a variety of reasons. Some reasons are for sound financial purposes while the need for others may indicate financial weakness.
- Revenue Anticipation Notes – These are normally for short-term cash flow needs. These are required to be paid down completely by year end. You will not see them on the Balance Sheet or Statement of Revenues and Expenses and you will not know they were issued unless you review the Notes.
- We normally do not see this debt recently but if they are issued it is usually an indication of insufficient General Fund Balance. You should find out why.

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## Debt

- Grant Anticipation Notes – these are usually done for a sound reason such as Chapter 90 deficits at year-end that will reduce free cash unless the funds are borrowed and MSBA school construction where the cost reimbursement submittals may take a month or two to receive the capital grant revenue.
- You will find this activity in the Notes to the Financial Statements and a description of the purpose of the note. These are usually not an indication of a problem.
- Bond Anticipation Notes – these are issued as temporary financing on major capital projects to cover the cash flow needed until the long-term debt is issued.

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## Debt

- Long-term Debt – is issued to pay for the acquisition or construction of long-term capital assets. There is a footnote on long-term debt that describes any new issues; current debt retirements; ending balance; and out-year debt service requirements for principal and interest until maturity.
- Things to look for is the percentage of the general fund budgeted expenses that current debt service expenses make up out of the total expenses.
- If that % is 10% or higher you should review your capital plan to see if debt service will require cutbacks in other areas.

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## Capital Assets

- Capital Assets – The value of the capital assets are tied in directly to long-term debt. The higher the capital asset net book value the higher debt should be.
- The entity-wide full accrual statements will capture within the Net Position section the difference between the NBV of Capital Assets less the outstanding debt used to acquire them. This is the Town's Investment in Capital Assets.
- If the NBV of Capital Assets are low this may be an indication of old buildings and infrastructure that may need to be replaced soon.
- But you should know this – You live in the Town.

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## Entity-Wide Financial Statements

- The entity-wide financial statements are the full accrual statements and are broken down by Governmental Activities and Business Type Activities.
- The Business Type Activity are the same as the Enterprise Funds except they are in a different format. Not need to review these again.

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## Entity-Wide Financial Statements

- The Governmental Activities are created by adding long-term assets and liabilities along with removing deferred revenues from the Governmental Funds discussed earlier.
- The easiest way to review these statements is to review the two reconciliation statements that detail the difference between the two bases of accounting.

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## Entity-Wide Financial Statements

- These statements will present the financial position of the Town and break down the balances into:
  - ◆ Net investment in Capital Assets
  - ◆ Restricted net position for trusts, grants and similar accounts
  - ◆ Unrestricted
- The major concern is how these long-term liabilities and assets will affect future budgets.

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## Thank You

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