

EXCELLING IN MUNICIPAL FINANCE

UNDERSTANDING FINANCIAL STATEMENTS

(Editor's Note: Below is the first in a series of articles on financial statements designed to help local finance and management officials analyze financial statements and strengthen their municipality's budget process.)

ACCOUNTABILITY

As dull and unimaginative as finance may seem, the realm of numbers and calculations serves an important role in the world of management. You can tell a lot about a municipality from its financial statements: what its priorities are, how well it plans for the future, how well it manages its resources, and what kind of resources it has.

Taxpayers approve a budget and hold the municipal government accountable for proper management of that budget and the resources that fund it. If you don't know where those resources are going, or if they are being used to accomplish the goals of your taxpayers as represented in the budget, you've failed in your role as steward of public funds.

The best way to be accountable is to know your way around your budget and your financial statements. Finance officials should be able to provide all three documents discussed below – Budget Report, Statement of Revenues, Expenditures and Changes in Fund Balance, and Balance Sheet - to managers and board members. Accounting software allows you to provide both annual and monthly reporting, with budget reporting on a more frequent basis. Managers and boards should be monitoring these reports on a regular basis, looking for signs of any potential problems. Remember: proactive financial management is the best way to prevent financial disaster and will protect your taxpayers from having to raise taxes to fund deficits.

Below is a brief overview of what is found in municipal financial statements. Next month, we will look at how to monitor and evaluate these statements. In March and April, look for articles in our Tech Check column on using Microsoft Excel to calculate ratios and to perform trend analysis and forecasting – all important building blocks for accurate and useful financial statements.

FINANCIAL STATEMENT BASICS

The first step in analyzing financials in a meaningful way is to have a good understanding of their basic structure. And the first important rule in municipal accounting is: **Assets = Liabilities + Fund Balance**.

Assets are what you own, and Liabilities and Fund Balance are how your Assets are divided up between your debt (all Assets that are financed, i.e. Liabilities) and what you own free and clear (Fund Balance). To go a step further, your Fund Balance can be calculated by taking the total of your Assets and subtracting what you owe (your Liabilities).

Fund Balance can be divided up into a couple of categories: Reserved and Unreserved. Reserves are funds that are set aside for a specific purpose and have some sort of legal basis, such as taxpayer approval, or state or federal mandate; these cannot be used for any other purpose. Unreserved funds are those discretionary funds that are left and will generally be carried over into the next budget to reduce taxes or to just leave as a contingency or to use in another fiscal year.

Every year when you complete your annual financial reporting, you find your ending Fund Balance by taking your Beginning Fund Balance, adding your Revenues (what you've earned), and subtracting your Expenditures (what you've spent). This will increase your current Fund Balance or decrease it depending on whether you had a surplus or a deficit for the year.

THE REPORTS

Your financial reports give you a snapshot of where you are financially at any given point in time. The **Budget Report**, or to use your auditor's terminology, the Budgetary Basis Report,

will show you how well you did against what you budgeted. It is a report of revenues collected and appropriations expended with a column for the variance - how much you were either over or under what was budgeted (Budget minus Actual).

The **Statement of Revenue, Expenditures, and Changes in Fund Balance** is exactly what it says it is. It details your revenues and expenditures, and at the bottom shows the difference between the two, either a surplus if you had more revenue, or a deficit if you had more expenditures. It then shows the beginning fund balance and adds the surplus (or subtracts the deficit) to give you the ending fund balance.

The **Balance Sheet** shows all of your assets, then looks at those assets in terms of the amount that is debt (Liabilities) and the amount that isn't (Fund Balance). The Fund Balance should of course match the ending Fund Balance from your Statement of Revenue, Expenditures, and Changes in Fund Balance. *Assets consist of:*

- **Cash and Investments** – Petty cash, checking and savings accounts, certificates of deposit, money market accounts, and all forms of investments.
- **Receivables** – Taxes, penalties, loans or any other bills owed to you, as well as interest that has accrued on investments but hasn't yet been paid to you.
- **Interfund Receivables** – (Due From Other Funds) – In Fund Accounting you have a situation where one fund, the General Fund, pays all the bills for other funds that may be accounted for separately, like a Fire Fund or Sewer Fund; every time a bill is paid in the General Fund for one of these other funds, an Interfund Receivable is set up to show that the other fund owes the General Fund for that transaction.
- **Prepaid Expenses or Deferred Costs** – Payments you've made for expenses that won't actually be incurred until after the current budget year; an example would be insurance that's paid for prior to the new fiscal year, or costs that may be paid in the current year but allocated to future years to offset revenues that will be received against them.
- **Property, Plant and Equipment** – The cost of these less depreciation.
- **Amount to be Provided for Long-Term Debt** – An offset to the funds you have to provide to pay off bonds or other long-term obligations; this kind of debt requires a commitment from your taxpayers and that commitment is recorded as an asset to offset the debt liability.

Liabilities consist of:

- **Payables** – Any bills, payroll and tax withholdings, or short-term loans and leases that you owe and haven't yet paid.
- **Interfund Payables** (Due to Other Funds) – Similar to Interfund Receivables. The General Fund receives all cash from revenues for other funds that may be accounted for separately, like a Fire Fund or Sewer Fund; every time cash is received in the General Fund for one of these other funds, an Interfund Payable is set up to show that the other fund owes the General Fund for that transaction.
- **Deferred Revenue** – Revenue you received this year that is really for next year's budget (such as taxes).
- **Compensated Absences** – What you owe your municipal employees for leave such as vacation and sick time accrued and not yet used.
- **Bonds, Notes and Capital Leases Payable** – All your long-term (over a year) debt that is owed (offset on the asset side by the Amount to be Provided for Long Term Debt).

Fund Equity consists of:

- **Contributed Capital and Retained Earnings** – These categories occur in Enterprise (such as Sewer and Water) and Internal Service Funds and refer to capital that is contributed to the fund to become permanent equity, and earnings that are retained in the fund including the net investment in property, plant and equipment.
- **Fund Balances** – Both reserved and unreserved balances; unreserved may also consist of both designated and undesignated funds (designated funds are funds set aside by

management to be used in the future for some specific purpose, as opposed to reserved funds which are set aside with taxpayer or by other legal mandate).

- *Mike Gilbar, VLCT Director of Administrative Services*

VLCT News, January 2002