

FUNDAMENTALS OF UNDERSTANDING GOVERNMENTAL AUDIT REPORTS

CITIZEN'S GUIDE TO UNDERSTANDING FINANCIAL STATEMENTS

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WHAT TYPE OF ACCOUNTING SYSTEM IS USED?

Any type of government unit that isn't the State of Michigan is called a unit of local government or local unit. Local units and the State of Michigan use an accounting system that is identified as fund accounting. It is called fund accounting because financial data is grouped into funds, also known as accounts. The accounts share a similar purpose and by grouping the accounts with similar purposes together, a local unit can easily identify resources (money) for a specific purpose or task.

There are three general categories of funds in a local unit's audit report, they are:

1. **Governmental Funds:** Governmental funds are used to cover expenditures of general operations (just like a person pays his or her household or business bills). Examples of general operations expenditures include construction costs, debt repayment, and local unit services that are not covered by fees such as public health and public safety.
2. **Proprietary Funds:** Proprietary funds are used to keep track of (account for) business like activities (activities supported, in part, by fees or charges). Examples of proprietary funds include trash collection fees, water and sewer fees, park fees, and highway repair fees.
3. **Fiduciary Funds:** Fiduciary funds are used to keep track of (account for) funds that are held by the local unit in a purely custodial capacity for a third party. An example of a fiduciary fund is the "Current Tax Collection Fund," which holds money on behalf of another governmental unit, such as the State of Michigan or the United States Internal Revenue Service.

HOW OFTEN ARE AUDIT REPORTS FILED?

Local units within the State of Michigan are required by law to file an audit report. Local units with populations less than 4,000 are required to file their audit reports every two years instead of every year. All other local units with populations over 4,000 are required to file their audit reports each year. Occasionally, you will hear the term "CAFR" used. This stands for "Comprehensive Annual Financial Report". A CAFR includes statistical data and additional schedules. As the name suggests, it is more comprehensive than an audit. A local unit is not required to file a CAFR with the State but it is not prohibited.

WHAT IS AN AUDIT?

A local unit contracts with an independent Certified Public Accounting (CPA) firm to opine on whether the financial statements prepared by the local unit and presented by its management are fairly presented. In part, the CPA (auditor) tests a sampling of financial transactions to ascertain the reliability of the financial statements. An audit provides reasonable assurances, not absolute, that the financial statements are free of material misstatements. Examples of financial transactions can include verifying bank account balances, tracing invoices, tracing cash receipts, and reviewing contracts to determine compliance. The CPA also obtains an understanding of internal controls to assess the risk of a material misstatement. Once the CPA completes the testing, the CPA issues an opinion letter. This letter does the following:

1. Asserts that the audit was conducted in accordance with generally accepted auditing standards.
2. Provides an opinion on the fair presentation of the financial statements. The opinion could be one of the following four:
 - a. **Unqualified** - there are no reservations concerning the financial statements. This is also known as a clean opinion meaning that the financial statements appear to be presented fairly.
 - b. **Qualified** - the auditor has taken exception to certain current-period accounting applications or is unable to establish the potential outcome of a material uncertainty which could have a material effect on the financial statements. A qualified opinion typically includes an "except for" clause or similar wording.
 - c. **Disclaimer** - the auditors were engaged to perform an audit, but are unable to express an opinion. This may be due to a lack of independence on the auditor's part; limitations on the scope of the audit, for example, the inability to obtain sufficient evidence; or material uncertainties for which the auditors were unable to obtain reasonable assurance about the outcome.
 - d. **Adverse** - this is a type of audit opinion which states that the financial statements do not fairly present the financial position, results of operations, and changes in financial position, in conformity with generally accepted accounting principles.

WHAT IS IN AN ACTUAL AUDIT REPORT?

Most Audit Reports contain the following information:

1. Financial Statements of the local unit including:

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- a. Statement of Net Assets (assets minus liabilities)
- b. Statement of Activities (net cost of a function)
- c. Balance Sheet (assets = liabilities plus Fund Balances)
- d. Statement of Revenues, Expenditures, and Changes in Fund Balance which shows what money came into the local unit, the bills paid, and how the fund balance has changed from one year to the next.

Financial Statements are usually presented in two different ways in the same audit report.

1. Government-Wide Financial Statements: Government-Wide Financial Statements show the financial position of the whole local unit and should be used to assess the local unit in its entirety.

2. Fund Financial Statements: Fund Financial Statements focus on the current financial position of the separate funds of the local unit.

To have an overview of how a local unit of government is performing financially, you should focus on the financial statements of the General Fund. In particular, you should look closely at the Statement of Revenues, Expenditures, and Changes in Fund Balance that contains the following:

1. Revenues: This tells you how much money the local unit has received from its own operations during a fiscal year, such as property taxes, license fees, fees for permits and grants.

2. Expenditures: This tells you the bills paid by the local unit during a fiscal year, such as general government expenses, utility charges, public safety and transportation.

3. Other Financing Sources/Uses: You may see other sources or uses of money not generated by the day to day operations. Those monies are received or used on a one-time basis and are not expected to be repeated. Examples of one-time sources of income include money resulting from issuing bonds (public borrowing of money), borrowing from other funds of the local unit (inter-fund transfers), and sales of capital assets such as buildings or land.

Examples of one time uses of income include loans to other funds (inter-fund transfers), and payments related to refunding a bond.

4. Fund Balance: This item shows you the changes

in the Fund Balance, such as:

- a. If the local unit is receiving more revenue than it needs to pay its bills its Fund Balance (net worth) will increase.
- b. If the local unit is paying out more money on its bills than it is receiving then its Fund Balance will go down.
- c. If the Fund Balance goes down far enough, it creates a negative Fund Balance called a deficit. In Michigan, any local unit with a deficit in any of its funds at the end of its fiscal year must prepare and send to the Michigan Department of Treasury, for approval, a Deficit Elimination Plan. This plan provides details of how the local unit will eliminate the deficit within a stated period of time.

To figure out the net worth of a local unit, the calculation is usually revenues minus expenditures, plus or minus other financing sources/uses that will either increase or decrease the Fund Balance.

Fund Balances can be split into two more categories:

1. Restricted Funds which are monies being held in this fund for a specific purpose.

2. Unrestricted Funds which are monies being held in the General Fund for all general operating purposes of the local unit.

The ending General Fund balance shows the "net worth" or equity of the local unit. The ending General Fund balance should be the same number as is shown for the Fund Balances reported on the Balance Sheet.

Notes to the financial statements are usually found in the middle of the audit report. When you read the notes, they give you insight into the details of the financial statements and are very important for you to understand the financial statements.

Budgetary comparison information is another useful part of the audit report to review. This typically presents the original budget, the final appropriated amounts, and the actual inflows, outflows, and balances. This is useful to determine if resources were obtained and used in accordance with the legally adopted budget.

This information was taken from the State of Michigan Department of Treasury's website at www.michigan.gov/treasury.

