Financial Reporting for Small Cities

In June of 1999 the Governmental Accounting Standards Board issued Statement 34 (commonly known as GASB 34), *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, which greatly expanded and changed the financial reporting requirements for state and local governments reporting in conformity with generally accepted accounting principles (GAAP). The statement’s effective date was over a three-year period beginning with the largest governments implementing for their 2002 fiscal year, medium size governments implementing for fiscal year 2003, and small governments in the third phase, fiscal year 2004. For Minnesota’s small cities, reporting on the GAAP basis, the new reporting requirements are effective for the year ended December 31, 2004. Thus with the end of calendar year 2004, all state and local governments that report GAAP financial statements are subject to the requirements of Statement 34, as amended.

The question is often asked, do local governments, in particular Minnesota cities, have to prepare GAAP financials and therefore need to implement the requirements of GASB 34? The always-popular answer is of course: it depends. In Minnesota, all counties have to report GAAP financial statements. For cities and towns it is a different story. Minn. Stat. §477A.017, subd. 2 requires the state auditor to prescribe uniform financial reporting that is in conformity with national standards for cities and towns over 2500 in population. Thus the financial reporting standards prescribed by the state auditor for cities and towns over 2500 in population are financial statements prepared in conformity with generally accepted accounting principles, including all applicable requirements of GASB 34, as amended. The statute goes on to require the state auditor to set uniform reporting standards for cities under 2500 in population. Missing is the requirement that the reporting standards be in conformity with national standards. Therefore, there is not a statutory requirement that cities under 2500 population report GAAP financial statements. Those cities may prepare GAAP statements as a good business practice or because of some contractual requirement, but are not required to by statute.

So what are the financial reporting requirements for cities under 2500 in population? To answer that you also need to look at Minn. Stat. §471.698 which requires cities under 2500 to prepare a detailed statement of its financial affairs in a form prescribed by the state auditor. The statute identifies the specific information required to be included in this statement. This statement is required to be submitted to the state auditor and kept on file with the city clerk or finance officer. Thus, the standards for the financial statements for small cities are prescribed by the state auditor and are commonly known as the minimum reporting requirements for cities less than 2500 in population.

So what were the minimum reporting requirements? Historically, the State Auditor has issued the minimum reporting requirements for small cities, which have consisted of certain required schedules designed to provide the information required by Minn. Stat. §471.698 and §471.6985, which deals with reporting by municipal liquor stores. Most of these schedules reported transactions on the cash basis. This meant revenues (receipts) were recognized when received and expenditures (disbursements) when the actual payment was made. The schedules for the liquor store and other enterprise funds were to be on the accrual basis of accounting. This mix of very different accounting bases can be confusing, especially if these financial statements are being audited.
So what effect does an audit have on the form of the financial statements? It can have a significant impact, because an auditor is providing third-party assurance that the financial statements are presented fairly in conformity with established criterion. One of the primary ways for enforcement of accounting principles is the independent auditor’s opinion. In most cases the auditor is giving an opinion on whether the financial statements are presented in conformity with GAAP. However, independent auditors also are allowed to give opinions on financial statements prepared on recognized other comprehensive bases of accounting (OCBOA). Audit standards recognize three other bases of accounting that could be applicable to local governments: the cash basis, the modified-cash basis, and the regulatory basis. The differences between these bases of accounting relate to when, what, and where assets, liabilities, revenues and expenditures are reported in the financial statements. Most people are familiar with the cash basis. The modified-cash is basically adding additional requirements to the cash basis that move the financial reporting towards GAAP presentation. Because audit standards only allow auditors to give opinions on these recognized accounting bases, generally the financial statements will conform to one of those accounting bases.

What is the guidance for these other comprehensive bases of accounting? There is little authoritative guidance for the cash or modified-cash bases of accounting. There are no recognized bodies for establishing standards for these bases, which has resulted in various practices in the form and content of cash or modified-cash basis financial statements. It is actually auditing guidance that provides some standard of uniformity for these OCBOA. The audit standards provide specific guidance for an auditor in determining and evaluating the appropriateness of disclosures in certain OCBOA financial statements. In general if guidance on a particular account or transaction that would be included in an OCBOA presentation, exists in GAAP, then that guidance would also be applicable to the OCBOA presentation. Therefore, some of the guidance for the form and content of cash or modified-cash bases financial statements would actually come from GAAP.

What effect does GASB 34 have on cash basis or modified-cash basis financial statements? Because similar information is required for either of these OCBOA financials, as well as GAAP financials, some of the GASB 34 requirements would be applicable to financial statements prepared on the cash or modified-cash bases of accounting. Some GASB 34 requirements that are applicable to the cash or modified-cash are the management’s discussion and analysis (MD&A), government-wide financial statements on a cash or modified-cash basis, separate broad fund-type category financials, reporting by major fund, and budgetary comparisons. There also could be additional GASB 34 requirements applicable to modified-cash basis financial statements depending upon the modifications to the cash basis. So even though an entity may not be required to report on a GAAP, some of GASB 34 requirements are applicable if they are reporting on a cash or modified-cash basis.

What is a regulatory basis of accounting? Audit standards define a regulatory basis as a basis of accounting that the reporting entity uses to comply with the requirements or financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject. In effect an entity would prepare its financial statements under the reporting requirements of a regulatory authority that would have oversight for that entity. In Minnesota, the State Auditor’s minimum reporting requirements for cities under 2500 is viewed as regulatory guidance for small cities to report on a regulatory basis of accounting. In the past most Minnesota’s audited small cities have reported on either the cash or regulatory bases of accounting.

So why have some chosen the regulatory versus the cash basis? Remember Minn. Stat. §471.698 requires cities to report certain financial information to the state auditor. This reporting
requirement is applicable to all cities under 2500 whether or not they are subject to audit. The minimum reporting requirements are not specifically required to be audited. There may be other reasons, but usually a small city has an audit requirement because they have combined the offices of clerk and treasurer. Since both the minimum reporting requirements and the audited financial statements are required to be submitted to the state auditor, some cities combine the requirements and have their independent auditor give an opinion on their financial statements prepared on a regulatory basis. Other cities prepared their financials on a cash basis, have their auditors give opinion on those financials, and submit to the state auditor additional information, either audited or unaudited, needed to meet the minimum reporting requirements. The drawback of the regulatory basis is that those financial statements would be considered a restricted use report, because they are intended for use only by the entity and the regulatory authority. This restriction and the intended uses of the report impact the independent auditor’s opinion on the financials.

What is the impact of a restricted use report and the auditor’s opinion? In general a restricted use report is a report by an independent auditor that is identified as being only for the use of specified parties, usually the entity and the regulatory authority. Usually this means that the report will have limited distribution. This is not the case of financial statements of Minnesota cities, which statements are considered a public document. Minn. Stat. 471.698 requires publication of the financials and that they be kept on file for public inspection. The effect of these requirements makes the statements a report for general distribution. In this situation it therefore requires that the independent auditor first give an adverse opinion on the fair presentation in conformity with GAAP and then give his/her opinion on fair presentation in conformity with the regulatory basis of accounting.

What are the current requirements from the State Auditor? The State Auditor’s office has just issued guidance on the format of financial statements for small cities that are subject to an audit. This publication provides example financial statements prepared on the cash basis with one modification. The one modification to the cash basis is to include long-term investments, valued at cost, as an asset. These financial statements have been changed to reflect applicable requirements of GASB 34. Also, the publication provides the option for small cities to prepare regulatory-based financial statements. The difference is that this regulatory basis eliminates the requirement for an MD&A and government-wide financial statements. These options provide for uniformity, but also give the cities an opportunity to select what type of audit opinion they feel meets their city’s needs. A city can choose to have either an opinion on presentation in conformity with the cash basis of accounting or one on the regulatory basis described above, which has the mix of an adverse opinion on the GAAP basis with the opinion on conformity with the regulatory basis. The reporting and publication requirements for small cities subject to audit are available on the State Auditor’s web site: www.auditor.state.mn.us. The State Auditor’s Government Information Division in September 2004 also issued minimum reporting requirements for those small cities that do not have an audit requirement. This document is also available on the State Auditor’s web site.

In summary, cities under 2500 in population have different options for preparing their annual financial statements. All small cities must prepare, keep on file, publish, and submit to the state auditor a detailed statement of its financial affairs pursuant to Minn. Stat. §471.698. Also, some small cities are subject to an audit and therefore must prepare financial statements on a basis of accounting upon which their independent auditor can, pursuant to auditing standards, give an opinion. Audited small cities basically have three options. First, the city, as some currently do, can decide to issue financial statements prepared in conformity with generally accepted accounting principles, which meet the new reporting model requirements of GASB 34, as amended. Alternatively, if a city is concerned about the cost benefit of preparing GAAP financial
statements, the city has two other options. The city can prepare financial statements on the cash (or modified-cash) basis of accounting, which are subject to some of the requirements of GASB 34. This basis requires some additional financial presentations, but allows an independent auditor to give their opinion on conformity with that basis. The last alternative is to prepare financial statements on a regulatory basis (State Auditor’s requirements), which eliminates some of the presentations required for the cash basis. The independent auditor can give opinion on this basis, but first must give an adverse opinion on the GAAP basis. If you have questions on the financial reporting requirements for small cities, contact the State Auditor’s office.