

Financial report user guide State and local governments

Understanding how to extract information from government financial reports is important when reviewing state or local government (government) financial performance and evaluating future financial decisions. This user guide describes key financial information contained within government financial reports and can help decision makers identify and understand the important and useful information presented in those reports.

Financial report information can help decision makers better govern state and local governments

Governments issue annual financial reports that are often included within a report called a comprehensive annual financial report or a single audit report. These reports provide useful information for understanding the government's financial structure, strategy, and performance, and include specific financial information presented in accordance with U.S. generally accepted accounting principles (GAAP). GAAP are standards of accounting and financial reporting established by the Governmental Accounting Standards Board for all governments in the U.S.

The financial report contains the following key components, which are discussed in further detail in the sections that follow:

- **Independent auditors' report**—prepared by the auditor and contains the auditors' opinion on whether the information in the financial report is presented in accordance with GAAP. The textbox to the right explains our Office's role as an independent auditor.
- **Management's discussion and analysis**—prepared by government management and provides explanations of and reasons for the government's financial activities for the fiscal year based on currently known facts, decisions, or conditions.
- **Government-wide financial statements**—prepared by government management and present a consolidated view of the government's financial activities for the fiscal year in two financial statements: the statement of net position and the statement of activities.
- **Fund financial statements**—prepared by government management and present a more detailed view of the government's financial activities for the fiscal year in five financial statements. Two financial statements are for the activities primarily supported by taxes and grant monies—the balance sheet and the statement of revenues, expenditures, and changes in fund balances. Three financial statements are for the activities primarily supported through user fees and charges—the statement of net position; the statement of revenues, expenses, and changes in fund net position; and the statement of cash flows.
- **Notes to the financial statements**—prepared by government management and provide essential explanatory information about the financial statements.

About our Office

The Office of the Auditor General serves as an independent source of impartial information concerning state and local government entities.

The Office conducts annual financial and compliance audits of state agencies, counties, community college districts, and universities in accordance with generally accepted auditing standards. Our reports provide the Legislature and other governing bodies with information on the receipt and use of public monies, provide specific recommendations to strengthen internal controls over assets and financial transactions, and help ensure compliance with applicable state and federal laws and regulations.

Independent auditors' report

Auditors, such as the Office of the Auditor General, prepare and issue an independent auditors' report at the conclusion of an audit to report on the results of the audit. The independent auditors' report accompanies a government's financial statements and includes three important pieces of information: (1) management's responsibility for preparing accurate financial statements, (2) the auditors' responsibility for expressing an opinion on the financial statements, and (3) the auditors' opinion as to whether the government's financial statements are presented in accordance with GAAP. See pages 13 through 14 for an example independent auditors' report.

Types of audit opinions

Unmodified opinion—the financial statements are presented in accordance with GAAP.

Modified opinions—

- **Qualified**—with the exception of the issues identified, the financial statements are presented in accordance with GAAP.
- **Adverse**—the financial statements are not presented in accordance with GAAP.
- **Disclaimer**—the auditors could not obtain enough evidence to support an opinion on the financial statements.

The auditors' opinion included in the independent auditors' report will be one of four types—unmodified, often referred to as a “clean” audit opinion, and three types of modified opinions—qualified, adverse, and disclaimer of opinion (see textbox to the left). Government leaders can confidently use financial statements with unmodified opinions to evaluate their government's financial position, show compliance with state and federal laws, and provide financial information to creditors. When auditors issue a modified opinion, the auditors' report will discuss the reason for the modification, such as management incorrectly reporting the value of equipment.

The auditors' opinion provides an assessment of whether the information contained in the financial report is presented in accordance with GAAP and is not a conclusion on the status of the government's financial

condition. Decision makers should refer to the management's discussion and analysis (MD&A) and basic financial statements for information about the government's financial health.

Management's discussion and analysis

MD&A is prepared by the government's management and provides an analysis of the government's financial activities based on currently known facts, decisions, or conditions. GAAP establishes the topics that MD&A must address, including the following:

- The year's financial highlights with comparisons to the previous fiscal year's;
- Descriptions and analysis of the financial statements contained in the report including the relationship of the financial statements to each other and the differences in the information they provide;
- Descriptions and analysis of significant revenue and expense activity with reasons for significant changes from the prior fiscal year;
- Significant capital asset purchases and long-term borrowings during the year; and
- Economic factors that can have an effect on the government's future operations.

In addition, management must explain why the government's financial position improved or deteriorated during the year. For example, if the government's financial position improved as a result of decreased spending, management would have to state the reasons for the decreased spending, such as the elimination of certain government programs.

Explanatory information about financial condition and activities can be subjective and open to some interpretation. Because of this, auditors report only whether management followed the appropriate rules of accounting when preparing MD&A and auditors provide limited assurance about the reliability of MD&A information.

Government-wide financial statements

Government-wide statement of net position and statement of activities

The government-wide financial statements are prepared by the government's management and present a consolidated view of the government's financial activities for the fiscal year. The required format and information contained in the government-wide financial statements is established by GAAP. A government's basic financial statements begin with two government-wide financial statements: the statement of net position and the statement of activities. The statement of net position provides an overall picture of the government's year-end assets, deferred outflows of resources, liabilities, deferred inflows of resources, and net position balances (see textbox below for definitions). The statement of activities provides the year's revenue and expense activities and change in net position, which is the difference between revenue and expense activities. Both statements include financial information for governmental activities and business-type activities. Governmental activities are programs primarily supported by taxes and grant monies, and business-type activities are programs primarily supported by user fees and charges.

Statement of net position sections

Assets—financial resources such as cash, receivables, and capital assets, such as equipment.

Deferred outflows of resources—transactions that have occurred but that are related to future reporting periods and increase total net position.

Liabilities—financial obligations such as accounts payable, bonds payable, and the government's net pension liability.

Deferred inflows of resources—transactions that have occurred but that are related to future reporting periods and decrease total net position.

Net position—the amount of financial resources that would be left after paying all liabilities. Net position is reported in three categories:

- Net investment in capital assets—the government's land, buildings, equipment, and infrastructure less any debt used to buy them.
- Restricted—financial resources that must be used for purposes specified by external entities, such as the federal government.
- Unrestricted—financial resources available for general use.

Statement of net position—Lists the government’s assets, deferred outflows of resources, liabilities, deferred inflows of resources, and net position as shown in the example below.

**Government-wide
Statement of net position**
(Example)

	Governmental activities	Business-type activities	Total government-wide activities
Assets			
Cash and investments	\$ 5,060	\$ 2,400	\$ 7,460
Accounts receivable	600	120	720
Capital assets, net	21,710	12,060	33,770
Total assets	27,370	14,580	41,950
Deferred outflows of resources	400	200	600
Liabilities			
Current, such as accounts payable	1,500	350	1,850
Long-term debt, such as bonds payable	3,000	2,500	5,500
Net pension liability	4,880	4,500	9,380
Total liabilities	9,380	7,350	16,730
Deferred inflows of resources	250	150	400
Net position			
Net investment in capital assets	18,710	5,060	23,770
Restricted	1,370	870	2,240
Unrestricted (deficit)	(1,940)	1,350	(590)
Total net position	\$18,140	\$ 7,280	\$25,420

Three things that can be learned from the statement of net position

- **The government’s ability to meet short-term obligations**—the degree to which current assets exceed current liabilities indicates the government’s ability to pay off debts due early in the next year.
- **The government’s long-term debt**—a summarized balance of the long-term debt the government has incurred to purchase items such as land or buildings or to fund operations.
- **The government’s net pension liability**—shows the extent to which pension plan liabilities exceed pension plan assets.

Statement of activities—Presents the government’s sources (revenues) and uses (expenses) of monies for the year for each of the government’s programs and for the government as a whole. Programs are a grouping of related activities or functions, such as public safety or education, that have specifically related revenues and expenses. Some programs are intended to be self-supporting through the generation of program revenues, while others are primarily supported by general revenues (see textbox to the right for definition of revenue types). As shown in the example statement of activities below, deducting program revenues from expenses results in the net program cost or gain. Adding taxes and other general revenues to the net program cost or gain shows the government’s increase or decrease in financial resources, also known as the change in net position.

Statement of activities revenue types

Program revenues—revenues received specifically to offset the costs of operating a program, such as:

- Charges for services—fees charged to program users.
- Operating grants—monies received that must be used for specific programs.
- Capital grants—monies received that must be used to buy, repair, or construct capital assets for specific programs.

General revenues—revenues received that are not specifically related to operating a program, such as taxes and investment income.

Government-wide Statement of activities (Example)

Programs	Expenses	Program revenues			Net program cost/gain	
		Charges for services	Operating grants	Capital grants	Governmental activities	Business-type activities
Governmental activities						
Public safety	\$16,600	\$ 1,050	\$ 600	\$250	\$(14,700)	
Education	5,300	150	2,800	150	(2,200)	
Business-type activities						
Wastewater treatment	10,300	10,500				\$200
		Net program cost/gain to government			(16,900)	200
		General revenues				
		Property taxes			17,000	
		Investment income			100	50
		Change in net position			\$ 200	\$250

Four things that can be learned from the statement of activities

- **The government’s program expenses during the year**—examining expenses for each program can provide an indication of a government’s spending priorities.
- **The net program cost/gain for the government’s programs**—analyzing the net program cost/gain can show whether the government’s programs are generally self-supporting or need to be supported by taxes or other general revenues.
- **The business-type programs the government offers**—the business-type activities section shows what fee-based services are offered to the public and whether each program was self-sufficient.
- **The current-year impact on overall resources**—the change in net position shows whether the government’s expenses were less than the revenues it took in, which increased net position, or were more than the revenues it took in, which decreased net position.

Fund financial statements

The fund financial statements present a more detailed view of the government's significant financial activities that occurred during the fiscal year. These significant activities are defined by GAAP and are called major funds. Although all governments will have a major fund to account for their general government activities, other major funds may be different for each government. For example, transportation programs may be significant to one government and they may be reported separately in one or more major funds. To another government, operating a wastewater treatment plant may be significant, and that government may have a related major fund while having no transportation-related major funds.

Major funds are reported on either governmental fund financial statements if their activities are primarily supported by taxes or grant monies or on proprietary fund financial statements if their activities are primarily self-supported by user fees and charges.

Governmental fund financial statements

The governmental fund financial statements report activities in major funds that are primarily supported by taxes or grant monies. Each major fund is typically included in one of three main governmental fund types: general fund, special revenue funds, and capital project funds (see textbox above for definitions). These funds' resources primarily include various tax revenues and grant monies. Unlike the government-wide financial statements, the governmental fund statements show each major fund's finances on an annual basis, meaning they do not include long-term items such as the value of capital assets or how much is owed for long-term debt. Because of this, the governmental fund financial statements focus only on the current financial condition of the government and they should not be used to evaluate its long-term financial condition.

The governmental funds comprise two statements: the balance sheet, showing each of the major funds' financial positions at the end of the year, and the statement of revenues, expenditures, and changes in fund balance, showing whether each of the major funds' financial positions improved or deteriorated during the year.

As shown in the example on page 7, the balance sheet presents assets and liabilities by type, total deferred inflows of resources for assets that are currently unavailable to pay for liabilities, and fund balances in five categories (see textbox on page 7 for fund balance categories and definitions). Each major fund is presented in a separate column.

Main governmental fund types

Governments record financial information for each operation or activity separately in their accounting records. These separate accounting records are called funds and are grouped into three main fund types:

General fund—the main operating fund used by every government to account for general governmental operations.

Special revenue funds—these funds may be used to account for restricted or committed revenue sources, such as federal grants or highway taxes.

Capital projects funds—these funds may be used to account for resources restricted or committed for purchases or construction of capital assets, such as buildings, roads, and equipment.

Governmental funds

Balance sheet

(Example)

	General fund	Special revenue fund transportation	Capital projects fund construction
Assets			
Cash and investments	\$2,500	\$3,000	\$1,350
Accounts receivable	550	700	300
Inventories	350	100	100
Total assets	3,400	3,800	1,750
Liabilities			
Accounts payable	1,000	1,000	550
Total liabilities	1,000	1,000	550
Deferred inflows of resources	200	150	50
Fund balances			
Nonspendable	350	400	100
Restricted	350	1,050	700
Committed	100	550	150
Assigned	200	100	150
Unassigned	1,200	550	50
Total fund balances	\$2,200	\$2,650	\$1,150

Fund balance—resources left after paying all liabilities that would be currently available for use, reported in five categories:

- Nonspendable—resources that cannot be spent, such as an inventory of office supplies.
- Restricted—resources that must be used for purposes specified by external entities such as a creditor or the federal government.
- Committed—resources allocated to certain purposes by the governing body, such as a governing board or commission.
- Assigned—resources earmarked for certain purposes by management, i.e., those responsible for the daily operations of the government.
- Unassigned—remaining financial resources, generally available to be used for any of the government's activities.

As shown in the example below, the statement of revenues, expenditures, and changes in fund balances presents cash receipt and payment activity during the year. Each major fund is presented in a separate column.

Governmental funds
Statement of revenues, expenditures, and changes in fund balances
 (Example)

	General fund	Special revenue fund transportation	Capital projects fund construction
Revenues			
Property taxes	\$2,700		
Intergovernmental	1,800	\$3,000	\$2,050
Charges for services	350	100	200
Total revenues	4,850	3,100	2,250
Expenditures			
General government	2,850		
Public safety	950		2,350
Education	900		
Highways and streets		3,000	
Total expenditures	4,700	3,000	2,350
Net change in fund balances	\$ 150	\$ 100	\$ (100)

Four things that can be learned from the governmental fund financial statements

- **Each major fund’s receivable and payable balances**—these represent what each major fund generally expects to receive or pay early in the next fiscal year.
- **The amount of available resources in each major fund**—unassigned fund balances can show the resources available for new projects or initiatives.
- **The allocation of fund balances**—restricted, committed, and assigned balances can show the degree to which each major fund’s resources have been designated for use. For example, assigned resources can be redirected more easily than committed resources.
- **Each major fund’s revenue sources**—the revenues section can show the different types of revenues generated in each major fund, and the net change in fund balances can show whether each major fund generated enough revenues to cover its costs.

Proprietary funds financial statements

The proprietary funds financial statements include information about programs that are operated in a manner to ensure that revenues received are sufficient to pay for expenses incurred, similar to a business, and are separated into enterprise funds and internal service funds (see textbox to the right for definitions). The proprietary funds statements present each major business-like program that the government operates, such as an enterprise fund wastewater treatment plant that charges fees for collecting and treating wastewater or an internal service fund motor pool that charges fees for use of the government's motor vehicles. The proprietary funds financial statements comprise three statements: statement of net position; statement of revenues, expenses, and changes in fund net position; and statement of cash flows.

Proprietary funds—include two different types of funds:

- Enterprise funds—include only programs that provide goods and services to citizens, like operating a wastewater treatment plant.
- Internal service funds—include only programs that provide goods and services internally within the government, like operating a fleet of motor vehicles.

As illustrated in the example below, the statement of net position lists the assets, deferred outflows of resources, liabilities, deferred inflows of resources, and net position for each proprietary fund (see textbox on page 3 for definitions of deferred outflows of resources and deferred inflows of resources).

Proprietary funds Statement of net position (Example)

	Enterprise fund wastewater treatment	Internal service fund motor pool
Assets		
Cash and investments	\$1,400	\$1,000
Accounts receivable	100	100
Capital assets, net	6,500	1,500
Total assets	8,000	2,600
Deferred outflows of resources	300	200
Liabilities		
Current	200	150
Long-term	4,000	250
Total liabilities	4,200	400
Deferred inflows of resources	200	100
Net position		
Net investment in capital assets	2,300	1,250
Restricted	600	
Unrestricted	1,000	1,050
Total net position	\$3,900	\$2,300

As illustrated in the example below, the statement of revenues, expenses, and changes in fund net position shows operating activities, nonoperating activities, and the changes in net position for each proprietary fund (see textbox below for definitions).

Proprietary funds
Statement of revenues, expenses, and changes in fund net position
 (Example)

	Enterprise fund wastewater treatment	Internal service fund motor pool
Operating revenues		
Sewer fees	\$1,750	
Vehicle use charges		\$ 850
Other	300	
Total operating revenues	2,050	850
Operating expenses		
Payroll expenses	550	250
Depreciation	850	100
Other	100	250
Total operating expenses	1,500	600
Results of operations	550	250
Nonoperating revenues (expenses)		
Investment income	150	100
Interest expense	(400)	(50)
Total nonoperating revenues (expenses)	(250)	50
Changes in net position	\$ 300	\$ 300

Proprietary funds

Operating activities—the revenues and expenses generated from the program’s main purpose, like charging fees for operating a wastewater treatment plant.

Nonoperating activities—those revenues and expenses not specifically related to the program’s main purpose, like earning interest on investments.

GAAP requires governments to present a statement of cash flows as part of the proprietary funds financial statements to help specifically identify how cash was generated and used during the year.

As shown in the example statement on page 11, the statement of cash flows presents the sources and uses of cash for each major proprietary fund. These sources and uses of cash are generally shown in four cash flow categories: operating activities, noncapital financing activities, capital financing activities, and investing activities (see textbox to the right for definitions).

Cash flow categories

Operating activities—cash received from customers for goods and services and payments to suppliers and employees.

Noncapital financing activities—borrowing of money or repayment of debt for purposes other than building or equipment purchases.

Capital financing activities—borrowing of money or repayment of debt for building or equipment purchases and proceeds from the sale of buildings and equipment.

Investing activities—interest received on investments and cash received from the sale of or used for the purchase of investments.

Proprietary funds
Statement of cash flows
(Example)

	Enterprise fund wastewater treatment	Internal service fund motor pool
Cash flows from operating activities		
Cash received from customers	\$1,800	\$ 950
Cash payments to suppliers	(500)	(200)
Cash payments to employees	(450)	(300)
Change in cash from operating activities	850	450
Cash flows from noncapital financing activities		
Payments for short-term operating loan	(150)	
Change in cash from noncapital financing activities	(150)	
Cash flows from capital financing activities		
Purchase of capital assets	(350)	(400)
Payments for sewer system bonds	(250)	
Sale of buildings and equipment	100	50
Change in cash from capital financing activities	(500)	(350)
Cash flows from investing activities		
Interest received on investments	100	50
Sale of investments	50	50
Change in cash from investing activities	150	100
Total change in cash	\$ 350	\$ 200

Four things that can be learned from the proprietary funds statements

- **Each program’s financial position**—the statement of net position shows what each program owns and owes, and unrestricted net position shows the resources each program has available for use.
- **Each program’s change in financial position**—the change in net position on the statement of revenues, expenses, and changes in fund net position shows whether each program’s resources increased or decreased during the year.
- **Each program’s revenue sources**—the operating and nonoperating revenues sections on the statement of revenues, expenses, and changes in fund net position show the different revenue types each program used to sustain its operations and pay for its expenses.
- **Each program’s main sources and uses of cash**—the sources and uses of cash in each cash flow category on the statement of cash flows shows where each program receives or spends its cash, and the total change in cash in each program shows whether cash increased or decreased as a result of current year operations.

Notes to the financial statements

The notes to the financial statements contain information that is essential to a user’s understanding of the government’s financial statements. Common note disclosures found in a financial report include:

- **Summary of significant accounting policies**—describes each financial statement, the major funds, and the accounting policies followed when preparing the financial statements.
- **Deposits and investments**—presents the government’s cash and investing policies along with the different investment types the government owns and the risks defined by GAAP, if any, associated with them (see textbox on page 12 for definitions of cash and investment risk types).
- **Capital assets**—shows the government’s capital asset purchases and disposals, including the estimated amount of resources needed to complete construction projects.
- **Long-term liabilities**—shows new debt issued and debt paid off during the year, ending debt balances, and future principal and interest payments.
- **Pension benefits**—describes the pension plan types the government provides to its employees and shows detailed information about them, such as benefits provided, information about pension plan assets, actuarial assumptions used in estimating the net pension liability the government owes at year end, and contributions the government and its employees made to the pension plans during the year.

Cash and investment risk types included in notes to the financial statements

Credit risk—the chance that an investment issuer will not fulfill its obligations.

Custodial credit risk—the possibility that an investment will be lost if the bank or brokerage firm holding the investment goes bankrupt.

Concentration of credit risk—the potential risk of loss from having too much money invested in one entity.

Interest rate risk—the possibility that changes in interest rates will reduce an investment's value.

Foreign currency risk—the chance that changes in the value of foreign currencies will affect an investment's value.

Example independent auditors' report

The following is an example of the main elements of an independent auditors' report with an unmodified audit opinion:



DEBRA K. DAVENPORT, CPA
AUDITOR GENERAL

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

MELANIE M. CHESNEY
DEPUTY AUDITOR GENERAL

Independent Auditors' Report

Members of the Arizona State Legislature

The Board of Supervisors of
Example County, Arizona

Report on the Financial Statements

We have audited the accompanying financial statements of the governmental activities, business-type activities, each major fund, and aggregate remaining fund information of Example County as of and for the year ended June 30, 20XX, and the related notes to the financial statements, which collectively comprise the County's basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express opinions on these financial statements based on our audit. We conducted our audit in accordance with U.S. generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditors consider internal control relevant to the County's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the County's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

Independent Auditors' Report

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We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

Opinions

In our opinion, based on our audit, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, business-type activities, each major fund, and aggregate remaining fund information of Example County as of June 30, 20XX, and the respective changes in financial position, and, where applicable, cash flows thereof for the year then ended in accordance with U.S. generally accepted accounting principles.

Other Matters

Required Supplementary Information

U.S. generally accepted accounting principles require that the Management's Discussion and Analysis be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with U.S. generally accepted auditing standards, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Arizona Office of the Auditor General

December XX, 20XX