

ACCOUNTING

Masquerade—Impersonating Analysis in MD&A

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Management's discussion and analysis, usually referred to by its initials MD&A, is the one element of required supplementary information [RSI] that applies to all governments that issue financial statements prepared in accordance with generally accepted accounting principles [GAAP]. MD&A is intended to provide users of government financial statements with some of the insight that managers have into the financial position and results of operations for which they are accountable, and the root causes of changes seen between years.

Analysis answers questions that begin with "why." Discussion

precedes *analysis* in the name MD&A, but only because of the logical imperative of financial statement users first knowing *what* the financial position and results of operations are before being able to comprehend why they are so. The overriding objective of MD&A is to provide *analysis*. GAAP states up front that MD&A "should introduce the basic financial statements and provide an analytical overview of the government's financial activities."¹ That two of the ten most frequent comments given to applicants to GFOA's Certificate of Achievement for Excellence in Financial Reporting award program ["COA"] are for missing analysis in MD&A speaks to a general scarcity of true analysis.²

Keep asking why

Anyone who has spent time with toddlers or young children knows that, to make sense of the astoundingly complex universe of which they gradually become aware, children ask a seemingly unending stream of "why" questions. Just ponder, if you will, how many millions of times an effort to have a 3-year-old don a raincoat may have led, step-by-step, to fervent pleas for what amounts to a meteorological dissertation. Perhaps children so encouraged now populate our universities, storm-tracking services, and newsrooms as adults.

The best MD&As are written by authors who seek out explanations as ardently as children, asking and

seeking answers about why their government's financial statements read as they do, by asking "why" often enough to uncover root causes. Take, for example, the question of why a county's net position increased from one year to the next. How many iterations of "why" questions might it take to reach satisfactory, root cause explanations? [See Exhibit 1.]

Following the analysis in Exhibit 1, this county might include an explanation like the following in their MD&A:

Net position of the county's governmental activities increased by 2.5 percent during the year, primarily because property taxes revenues rose by 2 percent. Property tax revenues, which represent approximately 60 percent of the county's tax revenue, grew as a result of both (1) an average rate increase of 1 percent on all classes of real property, which was enacted by the county legislature for the fiscal year, and (2) an average increase of approximately 5 percent in the taxable property values. Taxable property values in the county, which are set at 50 percent of estimated market values, generally followed upward national trends in home prices.

Of course, there may be multiple answers to any iteration of why questions, each of which may warrant its own follow-up "why" questions. [If that toddler instead asked why they should want to keep dry, an object lesson and a career in developing water-repellent fabrics rather than meteorology may have followed.] If a significant increase in grant revenue contributed to the increase in net position, or if a significant increase in one or more functional classifications of expenses partially offset the revenue increase, the analysis would need to explain the root causes of those changes as well. The table shown in Exhibit 2 would likely look more like a tree or flow chart, with multiple intermediate explanations branching into separate iterations of "why" questions.

"What" answers masquerading as "why" answers

Look again at the multiple iterations of "why" questions in Exhibit 1. What do you notice about the response to the first three iterations of questions—what do they have in common? After reading them, do you really know *why* net position or revenues increased?

No. In truth, those first few rounds of questioning have provided more detail about *what* the changes are, but no meaningful insight into *why* they changed.

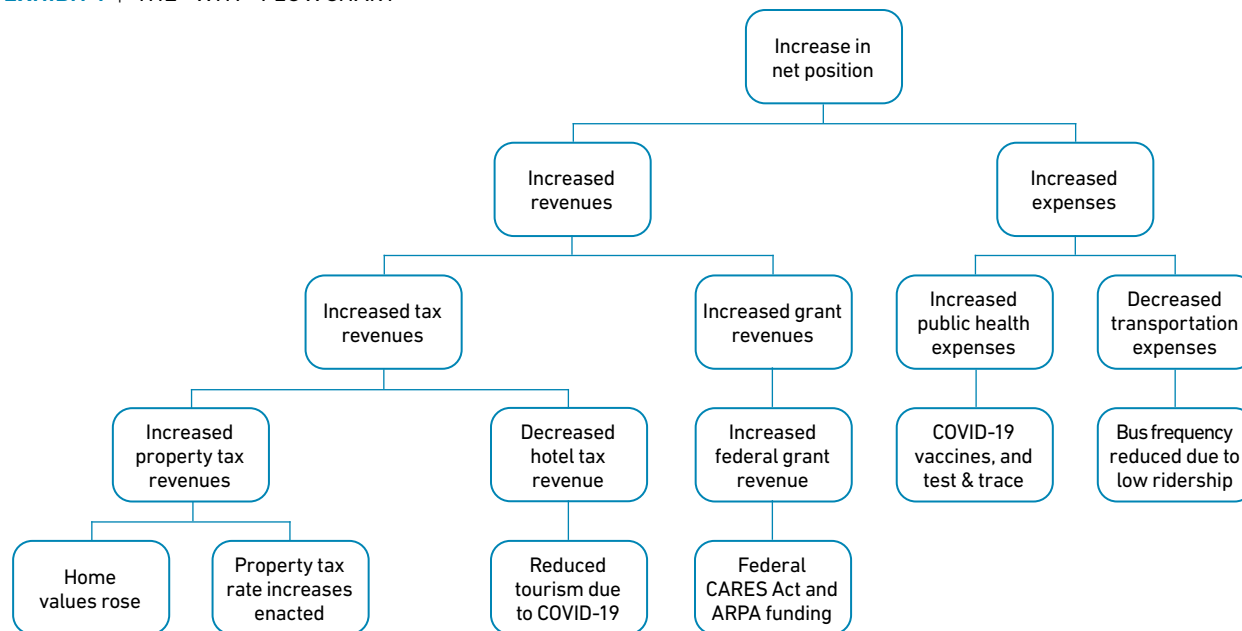
Those interim responses are not really answering *why* questions. They are answering *what* questions, which would more precisely be phrased as "What are the major components of the increase in net position?" or "What specific kind(s) of tax revenues grew?" These questions and their answers are not analytical, but they are an interim step necessary to providing meaningful analysis of amounts that are highly aggregated, as the condensed comparative financial statements in MD&A certainly are. These interim responses are a red carpet inviting the follow-up "why" questions that lead to analysis, but they are not themselves analysis.

The most common problem we see with MD&As in COA submissions is that their authors have stopped halfway into the journey, halting after answering only "what" questions. One typical statement found in the MD&A of a COA applicant's annual comprehensive financial report

EXHIBIT 1 | GETTING TO WHY

ITERATION	WHY QUESTION	RESPONSE
1	Why did the net position of governmental activities increase by 2.5% since last year?	Primarily because of revenue growth of 3%, which exceeded expectations and the net growth in expenses of only 1%.
2	Why did revenue grow by 3%?	Primarily because of a 2% increase in tax revenues, which constitutes 60% of county revenue.
3	Why did tax revenue increase by 2%?	Primarily because real property tax revenue increased by approximately 3.5%
4	Why did property tax revenue increase by 3.5%?	Primarily because of (1) a property tax rate increase of 1%, on average, across all classes of taxable real estate, enacted by the legislature for the fiscal year, and (2) an average increase in assessed taxable property values of approximately 5%.
5	Why did taxable property values increase by 5%?	Primarily because of increased market values of homes and properties, consistent with statewide and national trends.

EXHIBIT 1 | THE "WHY" FLOWCHART



stated: “The city’s total revenues increased by almost 1 percent to approximately \$67.4 million. This is primarily the result of an increase in charges for services and capital grant contributions.” It’s a good start, but this city fails to explain why charges for services and capital grant contributions increased—meaning they only answered “what” questions.

Many, if not most, governments manage their day-to-day operations using budgetary- or cash-basis financial information and don’t make the adjustments needed to report on a GAAP basis until year-end. For many governments, the first time they even see the amounts that need to be explained may be nearly at the moment they are expected to provide those explanations! When rushing to meet tight deadlines after months of hard work to prepare basic financial statements, it is understandable that preparers and their auditors may hope that drilling down into the detail is “close enough” to analysis—but it isn’t.

One approach to preventing analysis from being sidelined by the final push to the finish line is to prepare analysis in advance. Start

with the budgetary basis results that you have been tracking all year and then “layer on” analysis of the bases for the accruals and adjustments necessary for GAAP reporting. If the most notable driver of higher-than-anticipated expenditures in the budgetary reporting throughout the year is greatly increased spending on gasoline for the public works and public safety vehicles, as a result of higher gas prices, be prepared to include that analysis in the explanations of changes for expenses in those functions, if they should prove significant to those expense amounts overall. A large decrease in pension expense accrued at year’s end, caused by the phasing-in of market gains on exchange-traded investments held by plans covering all employees, would be offsetting changes to total expenses for those functions, and can be anticipated as soon as the market closes on the last day of the fiscal year. Long-term borrowing and capital expenditures made throughout the year will be part of the explanation for changes in *governmental fund* balances, but

we know in advance that they will be “backed out” of *governmental activities* in the statement of activities and be added to the statement of net position, so we can factor them out when doing advance analysis of changes in resource flows for governmental activities.

Conclusion

With only a few relatively rare exceptions, we will be able to identify all potentially significant changes and their explanations well before we finalize financial statement amounts, even if their relative significance may not be crystal clear until financial statement amounts are finalized. With preparation, we can unmask them for the great reveal in MD&A.

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¹ Governmental Accounting Standards Board (GASB), 2021-2022 Codification of Governmental Accounting and Financial Reporting Standards (Cod.), Section (Sec.) 2200, “Annual Comprehensive Financial Report,” paragraph.102).

² Comments given for annual comprehensive financial reports for fiscal years ending in 2020, based on data available as of April 2022.