RETHINKING FINANCIAL REPORTING

VOLUME 1

URBAN LEGENDS OF PUBLIC FINANCE

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ABOUT THE AUTHOR

- **Todd Buikema**, Principal Technical Advisor, Accounting and Reporting, GFOA
- **Shayne C. Kavanagh**, Senior Manager of Research, GFOA
- **Michele Mark Levine**, Director of Technical Services, GFOA

ABOUT GFOA

The Government Finance Officers Association (GFOA) represents over 33,000 public finance officers throughout the United States and Canada. GFOA's mission is to advance excellence in government finance. GFOA views its role as a resource, educator, facilitator, and advocate for both its members and the governments they serve and provides best practice guidance, leadership, professional development, resources and tools, networking opportunities, award programs, and advisory services.

ABOUT RETHINKING FINANCIAL REPORTING

Local government is in a time of constrained resources, declining trust, and rapid change. This has prompted GFOA to launch a "rethinking" of several aspects of public finance, including **Rethinking Financial Reporting**. For example, in a time of decreasing trust in government, we should ask if lengthy, technical financial reports that take significant time to compile, undergo lengthy audit processes, and, as a result, are often published many months in arrears are the most effective way to build trust with government's most important constituency: the public. In a time of declining resources, we should ask if the finance officer's time is well spent producing these reports, if, in fact, these reports are not the best way to provide accountability to the public. Time spent on general purpose external financial reports is time not spent on other forms of decision support and public engagement. Simply put, this time is lost opportunity cost that could otherwise be used to build trust. Rethinking Financial Reporting is a fact-based examination into the costs and benefa1its of the current model of financial reporting and how we can decrease the former and increase the latter.

USE OF GENERATIVE ARTIFICIAL INTELLIGENCE IN THIS REPORT

This report was developed with the assistance of generative artificial intelligence (AI) tools, used in the following ways:

- **Idea development** — brainstorming and structuring the report outline.
- **Drafting** — generating text for select sections. Where AI's contribution to the final language is material, this is noted in the report. Minor assistance, such as wording or grammar suggestions, is not separately flagged.
- **Editing** — reviewing drafts for clarity and accessibility for the intended audience.
- **Challenge review** — using AI to challenge the report's assumptions, arguments, or conclusions and surface weaknesses before publication.

All facts, data, and ideas sourced from AI tools were independently verified by the author(s) before inclusion; none were taken at face value. GFOA recognizes that generative AI can produce biased, incomplete, or inaccurate output, and applies this same scrutiny regardless of which AI tool was used.

Did you know that you have to wait 24 hours before reporting a missing person? Or that an undercover police officer must admit they are a police officer if asked directly—and if they lie, that's entrapment? These are two common urban legends about the rules that govern our local government colleagues in law enforcement…and they are both false.

Urban legends endure because they sound believable and are repeated by sources we trust, such as friends, family, and television shows. They also stir an emotional response. Law enforcement can seem *exciting*—which helps explain the popularity of police-procedural television and urban legends about how high-profile cases, such as missing persons and undercover sting operations, are handled. Finally, most urban legends contain some kernel of truth that grows into something much bigger. For example, adults have the legal right to go "missing" by leaving their lives behind without telling anyone. As a result, law enforcement may not prioritize looking for a low-risk adult who has been reported missing only a short time. Entrapment is also real, but it generally means inducing someone to commit a crime they were not already predisposed to commit. Officers are sometimes required to identify themselves in certain situations outside of undercover work. Put those two truths together, and you get the urban legend.

Public finance has its own urban legends. They sound plausible and are repeated often. They also work on emotions—commonly fear.

These urban legends are not just harmless misconceptions. For example, law enforcement agencies spend time and energy correcting the false belief that people must wait 24 hours before reporting a missing person because the first hours of a legitimate missing-person case are the most important.

Public finance has its own urban legends, even if they are not as widely known as those in law enforcement. They sound plausible and are repeated often. They also work on emotions—commonly *fear*. Public finance requires complying with rules. An urban legend that works on the fear associated with possible noncompliance will persist. These urban legends contain kernels of truth. But they also have consequences, mostly in the form of wasted time and energy.

Here are four urban legends of public finance that affect annual financial reporting:

#1 "Federal rules require us to capitalize assets over $10,000."

#2 "The auditors decide what's material."

#3 "We need a separate fund for that."

#4 "We need to make all the auditor's proposed adjustments."

URBAN LEGEND #1

Federal rules require us to capitalize assets over $10,000

Many governments use a $10,000 capitalization threshold because of this urban legend. Others still use $5,000 because of an earlier version of the myth. The kernel of truth comes from the Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards (Uniform Guidance). Most importantly, the $10,000 figure (recently updated from $5,000) appears in the definition of equipment in Section 200.1:*

> *Equipment means tangible personal property (including information technology systems) having a useful life of more than one year and a per-unit acquisition cost that equals or exceeds the lesser of the capitalization level established by the recipient or subrecipient for financial statement purposes, or $10,000.*

The $10,000 figure does *not* establish a capitalization threshold. Instead, the federal rule uses the lower of the government's own financial-reporting threshold or $10,000 to decide what counts as "equipment" for federal award purposes. That definition triggers federal property-management requirements. It does not determine which assets the government must capitalize in its financial statements.

Section 200.313 of the Uniform Guidance describes how federally funded equipment must be used, managed, and disposed of. For local governments and most other nonstate recipients and subrecipients, subsection (d) requires procedures such as:

- Property records showing the acquisition date and cost.
- A physical inventory that is reconciled with property records.
- A control system to safeguard against loss, damage, and theft.

The federal requirements are about stewardship of federally funded property. They do not determine what assets belong on the statement of net position. Governments often confuse capitalization records with records used to manage and safeguard assets. The two serve different purposes. For example, everyone agrees that law enforcement weapons require strict inventory and safekeeping controls. Few would argue, however, that every $700 handgun must therefore be capitalized in the financial statements.

This legend grows from two ideas. First, the $10,000 figure appears next to a reference to a government's own capitalization threshold. Second, people often confuse asset capitalization

* The $10,000 figure appears other places as well, such as in the disposition rules.

procedures with procedures for safeguarding assets. Put those two ideas together, and you get the legendary federally required $10,000 capitalization threshold. Even the "weak form" of this legend is false. Assets purchased with federal awards are not subject to a federally required $10,000 capitalization threshold.

The benefit of letting go of this legend is that local governments can evaluate their capitalization thresholds and raise them when the administrative savings outweigh any loss of useful financial information. GFOA has documented that raising the threshold can substantially reduce the work required for asset capitalization while having only a small effect on the total reported value of assets.

URBAN LEGEND #2

The auditors decide what's material

This urban legend has an obvious kernel of truth: auditors decide what is material for audit planning, testing, and forming the audit opinion. They determine what could materially affect the audit work, the evaluation of misstatements, and, ultimately, the audit opinion. when the auditor's authority is thought to supersede—or even replace—management's role in making materiality judgments. Management must decide what information and accounting treatments are needed for the government's financial statements to be fairly presented. Management represents that the financial statements are prepared, in all material respects, in accordance with Generally Accepted Accounting Principles (GAAP).

Let's look at two common financial reporting topics and compare management's and the auditor's actual roles with the legendary role.

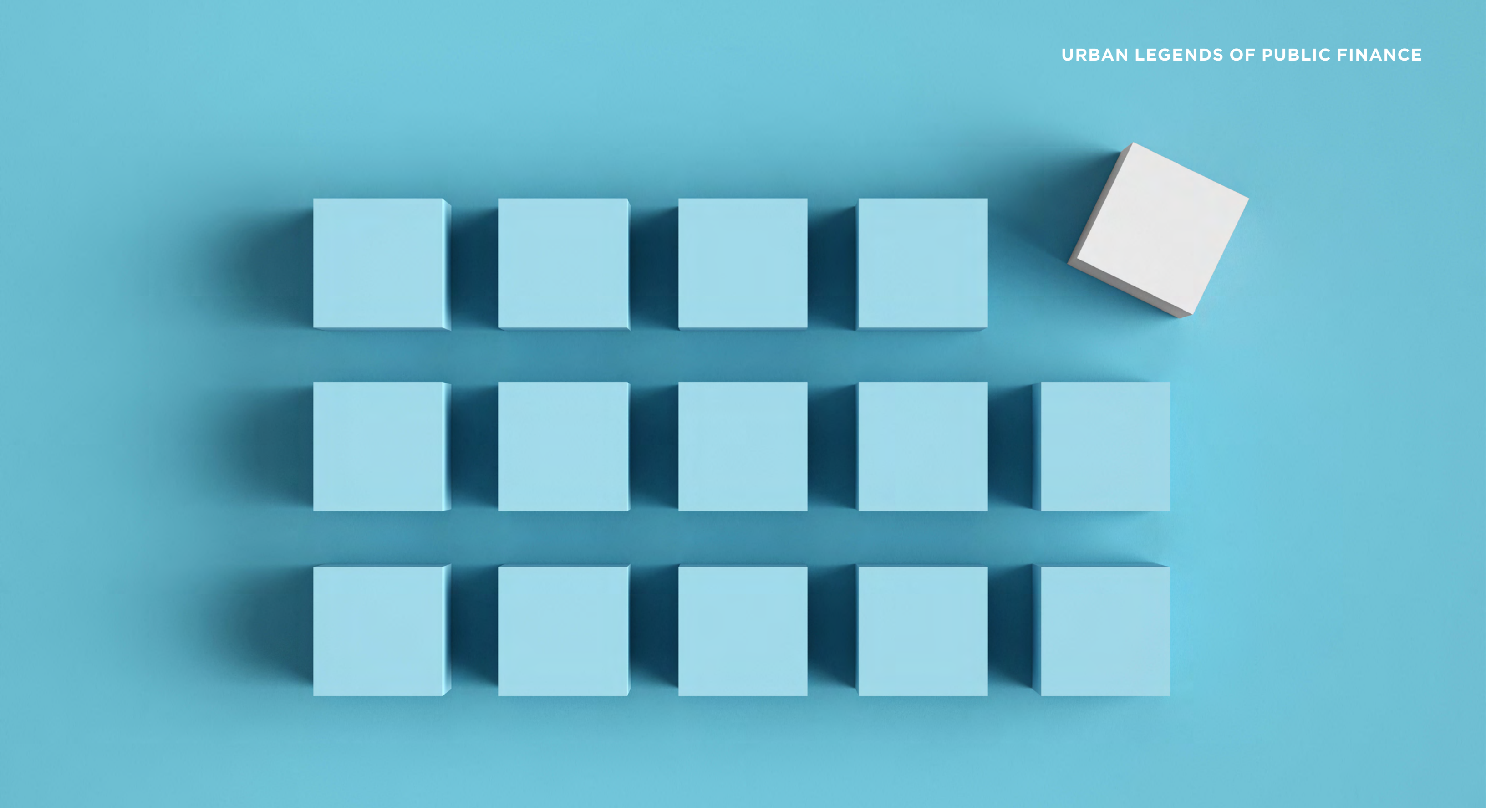
CAPITALIZATION THRESHOLD

Management's Actual Role	Establish a policy that produces financial reporting that is materially correct without unnecessary administrative costs. Apply the policy and periodically review the threshold.
Auditor's Actual Role	Evaluate whether the policy and its application could materially misstate the financial statements.
Auditor's Legendary Role	Approve or even set the government's capitalization threshold.

YEAR-END ACCRUALS

Management's Actual Role	Record all material accruals needed to report transactions and other events in the correct reporting period, using thresholds and estimates when appropriate.
Auditor's Actual Role	Test whether accruals are complete and reasonable, and determine whether any differences could materially misstate the financial statements.
Auditor's Legendary Role	Decide which accruals management must record and insist that management obtain exact amounts rather than use reasonable estimates.

The benefit of recognizing these urban legends is that finance officers can and should exercise their professional judgment about what is material. Making savvy decisions about what is material helps balance the cost of preparing financial statements with the value of the information they provide. Otherwise, public resources are wasted.



URBAN LEGEND #3

We need a separate fund for that

A common urban legend in local government finance is that every project, program, grant, or service a government provides needs its own fund to track financial results and available balances.

There are two elements to this legend's kernel of truth. First, a separate fund is sometimes required. State law, for example, might require that a local option tax approved for special purposes be accounted for in its own fund. This reality can then grow into the belief that separate funds are required (by law, by contract, etc.) for other activities.

Second, legacy financial systems lacked the flexibility in their charts of accounts to add segments and track projects, programs, grants, or services. At one time, adding a fund may have been the most—or even the only—practical way to track a separate program, initiative, or revenue stream. This truth became an urban legend as modern systems made it easier to track those activities without creating another fund.

In reality, governments often do not need separate funds to track distinct activities. In fact, the accounting rules prescribe that governments establish the *minimum number* of funds needed to meet legal, operational, and reporting requirements. Too many funds make budgeting, accounting, and financial reporting more complex. They also create inefficiencies in financial administration (GASB Codification Section 1300, paragraph 120).

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URBAN LEGEND #4

We need to make all the auditor's proposed adjustments

A common urban legend is that governments need to make all the auditor's proposed adjustments. Auditors often find differences between their measurements of transactions and other events and how those items are recorded in a government's accounting records or government-prepared financial statements. They accumulate all proposed adjustments that management does not record. These include adjustments identified in the current year's audit and any from prior years that continue to affect the current period's financial statements. If the unrecorded adjustments are individually and collectively immaterial in the auditor's professional judgment, management need not record them. he auditors will not modify their opinion as a result.

However, here lies the legend's kernel of truth: auditors are required to communicate these "passed adjustments" in writing to the government's audit committee or governing board. Finance officers often make all the auditor's proposed adjustments to avoid having any highlighted in these required communications. They may fear the adjustments will be viewed as mistakes found by the auditors but ignored by management.

A better approach is for management and the auditors to explain that the financial statements are materially correct without the proposed adjustments. Management has consciously decided, using professional judgment, not to make them because the cost of greater precision outweighs the benefits. By "passing" on the adjustments, the auditors agree with management's judgment.

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For example, assume a government establishes a threshold and does not report leases below that threshold. Instead, lease payments are expensed as incurred. Using professional judgment, management determines that the cost of capitalizing and amortizing the related lease asset and recording and amortizing the related lease liability would exceed the benefit of the small improvement in precision that would result. Management also determines that the differences would be immaterial.

Now assume a government entered into two leases during the current year, both below the threshold. The auditor will include the estimated "missing" lease assets and liabilities, along with any differences in the reported expenditures or expenses from these unrecorded leases, as part of the current year's passed adjustments. However, non-GAAP treatment of the leases is not a mistake. Rather, it reflects the government's professional judgment that the leases are immaterial to the financial statements and that staff should focus their time on other material issues.

Conclusion

Recognizing urban legends for what they are allows finance officers to replace inherited practices with informed professional judgment. The result is less wasted effort and better decisions based on what is actually required—not on what everyone has heard is required.

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Government Finance Officers Association
203 N. LaSalle Street, Suite 2700
Chicago, IL 60601
312-977-9700 | **gfoa.org**