



STATE OF VERMONT
OFFICE OF THE STATE AUDITOR

MEMORANDUM

To: Honorable Susan Bartlett, Chair of the Legislative Joint Fiscal Committee
Michael Smith, Secretary of the Agency of Administration

From: Thomas M. Salmon, CPA, State Auditor *Thomas M. Salmon CPA*

Subject: Accounting and financial reporting for income sensitivity adjustments related to property taxes

Date: April 9, 2007

Per your request, my office has reviewed the accounting and financial reporting for the income sensitivity adjustment related to statewide education property taxes, subsequent to the effective date of Act 185.

Based upon our review of Act 185 and Government Accounting Standards Board (GASB) statements, discussions with key legislative and State managerial personnel, and consultation with GASB staff, we conclude the following:

- 1) Under Act 185 the income sensitivity adjustment to statewide education property taxes does not represent additional education expenditures. Rather, it reduces property tax revenue as a source for payment of education costs and, as a result, the State utilizes other revenue streams as the source for funding education spending.
- 2) With respect to GAAP presentation, we recommend that property tax revenue be shown gross on the Education Fund GAAP financial statements and the income sensitivity adjustment should be shown as an offset, directly below the property tax revenue line.¹

Review of Act 185

Prior to Act 185, payments for income sensitivity in the form of prebates or rebates were distributed to homestead property tax owners and the property owner's property tax liability to the town was gross of the income sensitivity adjustment amount.

Effective fiscal year 2008, payments for income sensitivity will no longer be distributed to individual homestead property owners. Rather, homestead property owners eligible for a tax adjustment, will receive a property tax bill, net of adjustments, which represents their property tax liability to the state. Municipalities will receive a payment from the State each fiscal year on July 1. These payments represent an advance of funds to towns for education spending, supplanting the payments collected

¹ See example presentation under Generally Accepted Accounting Principles, on page 2.

from income sensitized property tax payers in prior years. Subsequently, the towns will transfer these funds to school districts, along with additional funds required to meet the budgetary spending requirements of the district. Ultimately, the funds received by school districts are not impacted by the amount of the income sensitivity adjustments. However, the amount of revenues collected from property taxes is reduced by the income sensitivity adjustments. Other revenue sources, such as the Meals and Room tax, Purchase and Use tax or General Fund transfer, make up the shortfall.

Review of Generally Accepted Accounting Principles (“GAAP”)

The fundamental premises for GAAP revenue recognition are that an earnings process has occurred and revenues should be reported net of discounts, refunds and allowances.² In the context of property taxes, revenue should be recognized in the period for which the tax has been levied and the amount of revenue recognized should be equal to the tax owed by property owners less amounts the State does not expect to collect.

GAAP provide three alternatives for presenting revenues net of adjustments.

- (1) The discount, refund or allowance amount may be parenthetically disclosed on the face of the financial statements.
- (2) The discount, refund or allowance amount may be disclosed in a footnote to the financial statements.
- (3) Revenues may be reported gross with the related discounts and allowances reported directly beneath the revenue amount.

The following table presents the third option.

Revenues	
Property tax assessments	\$ 813,000,000
Less income sensitivity adjustments	<u>(\$107,000,000)</u>
Property tax revenue, net	\$ 706,000,000

While each option is compliant with GAAP, the third option presents the substance of the transaction with the greatest clarity and is the option we recommend. Finally, we suggest that to provide the greatest transparency and clarity in budgetary reporting, property tax revenue should continue to be reported gross with the income sensitivity adjustment presented as a reduction, directly below the property tax revenue line.

² Statement No. 33, Government Accounting Standards Board (GASB) “Accounting and Financial Reporting for Nonexchange Transactions.” Footnote 41, Statement No. 34 GASB, “Basic Financial Statements – and Management’s Discussion and Analysis – for State and Local Governments”

SCOPE OF WORK

Our office performed the following due diligence to understand the changes enacted under Act 185 and to determine the accounting and financial reporting impact, if any:

- Reviewed the amendments enacted via Act 185 related to the income sensitivity adjustment.
- Discussed education spending payments to municipalities under Act 185 with Stephen Klein, Chief Fiscal Officer, Joint Fiscal Office, Bill Talbott, Chief Financial Officer, Department of Education, and Brad James, Education Finance Manager, Department of Education.
- Studied relevant statements of the Government Account Standards Board (“GASB”) and discussed accounting and financial reporting for property tax adjustments with Thomas Pelham, Commissioner of Taxes, Jim Reardon, Commissioner of Finance and Management, and Stephen Klein, Chief Financial Officer, Joint Fiscal Office.
- Participated in a conference call with GASB technical staff, Ken Schermann, Gregg Driscoll and Wes Galloway. Other participants included Thomas Pelham, Commissioner of Taxes, Jim Reardon, Commissioner of Finance and Management and Nancy Collins, Director of Financial Reporting.

cc:

Stephen Klein, Chief Fiscal Officer, Joint Fiscal Office
James Reardon, Commissioner of Finance and Management
Thomas Pelham, Commissioner of Taxes
Bill Talbott, Chief Financial Officer, Department of Education
Brad James, Education Finance Manager, Department of Education
Nancy Collins, Director of Statewide Reporting
Brad Ferland, Director of Statewide Operations