State of Colorado

DPA

Department of Personnel & Administration

Office of the State Controller 633 17th Street, Suite 1500 Denver, Colorado 80202 (303) 866-6200 Fax (303) 866-4233 www.colorado.gov/dpa

John W. Hickenlooper

Governor

Kathy Nesbitt

Executive Director

Jennifer Okes

Deputy Executive Director

David J. McDermott

State Controller

October 15, 2011

Director of Research and Technical Activities Project No. 3-23 Governmental Accounting Standards Board 401 Merritt 7, PO Box 5116 Norwalk, CT 06856-5116

Dear Mr. Bean:

This letter is the Colorado Office of the State Controller's response to the Exposure Draft (ED) document titled <u>Reporting Items Previously Reported as Assets and Liabilities</u>. Thank you for the opportunity to participate in this important due process.

We believe this Exposure Draft satisfactorily addresses the need to classify certain assets and liabilities under the Concept Statement No. 4 categories of deferred inflows and deferred outflows. We also believe it was appropriate for the Board to determine if any of the items warranted presentation as inflows or outflows, and for pragmatic reasons we agree with the result that some items be presented as inflows or outflows. However, in most instances, we found the supporting arguments for those classifications to be unconvincing (examples include initial operating lease direct cost, debt issuance costs, and various direct loan origination costs and fees). We believe those initial costs and fees are integrally related to the cash flows of future periods and should not be presented as initial period costs except under a cost benefit imperative.

We believe from a purely theoretical perspective that most of the items moved to inflows and outflows should be reported as deferred items applicable to future periods. The unconvincing nature of the arguments presented made the document and the conceptual classification difficult to grasp. The lack of clarity leads us to believe the Board may be considering the inordinate cost of deferring and amortizing the balances as compared to the benefit to financial statement users of deferring normally minor costs. If that is the case, we would prefer that the Board arbitrarily classify those items, because the arguments presented (such as interperiod equity) are detrimental to preparers attempting to come to logical conclusions in implementing the proposed standard.

This Exposure Draft had an overlapping comment period with the Preliminary Views on Recognition of Elements of Financial Statements and Measurement Approaches. We found it difficult to keep from confusing the classifications under the current resources measurement focus with the proposed classifications under the near-term measurement focus in the

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Preliminary Views document. We suspect the confusion caused by this overlap degraded the understanding and quality of the responses for both documents. We would have preferred this exposure draft been released and completed before the new near-term concepts were introduced. While it may have been time sensitive to classify assets and liabilities under the Concept Statement No. 4 elements, we believe the Preliminary Views document could have and should have been delayed and released after the project represented by this Exposure Draft was completed. In speaking with colleagues in the various states, there does not appear to be a common understanding of either document, and we believe it will take a major education effort on GASB's part to inform preparers and other stakeholders. In addition to the conflicting concepts issue, the release of this document during the preparation of many government's financial statements detracted from it receiving the attention it deserves.

We found the technique used in paragraph 3 of identifying applicability to reporting levels (that is, economic resources versus current financial resources) of the various paragraphs to be ineffective for the following reasons.

- Paragraph 3 only referenced the paragraphs in the body of the proposed standard. As is often the case, the body was necessarily cryptic and thus difficult to understand; it made the additional information in the Basis for Conclusions (BFC) of particular importance. However, in nearly all instances the BFC did not contain information about the reporting level to which individual paragraphs applied. As a result, it was necessary to attempt to cross reference between the body and the BFC to identify reporting level information. That was not possible for most of the items addressed in the BFC as assets or liabilities. As a result, we are uncertain whether the Board intends that all items identified as assets and liabilities in the ED (paragraphs 47 and 51) would be reported on both statements prepared under the economic resources and the current financial resources measurement focus.
- Several of the paragraphs not identified as applicable to governmental funds address transactions that we believe would produce reportable activity for governmental funds (whether assets/liabilities, deferred, or currently recognized). Examples include debt issuance costs (paragraphs 14 and 15), acquisition costs for insurance activities (paragraphs 19 and 20), lending and mortgage activities (paragraphs 22-27). Only paragraphs 28 and 29 on regulated operations specifically limit their applicability to business-type activities. If the Board has concluded that paragraphs 14-15 and 19-27 represent activity that can only occur in nongovernmental funds then that should be stated; otherwise we believe those paragraphs should also be identified as applicable to governmental funds.

Paragraphs 46-48 and 50-52 in the BFC identify items that retain the classification as assets and liabilities respectively. Except for the attributes of refundability addressed in paragraph 48 and 52, the document does not provide explanation or justification for the classification of these items as assets and liabilities. The text restates the Concept Statement No. 4 definition of elements rather than explaining how each of the identified transactions meets that definition. Given the hierarchy of classification established in paragraph 44, these items warrant explanation of how they meet the definition of assets and liabilities because that determination precludes them being considered for deferral or current recognition. For example, we do not believe prepaid items meet any of the three control criteria applicable to assets. Prepaid subscriptions, insurance, and rent all are intrinsically related to future periods that would preclude present service capacity to provide services to citizens, in most instances they cannot be exchanged for another asset, and there is no alternative way to use the prepaid item to provide service benefit.

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In paragraph 47 the intent of the cross reference to paragraph 73 of NCGA Statement No. 1 is unclear. Is this just to provide a standards-based recognition of the prepayment concept? The text of paragraph 73 addresses prepaid items as an alternative recognition method that is "usually of a relatively minor nature" in allowing the item to be expended rather than capitalized as an asset (as is required by paragraph 47).

In paragraph 62, the cases presented appear to us to be backward. When the value of resources required to refund old bonds is less than the carrying value, the result is a credit not a debit (dr bonds 200, cr cash 100, cr gain on refunding 100). The discussion in this instance should be about whether the credit represents a liability or a deferred inflow not whether it represents an asset or deferred outflow. When the value of resources required to refund old bonds is more than the carrying value, the result is a debit not a credit (dr bonds 100, dr loss on refunding 100, cr cash 200). The discussion in this instance should be about whether the resulting debit represents an asset or a deferred outflow not whether it represents a liability or deferred inflow.

Except for the technical issue in paragraph 62 discussed above we agree with the deferral of gain/loss on refunding. However, we do not agree with the conclusion about debt issuance costs in paragraph 73. We believe the gain/loss that is deferred could not occur without the debt issuance costs, and the recognition in future periods of the gain/loss as revenue/expense will be misstated by the costs actually incurred to achieve that gain or incur that loss. Debt issuance costs were essential to either lowering future interest outflows or extending/shortening the debt service schedule, and therefore, we believe these costs are applicable to future periods. In each of the instances where the Board has chosen current recognition of initial costs, it has cited a) the temporal nature of the transaction, b) the lack of subsequent similar costs, and c) completion of the transaction as the basis for reaching the conclusion to currently expense the transaction. We find these attributes to be of significantly less relevance than the accurate presentation of future gain/loss recognition to be achieved through deferral and amortization. If the substantive issue is that the initial costs are normally expected to be small in relation to the gain/loss and that deferral and amortization is not cost beneficial, then we accept that argument and would support current recognition of initial costs. The same arguments are applicable to initial fees collected that the Board has specified for recognition as revenue in the period of the initial transaction for other items in this ED. As noted in our general comments above, we are unable to determine if the Board believes cash disbursed from current resources for debt issuance should be expended (in governmental funds) because paragraphs 14-15 and 72-73 are not designated as applicable to governmental funds. The arguments presented in this paragraph apply equally in other instance of initial costs and fees that the Board has chosen to designate for recognition in the period of the initial transaction, and we will not repeat them for each instance.

In paragraph 74, the ED states, "the Board does not believe the costs incurred to originate the lease directly relates to future periods." In using the term "directly relates" we believe the Board has gone beyond the Concept Statement No. 4 criterion that deferred items be applicable to future periods. The ED applies the "directly relates" criterion throughout.

In paragraph 78, the ED requires current recognition of loan origination fees. We disagree with this conclusion because we believe those fees are indistinguishable from compensation for surrendering the opportunity to use the funds for other investments in the future. In addition, a lending activity inherently is related to future periods, and we believe it is incorrect to consider administrative costs of loan issuance to be related to only one of those periods. Although it may not be practical or cost beneficial to defer and recognize these

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fees over time, we believe the Board eschewing deferral on a theoretical basis in interperiod equity will further degrade understanding of that concept. Again, we believe the Board will achieve more consistent understanding and application of this proposed standard if it allows current recognition of loan origination fees (and other initial costs and fees) based on cost benefit and lack of materiality rather than arguments around applicability to a single period.

The reference in paragraph 81 to paragraph 56 is confusing. Paragraph 56 does not specifically address commitment fees, but rather, it generically addresses the impracticability of segregating a large number of transactions between the transaction price and performance obligation cost (for potentially deferring the difference to be earned in future periods). Perhaps the reference should be to paragraph 51 where commitment fees are listed as retaining their classification as a liability. Or alternatively, it could be rewritten to state that the generic discussion of performance obligations (that is, being treated solely as liabilities rather than partially deferred) applies to commitment fees.

In paragraph 82 we agree with the recognition as revenue of commitment fees when the commitment expires unexercised and when the probability of exercise is remote. However, we do not agree that there is a theoretical basis in interperiod equity for recognizing commitment fees in the initial period rather than deferring them. We believe the commitment fees constitute compensation for foregoing the future opportunity to invest in other activities. For similar reasons we disagree with current recognition of fees and costs related to purchases of loans (paragraphs 84 and 85) and mortgage loan origination fees (paragraphs 87 and 90).

In paragraph 98, we agree with the deferral of gains that reduce net allowable costs. However, we believe it would be beneficial for the Board to address how the deferred inflow should be cleared. We expect that it would be a reduction of the deferred inflow and an increase in revenue, that is, in excess of the rates or fees charged. However, we believe the Board should specify whether that recognition occurs over the remaining life of the early extinguished debt or over some other period.

We believe paragraphs 100 and 101 address a long standing area of confusion and we agree with the Boards decision to limit the use of the term deferred to deferred inflows and outflows. However, we found the text confusing and believe it could be more directly and simply stated. The following is our understanding of the substance of paragraph 100:

Resources received in advance of meeting grant eligibility requirements have historically been reported as "deferred revenue", for example when cash has been received for an expenditure reimbursement grant for which costs have not yet been incurred. Because these resources are a liability of the government they should be reported as payable to the grantor rather than as deferred revenue until eligibility requirements (other than time requirements) are met – at which time they should be reported as deferred inflows. When time requirements are also met the deferred inflow should be recognized as revenue.

We believe paragraph 101 effectively communicates the prohibition on using the term "deferred" for items other than deferred inflows and deferred outflows.

In paragraph 105 (line 7), we believe the word "and" is missing and is essential between the words "governmental enterprise". We are unclear of the meaning of the sentence in this paragraph that begins "This approach would address the issue of giving too much

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weight...". Does this sentence presume another approach under which deferred items would be separately tested for the major fund determination? If that is the case it needs to be stated. Similar confusion also arises in the last sentence of paragraph 105.

In Appendix C paragraph 113, we were unable to determine whether the items listed as continuing to be reported as assets and liabilities should be reported on both the economic resource measurement focus based statements and the current financial resources measurement focus based statements. For the third and fourth to last bullets of the liabilities section, loan commitment fees (related to paragraph 23) and fees received for mortgage loan guarantees (related to paragraph 27) it is implied that these fees would not be reported on the governmental fund statements because paragraphs 23 and 27 are not marked as applicable to governmental funds. If the Board believes these two items, or any of the other items in the asset or liability sections, would only occur in proprietary funds or the government-wide statements that should be stated. However, we do not believe that is correct, and as a result, additional paragraphs in the body of the ED should be identified as applicable to governmental funds. It seems inconsistent that many of the items listed in the asset and liability sections of Appendix C are only mentioned in the Basis for Conclusions and not in the body of the ED. Since this proposed standard is intended to designate transactions for specific treatment, we believe those transactions retaining their historical treatment should be addressed in the body not just the Basis for Conclusions and the Appendix C summary of treatments.

We believe the Board should consider adding indicators to the classification of items in Appendix C to show whether each item is applicable at the government-wide, proprietary, and fiduciary level only (economic resources focus) or if the item also is applicable at the governmental fund level (current financial resources focus).

We believe the following additions are needed to the Listing of Classification of Items.

- The reduction of revenue or the expense identified in paragraph 29a should be reflected as "Refunds imposed by a regulator (paragraph 482 of Statement No. 62) in the section related to "items that should be reported as an outflow of resources" (page 32) and/or the section related to "items that should be reported as an inflow of resources" (page 34).
- Recognition by a regulated Business Type Activity of rates previously collected (and deferred) at the point in time that related costs have been incurred should be included in the section related "items that should be reported as an inflow of resources" (page 34)

Overall we found this ED challenging to understand, and we expect that difficulty will be reflected in inconsistencies in application by preparers across all governments.

Thank you for the opportunity to participate in this important due process.

Sincerely,

David J. McDermott, CPA Colorado State Controller

David J. M. Demott