

DEPARTMENT OF STATE TREASURER

STATE AND LOCAL GOVERNMENT FINANCE DIVISION AND THE LOCAL GOVERNMENT COMMISSION

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Mr. David Bean
Director of Research and Technical Activities
Project No. 13-3
Governmental Accounting Standards Board
PO Box 5116
Norwalk, CT 06856-5116

Dear David,

Thank you for the opportunity to comment on the Preliminary Views document "Economic Condition Reporting: Financial Projections". The document requests comments on eight specific topics, which we provide below, as well as some general comments on the document as a whole. After careful consideration we offer the following:

- 1) There are five components of information necessary to assist users in assessing a government entity's fiscal sustainability.
 - a. Components 1 and 2 (inflows and outflows) seem to be reasonable categorizations by which to organize projections. We believe, however, that the projections should be limited to major funds only. We do not believe that the information that results from projecting non-major funds is cost beneficial to the reporting entity because non-major funds are often dissimilar in nature and must be projected individually. Reporting by major funds will supply the reader with projections of the entity's most significant inflows and outflows.
 - b. Component 3 is of concern to us because of the inclusion of pension and other postemployment benefits (OPEB) in the types of financial obligations to be projected.
 We believe the disclosures already included (or soon to be included) in the audited
 financial statements provide more reliable information on the nature and extent of
 these liabilities than a projection of five year-end amounts based solely on historical
 data and known facts. The pension liability figure is heavily affected by market
 performance and any estimate of that performance as of a specific date five years
 into the future would be unreliable at best. The OPEB figure is heavily dependent
 on changes in the health care industry and the activities of the federal government,
 neither of which can be reasonably predicted based on historical data.

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- c. Component 4 seems somewhat redundant to what is already included in the audited financial disclosures. The only additional information this component would provide is the projected debt service for any authorized and unissued debt that will be issued during the five year projection period. We question the value of estimating what annual principal and interest payments would be on this debt based solely on historical data and known facts. Requiring a government to project what interest rates will be five years into the future seems unreasonable.
- d. Component 5 requiring a narrative description of intergovernmental service interdependency seems reasonable, although more guidance is needed on what is expected.
- 2) Financial projections should be based on current policy, informed by historical information and adjusted for known events and conditions that affect the projection periods.

We strongly disagree with this requirement. First, the GASB did not define the term "known" in the guidance. The units in North Carolina that field tested this proposal struggled a great deal with this term. More guidance is needed with regards to how GASB wishes units to define "known events".

Second, widely accepted best practices state that a unit of government should develop and maintain minimum fund balance policies, capital improvement plans (CIP) and utility rate These policies and plans are forward-looking in that they anticipate the government's needs and identify potential resources to be used and actions to be taken to fill those needs. These policies and plans are researched and developed by professional staff and vetted by the public and elected officials. However, because they are not based solely on historical data and known events, they cannot be used in developing the projections that would be required by this preliminary views document. The end result is that a government could have multiple and likely conflicting documents available publicly that purport to accomplish the same goal - to project future resources and uses of those resources by the government. How is the user of a government's financial statements and other data able to reconcile the two very different sets of information available, particularly when they have both been issued by the same entity? It is our belief that this conflicting information will undermine the credibility of the government's elected officials and professional staff with their constituents, with other users of the data, including bond rating agencies, and potentially with each other.

Third, the GASB states that projections are to be made based on current policy. However, current policy may be changed by the governing board of the unit at any time. It is not clear to us why it is inappropriate to use well-developed rate models and CIPs based upon current policy as long as the current policy is disclosed to the reader. If rate models and CIPs based upon current policies are not considered to be a reasonable prediction of future actions, it is not clear to us why current policy is considered to be a factor in making projections as proposed.

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Finally, we are concerned about the ability of a unit of government to manipulate the results simply by the choice of the time period from which to draw its historical data. The two local governments in North Carolina that field tested this methodology both stated that their results would be very different had they chosen a longer period of time from which to draw the historical data that was the basis for their projections.

3) Inflows and outflows should be projected on a cash basis, while financial obligations should be projected on an accrual basis.

For a local unit of government in North Carolina, the requirement to project inflows and outflows on a cash basis is problematic. State statute requires our local governments to maintain their books on the modified accrual basis. Larger governments that have sophisticated accounting systems maintain their daily records on a modified accrual basis, and conversion to cash is difficult and time consuming.

While we understand the underlying accounting principle that calls for financial obligations to be estimated using full accrual accounting, we do not believe it is reasonable or useful to ask units of government to estimate pension and OPEB liabilities for future years. Please see our comments to Item 1.b. for our reasoning on this issue.

4) The identification and development of assumptions for making financial projections should be guided by a principles-based approach and should be disclosed.

The assumptions used in determining any financial projection should be reasonable, consistent, and defendable by the unit of government, and should be disclosed in summary. The constraints of the requirements of this document, however, require a unit of government to base projections on historical data and known events, even in situations where better information has been developed through rate models and capital improvement plans. This requirement forces the unit of government to use assumptions that are contrary in some instances to the assumptions used to create and refine these well-developed tools.

5) Projections should be made for five individual years beyond the reporting period.

Five individual years beyond the reporting period seems reasonable.

6) The components of fiscal sustainability should be required and communicated as required supplementary information.

We do not believe that projections should be included in the audited financial report, even if they are reported as required supplementary information. Less sophisticated users of the audited financial statements may fail to understand the difference between audited information and required supplementary information. The audit community in North Carolina is concerned that this lack of understanding may lead to perceived liability on the part of the auditor for the accuracy of the projections. Regardless of the fact that a

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disclaimer is made on the data, the resources spent responding to claims of potential liability could be substantial and potentially damaging to the auditor. Auditors also believe that the addition of the projections to the report will result in increased audit fees to local governments as a result of the additional time that will be needed to apply limited procedures to the information.

7) All governmental entities should be required to report financial projections and related narrative discussions.

We do not believe that financial projections should be required of any governmental unit under the requirements as laid out in this preliminary views document.

8) Is a phase-in period appropriate for implementing the reporting requirements?

Yes. A phase-in period would allow time to identify where resources are needed to assist smaller units with less capacity to comply with the standard.

We have some additional concerns that did not fit particularly well into the eight questions above as follows:

- The two local governments in North Carolina that field tested this methodology both stated that the time to prepare the required documents was excessive. These are both sophisticated units with professional staff. The time burden on our smaller governments with limited resources will likely prove to be even more burdensome. We believe the requirement to include the additional information in the audited financial statements will slow down the completion of the audit and delay the release of the report. At a time when regulatory agencies are pushing for faster release of data, it seems counterproductive to continue to add to the requirements and thus the time it takes to produce financial statements prepared under generally accepted accounting principles.
- Governments in North Carolina must operate under a balanced budget. Based on our understanding of the requirements of this standard, the projections based on historical data and known facts could easily produce results that reflect estimated expenditures in excess of estimated revenues. Because of our statutory requirements, this could not legally occur in this state. A unit of government would have to reduce expenditures or develop an additional revenue source to support the higher level of spending. The projections prepared under this proposed standard do not reflect this requirement.
- We believe that the information produced from this proposed standard can be beneficial to units of government and users of their financial statement, provided that the information indicates the circumstances under which the programs are sustainable in the future. Displaying negative cash inflows in years that expenditures exceed revenues undermines the credibility of the unit's governing board and the staff with its constituents, rating agencies, and other users of the statements because it indicates that the unit would spend more than it has. In North Carolina, fiscal control laws require an annually balanced

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budget. The government would have to increase inflows or decrease outflows to comply with that law. As an alternative to projections showing negative amounts of cash, we suggest that the proposal be modified to indicate an amount that would have to be provided by increasing revenues to the program or an amount by which service levels would have to be decreased.

The Department is strongly in favor of units of government looking forward and planning for needs, changes in services provided, and changes in revenue streams, debt, and capital. We encourage this planning as part of overall strong fiscal management. We appreciate the GASB's efforts in encouraging units to plan ahead and keep their citizens informed. However, we do not believe the projections that would be required by the implementation of this guidance would produce meaningful results. In some cases, they may produce information that is misleading to the users of the financial statements. If the GASB elects to continue this project, modifications are needed to allow units to project if programs are sustainable and the conditions under which they are sustainable in a way that would be meaningful to the reader.

Thank you again for the opportunity to comment on this proposal.

Sincerely,

Vance Holloman Deputy Treasurer