

State of Colorado



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February 6, 2012

Director of Research and Technical Activities
Project No. 13-3
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 Preliminary Views (PV) document titled Economic Condition Reporting: Financial Projections. Thank you for the opportunity to participate in this important due process.

We fully support the Board's objectives outlined in the PV, and we believe that those who are reliant on services provided and cash outflows of governments should be able to look to the Comprehensive Annual Financial Report to determine the sustainability of those services and cash flows. We agree with and appreciate the Board's view that projections based on known information are intrinsically different from forecasts or predictions, although we are concerned users and government managers are unlikely to honor that subtlety.

It is our experience that external factors adversely affecting forecasts and projections normally have much greater impact on State government's ability to preserve cash inflows and services delivery than does the historical pattern of cash flows or its projection into the future. However, when environmental conditions are stable or improving, users should be warned by the government if structural inflow and outflow patterns presage a change in service delivery or resources demands.

The following text provides the questions posed by the Board in the PV along with our responses in italics. After Question #8, we have provided additional comments on specific issues in the PV.

1. The Board's preliminary view is that there are five components of information that are necessary to assist users in assessing a governmental entity's fiscal sustainability (Chapter 3, paragraph 2):

- Component 1—Projections of the total cash inflows and major individual cash inflows, in dollars and as a percentage of total cash inflows, with explanations of the known causes of fluctuations in cash inflows (Chapter 3, paragraphs 4–9)

Director of Research and Technical Activities
February 6, 2012

Page 2 of 8

- Component 2—Projections of the total cash outflows and major individual cash outflows, in dollars and as a percentage of total cash outflows, with explanations of the known causes of fluctuations in cash outflows (Chapter 3, paragraphs 10–14)
- Component 3—Projections of the total financial obligations and major individual financial obligations, including bonds, pensions, other postemployment benefits, and long-term contracts, with explanations of the known causes of fluctuations in financial obligations (Chapter 3, paragraphs 15–20)
- Component 4—Projections of annual debt service payments (principal and interest) (Chapter 3, paragraphs 21–23)
- Component 5—Narrative discussion of the major intergovernmental service interdependencies that exist and the nature of those service interdependencies (Chapter 3, paragraphs 24–26).

Do you agree with this view? Why or why not?

Although inflows and outflows are necessary to assist users, we do not agree with the requirement for those flows to be presented on the cash basis. See our response to question #3.

Notwithstanding our objection to cash basis flows, the five components listed are useful to the objective of informing users about the sustainability of government's outflows and service. However, we have two primary concerns. First, debt and other borrowing proceeds should not be included in inflows because they distort the assessment of operational sustainability. Removing those inflows would also require removing the related outflows that result in illiquid assets, such as, capital assets and long-term loans. The proposal does not (and should not) include the detailed information that would be necessary to allow users to make their own determination of whether borrowing inflows are for operations rather than restricted to conversion to illiquid assets. Therefore it is important for borrowing proceeds to be excluded. Simply segregating the presentation of these flows (as required by paragraph 22 and 26 of Chapter 5 and shown in illustration 11) is inadequate to avoid the overall distortion of balanced inflows and outflows. Second, the inclusion of capital and related maintenance outflows (especially as a separate category) makes the projections highly suspect. The State of Colorado intentionally uses capital and related maintenance outflows adjustments as a means to mitigate inflow variances. The historical pattern of capital and related maintenance is highly erratic. A trend line based on this erratic pattern produces a projection that in no way represents either what occurred historically or what is likely to occur. There is no valid basis for projecting an erratic pattern. Capital grants are equally erratic and related inflows are not reasonably projected.

We view Component 5 as inadequate to address the state and local government dependencies on the federal government. We believe that dependency is (or should be) driving the concern about fiscal sustainability. In paragraph 24 of Chapter 3 the Board expresses the view that resource interdependencies would be included in cash inflows and outflows. However, with the exception of ad hoc stimulus funds such as ARRA, states are unlikely to know at what point in the five year projection period that significant portions of federal revenue could become unavailable. Notwithstanding that federal funding reductions are not subject to projection, we believe that the dependency on the federal government should require specific disclosure in the intergovernmental interdependencies section rather than limiting that section to service interdependencies only.

Director of Research and Technical Activities
February 6, 2012

Page 3 of 8

2. The Board's preliminary view is that financial projections should be (a) based on current policy, (b) informed by historical information, and (c) adjusted for known events and conditions that affect the projection periods. Current policy includes policy changes that have been formally adopted by the end of the reporting period but that will not be effective until future periods (Chapter 4, paragraphs 2–7). Do you agree with this view? Why or why not?

Notwithstanding our general concerns about the capacity for projections to produce relevant information, we agree that if projections are required they should be based on current policy. We are less convinced that historical information will be a reasonable basis for meaningful projections. Colorado's history is a case in point. Over the last twenty years the State has continuously removed activities from general-purpose revenue funding in the General Fund and replaced those activities with special purpose revenue funding as the education, health care, and social services functions have grown from 61.7 percent of the General Fund budget to 71.6 percent. A projection based on this history would presume that such a trend would continue, but that is likely impossible. There are no known events or conditions at this time that would support adjustment to the historical information, and the result will be projection of a pattern that eventually will become unsustainable in the context of revenue growth limits. The revenue growth limits are tied to population and inflation which can only be based on forecasts or predictions, and as noted are appropriately prohibited from inclusion the financial projections requirement.

3. The Board's preliminary view is that inflows and outflows should be projected on a cash basis of accounting, and financial obligations should be projected on an accrual basis of accounting (Chapter 4, paragraphs 8–12). Do you agree with this view? Why or why not?

We do not agree with the cash basis requirement for presenting inflows and outflows. Except in the limited instance of proprietary fund types there is not a useable cash flow presentation in governmental financial reporting upon which to base projections. Given that the majority of financial reports are prepared on the modified or full accrual basis of accounting, the cash flows focus of components 1 and 2 will require Colorado to translate its historic modified and full accrual information to the cash basis in order to generation projections "informed by historical information". That conversion would be difficult, time-consuming, expensive, and potentially impossible. The cash basis requirement seems inconsistent with the GASB's traditional focus on accrual based information. We support the Board's traditional accrual focus because we recognize that eventually most transactions have a cash impact that is better presented sooner rather than later. The five year requirement for projections does not extend far enough to obviate the shortcomings of cash basis reporting. In addition, there is not an adequate tie between the cash flow information in Components 1 and 2 and the full accrual information on total obligations in Component 3. Changes in variable borrowing interest rates and discount rates (investment return rates) could render the relationship between components 1 and 2 and 3 and 4 not only meaningless, but also misleading.

4. The Board's preliminary view is that the identification and development of assumptions for making financial projections should be guided by a principles-based approach. Such an approach would set forth principles that require assumptions to be based on relevant historical information, as well as events and conditions that have occurred and affect the projection periods. Furthermore, these assumptions should be (a) consistent with each other (where appropriate) and with the information used as the basis for the assumptions and (b) comprehensive by considering significant trends,

Director of Research and Technical Activities
February 6, 2012

Page 4 of 8

events, and conditions (Chapter 4, paragraphs 13–16). Do you agree with this view? Why or why not?

In question #2 above, we have argued that basing the projections solely on historical trends and events and conditions that have occurred will likely prevent the projections from being relevant in many instances. The requirement for the assumptions to be internally consistent and comprehensive is appropriate. However, the requirement for assumptions based on existing events or conditions is not entirely compatible with the notion of comprehensiveness if anticipated future conditions are more meaningful to the analysis.

While we agree that a principles based approach is best to provide the flexibility to make the projection assumptions meaningful, it is also the case that the lack of specificity in the principles based approach will diminish compliance. We have no solution to this conundrum.

5. The Board's preliminary view is that annual financial projections should be made for a minimum of five individual years beyond the reporting period for the purpose of external reporting (Chapter 4, paragraphs 19–23). Do you agree with this view? Why or why not?

We agree that a minimum of five years is appropriate. As noted above, we believe that structural imbalances between inflows and outflows can be obfuscated by intermediate and long-term borrowing and the incurrence of other obligations that may not be obvious in the information provided in Components #3 and #4. While we recognize that longer projections decline in reliability, we believe it is important to allow preparers to provide longer term projections if the structural imbalance is expected to occur outside the five year minimum.

6. The Board's preliminary view is that all of the components of fiscal sustainability information are essential for placing the basic financial statements and notes to the basic financial statements in an operational or economic context and therefore should be required and communicated as required supplementary information (Chapter 5, paragraphs 7–12). Do you agree with this view? Why or why not?

We do not agree with this view. The components of fiscal sustainability are essential for the user to understand the government's prospects over time, but we cannot see how they are essential to placing the basic financial statements and notes to the basic financial statements in operational or economic context. The basic financial statements and related notes are by necessity and appropriately historical information. At the risk of oversimplifying, the past can affect the future but the future (and projections about it) cannot affect the past. The current statements present the financial position and operations of the government and nothing that is presented about the future will change that position or results of operations. We believe the projection information is important to assessing the prospects of the government, but it goes too far to say that the projection is essential to understanding the current year or historical statements and notes.

It seems the determination of communication method is being influenced by the fact that treatment as Supplemental Information will reduce governmental compliance. While it is likely true that communication as Supplemental Information will reduce compliance, it is also the case that interpretations in assumptions and decisions about inclusion will have greater adverse impacts even if the projections are Required Supplementary Information. The Board cannot force compliance with meaningful disclosure of fiscal sustainability, but is at risk of making the communication less

Director of Research and Technical Activities
February 6, 2012

Page 5 of 8

relevant by placing it in a location where it is required and thereby likely to be adversely manipulated.

7. The Board's preliminary view is that all governmental entities should be required to report financial projections and related narrative discussions (Chapter 5, paragraphs 13 and 14). Do you agree with this view? Why or why not?

We believe all governments should embrace the opportunity to present financial projections and related narratives in Supplementary Information. The requirement should apply to all governments regardless of the communication method selected by the Board. If a preparer or government managers have knowledge of a sustainability problem, it is their responsibility to disclose that conclusion as a matter of basic accountability. It is reasonable to conclude that citizens also have the right to know that elected officials and government managers do not anticipate a sustainability challenge.

8. Do you believe that a phase-in period for implementing the reporting requirements for financial projections and related narrative discussions would be appropriate (for example, requiring governmental entities over certain dollar thresholds to implement first)? If so, what phase-in criteria would you recommend (Chapter 5, paragraph 14)?

We do not believe a phased in approach is necessary or appropriate. Traditionally the Board provides additional time to smaller governments in such phasing. We believe that type of phasing is contraindicated. Smaller governments have less complexity, often have more stable revenue streams, and are likely operating on the cash basis required by the PV. Therefore, we believe small governments would be able to implement any resulting standard more readily than will large governments that have complex inflows and outflows, large and complex obligations, and may be maintaining accounts, funds, and activities on the modified or full accrual basis.

Notwithstanding our support for the PV objectives, we believe the Board should consider the following concerns we have about the PV.

In Chapter 2 of the PV, the Board defines fiscal sustainability with one component of the definition relying on the concepts of interperiod and intergenerational equity. While cost shifting to future generations is clearly irresponsible, the Board's view of interperiod/intergenerational equity also eschews consuming resources accumulated in past years and accumulating resources in the current year. We believe this view ignores the importance and the success our nation has enjoyed because we have invested in governmental infrastructure. That investment requires that every generation both consume previously accumulated resources and accumulate resources to provide for future generations. The inordinate focus on current matching promotes excessive individualism, discourages altruism, and inhibits the synergy of all sectors of society investing in the future.

In Chapter 3 of the PV the components of fiscal sustainability are discussed. We found the focus on cash inflows and outflows to be inappropriate because we believe true sustainability can only be measured on the accrual basis. Although a government cannot sustain an imbalance in cash flows over the long-term (which we consider to be longer than the five year projection period), it is possible and even likely that short-term borrowing will

Director of Research and Technical Activities
February 6, 2012

Page 6 of 8

make the focus on cash flows misleading. In paragraphs 9 through 12 of Chapter 4, the Board presents its view that cash basis of accounting should be used for inflows and outflows. In those arguments the Board notes that governmental entities may not have the resources necessary to project inflows and outflows on a basis other than cash. We did not find this argument convincing because all governments are required to produce government wide statements on the accrual basis. In paragraph 5 of Chapter 4, the Board notes that applying historical rates of change is a reasonable and established method of projecting financial results. Given that cash flow statements do not exist for any activities except enterprise and internal service funds, we believe the most cost beneficial means to develop financial projections is through application of historical rates of change to the government wide Statement of Activities. This approach will ensure that sustainability is measured on accrual based fund equity, which is not subject to manipulation through short and intermediate term borrowing. In addition, the Statement of Activities is already in the format of governmental functions, which we find more meaningful than the disparate collection of items defined as major in paragraph 22 of Chapter 5. The Statement of Activities also honors the important concept of general-purpose inflows. With GASB 54 placing significant special purpose activities in the General Fund, important sustainability information regarding general-purpose inflows cannot be meaningfully presented.

We are not sure why the Board believes cash flow is important as a government-wide sustainability measure when it appropriately carries low importance in measuring financial position and results of operations at the primary government level. We do not find debt service cash flows or capital asset acquisition to be a reason to avoid the Statement of Activities projection approach. Debt service cash flows are effectively presented in the GASB 38 Notes, but adjusting them for expected issuances is impractical because the debt service pattern cannot be known until issuance is complete. It would be appropriate to present known debt service cash flows in the Schedule of Financial Obligations, along with actual cash flows projected for other financial obligations (pension, OPEB, and pollution remediation). As previously noted, changing the extent of capital assets acquisition and maintenance is a commonly used technique for addressing external environmental conditions adversely affecting cash flows; therefore, projecting capital outlays based on historical patterns will almost always be misleading. In addition, capital grants are normally at the discretion of the grantor, and therefore, they do not have the certainty attributes necessary to be presented as projections.

We agree that it is not practicable for governments to prepare service level projections as noted in paragraph 14 in Chapter 3 (page 11).

In paragraphs 15 through 19 of Chapter 3 (page 11) the Board makes assumptions about the projection of financial obligation that we find specious. Each obligation type must be individually analyzed.

- For debt and lease obligations, barring expected issuance of authorized obligations, fixed rate debt should only be declining as debt service occurs. In Colorado state government, debt and major lease obligations are normally approved in annual legislation. Colorado has only one debt issuance program that involves advance authorization, and because of local school district participation there is no viable way to project the expected issuance level for this program. The historical record reflects both reduction of principal due to debt service and increases in principal due to newly approved issuances; the latter is not valid for projection purposes given that each new issuance must be legislatively approved. Legislative approval is a function of economic conditions that would require forecasting prohibited in the projection process. Variable rate debt liability projections can only be based on interest rate

Director of Research and Technical Activities
February 6, 2012

Page 7 of 8

changes, which would require forecasting that is appropriately prohibited in the projection process.

- For pensions and OPEB under current standards, which the Board has declared as inadequate for obligation display, growth in the obligation presented would be representative of deferral of pension and OPEB costs (except for cost-sharing plans making statutory rather actuarially determined ARC). However, under the Board's proposed pension standards, which the Board has indicated will be expanded to OPEB, the liability related to deferral of pension costs will be currently recognized. As a result, the only relevance of the projection would be the extent to which future contributions are currently known to be inadequate to meet future pension costs. This would require actuarial projections that are not required by the Board's proposed pension standards and are not practicable for the State to carry out. We believe that under the Net Pension Liability approach, except for major changes in benefits which would be disclosed in the financial statement notes, the actual liability change will be affected to the largest extent by changes in the discount rate related to investment returns. Meaningful projection of the NPL would require assumptions about discount rate that are forecasts prohibited in the projection process.
- Derivative liabilities are most often subject to hedge accounting that is dependent on future market conditions; project of these liabilities would require forecasts that are appropriately prohibited in the projection process. A projection based on current market conditions would be irrelevant and likely misleading.
- Compensated absences liabilities are primarily a function of employee behavior, which can scarcely be forecasted and projections will be even less meaningful. Changes in compensated absence benefits could be disclosed when known, but they are highly infrequent and employee reaction to those changes is unknown.

A close look at the individual components of financial obligations indicates that projections of these liabilities are likely to be of little value to the user, and could potentially be misleading.

In paragraphs 24 through 26 of Chapter 3 (page 13), we are concerned about the subtle distinction drawn by the Board between intergovernmental service interdependencies and intergovernmental resource flows, which are primarily in the form of federal grants and will be confusing to users. As demonstrated in Illustration 14, the impact of intergovernmental service interdependencies is negligible in relation to the impact of a significant change in intergovernmental resource flows (such as federal grant revenues). We believe it will be confusing to users that the disclosure focuses on the relatively minor interdependency rather than the more significant resource flows interdependency.

We find the requirement in paragraph 24 of Chapter 5 to be onerous. Testing all cash inflows, cash outflows, and obligations across all five years of the projection for meeting the ten percent threshold in any year would require that some discrete definition of cash inflow, cash outflow, and obligation be available. Since the discussion of "major" does not take a fund based approach, governments will be left to define the appropriate level of aggregation for the terms cash inflow, cash outflow, and obligation in order to carry out the ten percent threshold test. Many approaches could be adopted (revenue source, expenditure object, agency, program, function, etc.), and significant inconsistency in application is likely to result.

Having independently come to the conclusion that the characteristics of relevance, reliability, comparability, consistency, timeliness, and understandability could only marginally be met for financial projections, we found the alternate view more convincing than the majority position, which requires financial projections as Required Supplementary Inform-

Director of Research and Technical Activities
February 6, 2012

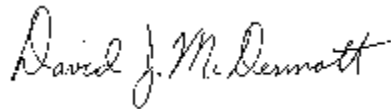
Page **8** of **8**

ation. Although we believe financial projections are important to users understanding of prospects for the government, we do not understand how projection that are subject to significant uncertainty can be essential to placing currently known actual results in operational or economic perspective. We believe financial projections should only be presented as Supplemental Information. The State of Colorado is required to produce Basic Financial Statements (including RSI) by September 20 each year (for Fiscal Year Ending June 30), and the placement of financial projections in RSI will likely make that statutory deadline impossible to meet. We do not support the alternative view's suggestion to move ten year information to RSI.

The Board has appropriately determined that forecasts and predictions are not practicable for achieving the fiscal sustainability objective. However, a review of the ten-year data in Colorado's CAFR Statistical Section makes it clear that economic conditions have a much greater impact on fiscal sustainability than do the static environmental conditions that are by necessity the basis for financial projections. While we believe it is important for governments to understand and disclose structural imbalances between inflows and outflows and between obligations and resources, we do not believe the proposal addresses that need because such structural imbalances frequently have adverse impacts well beyond the proposal's five year horizon. In addition, a meaningful analysis of such structural imbalances normally requires a longer time horizon and inclusion of economic and other environmental variables in the form of forecasts. As a result, we believe that any standard issuing from the Preliminary Views will produce much preparer work but little user value.

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

Sincerely,

A handwritten signature in cursive script that reads "David J. McDermott".

David J. McDermott, CPA
Colorado State Controller