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March 29, 2012

David R. Bean, CPA
Director of Research and Technical Activities
GASB
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Re: November 29, 2011 Preliminary Views of the Governmental Accounting Standards Board on major issues related to *Economic Condition Reporting: Financial Projections* [Project No. 13-3]

Dear Mr. Bean:

One of the objectives that the Council of the American Institute of Certified Public Accountants (AICPA) established for the PCPS Executive Committee is to represent the views of local and regional firms on professional issues in keeping with the public interest, primarily through the Technical Issues Committee (TIC). This communication is in accordance with that objective. These comments, however, do not necessarily reflect the positions of the AICPA.

TIC has reviewed the preliminary views document (the PV) and is providing the following comments for the Board's consideration.

GENERAL COMMENTS

TIC appreciates the Board's efforts toward developing a financial model designed to measure fiscal sustainability of governmental entities. However, TIC is doubtful that the model proposed in the PV will achieve that goal. Furthermore, TIC is not optimistic that any financial model could provide a true barometer of sustainability. Even if projections of sustainability had been prepared years ago, TIC believes that the potential effects of the financial crisis could not have been predicted and therefore little could have been done to prevent the resulting adverse consequences for governmental entities.

As TIC reviewed the PV, the committee was unconvinced that the proposed projections were an improvement over the budgeting process that most governments currently use. In particular, TIC disagreed with limiting the hypothetical assumptions to current policies, historical information and known events and conditions that affect the projection periods. TIC fails to see how these hypothetical assumptions would produce projections that could realistically demonstrate the government's ability and willingness to generate sufficient inflows of resources to honor current service commitments and to meet financial obligations as they become due. The concept of sustainability should

involve more than just the government's ability and willingness to keep things as they are. The concept should allow for the inclusion of certain realistic expectations, even if such expectations are hypothetical and therefore more subjective.

TIC also has concerns about certain measurement assumptions underlying the projections. TIC opposes the proposed requirement to measure projected inflows and outflows on the cash basis and believes the projections would be incomplete without at least a narrative discussion of infrastructure replacement.

While TIC does not oppose the development and presentation of forward-looking information for financial statement users, TIC disagrees with the notion that such information is essential for placing basic financial statements and notes to basic financial statements in an appropriate operational, economic, or historical context. TIC sees a distinction between external, historical financial reporting and budgeting, forecast modeling, and strategic planning and believes the line between them should be clearly maintained, as discussed in GASB Concepts Statement 3, *Communication Methods in General Purpose External Financial Reports That Contain Basic Financial Statements*. Therefore, TIC believes it is inappropriate to establish a requirement to present projections as required supplementary information (RSI) in an annual financial report or a comprehensive annual financial report.

TIC also believes the proposal is unworkable from a practical perspective. A requirement to present projections will be burdensome to smaller governments and could result in unintended consequences. Governments that do not have sufficient internal personnel with the required expertise to prepare the projections will have to incur the added cost of hiring outside help to fill the gap. TIC also shares the concern expressed in paragraph 2 of the Alternative View that presenting projections as RSI could potentially delay the issuance of audited financial statements and affect a government's willingness to prepare its financial statements in accordance with GAAP.

Another unique feature of the PV is the proposal to present hypothetical projections within a general use document, which presented two concerns for TIC. First, TIC believes that the sample cautionary paragraph in the PV does not provide enough information to adequately inform the user about the limitations of the presentation and how it would be used to assess sustainability. As indicated below, users may therefore be confused by the projections and misunderstand their intent. Ultimately, the risk is that the users would misapply the information and draw incorrect conclusions from the data.

Secondly, TIC members are wary of association with projections in general use documents due to their subjective nature and the potential for misapplication by users. This, in turn, creates concern surrounding the auditor's perceived role in connection with these presentations. Even though the explanatory paragraph on RSI in the auditor's report explains that limited procedures were performed and states that no opinion is being expressed, TIC has concerns that users may not understand the auditor's role. Potentially, users may erroneously believe the auditor is providing assurance on the RSI when none was intended. TIC will be monitoring the activities of the AICPA's Auditing

Standards Board (ASB), which is expected to address reporting issues regarding projections in general use documents.

Based on the multitude of issues that TIC identified concerning the PV, TIC recommends discontinuing this project or at least significantly deferring it until more research can be performed on the proposed model and more consideration can be given to presentation issues. In the meantime, TIC suggests another alternative. Many governments already prepare long-term budgets of operations and future capital needs. Under the open records laws of most states, such information would be available to those who want it. To accommodate such users, TIC recommends adding a reference in the notes to the budgetary information directing financial statement users to where long-term budgets may be obtained. Third party users may not be aware that such information is available, and it may satisfy their information needs without the government incurring additional cost.

Even if the Board decides to move forward with the PV as proposed, TIC believes the Board should implement the following recommendations before proceeding to the exposure draft stage:

- The stated criteria for projections should be subject to extensive testing with financial statement users of all types and sizes. TIC questions whether the projections will be a valid predictor of sustainability, whether financial statement users will understand the presentations, whether the proposal will have unintended outcomes, and whether a one-size-fits-all approach will be appropriate for all entities. These questions may be answerable through such additional research.
- The basis of accounting used to calculate certain components of the projection should be re-examined. Under the proposal, some governments will have to prepare financial reports under three different bases of accounting, which will create excessive confusion for preparers and financial statement users and cause the governments to incur significant additional costs.
- The proposed RSI presentation should be removed from the final standard. As an alternative to RSI, TIC recommends that the projections be published as supplementary information (SI), as defined by the GASB.
- The cautionary paragraph preceding the projections should be revised to provide a more robust description of the purposes and limitations associated with the projections and to provide linkage between the projection and the assessment of sustainability.
- Reduce the projection period from five years to three years.

The Specific Comments section below includes responses to each of the Board's questions and explains each of TIC's concerns in more detail.

SPECIFIC COMMENTS

- 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)
- 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?

As discussed above and in Question 6 below, TIC does not support including this information as RSI. However, if the Board proceeds with its project as proposed, TIC would offer the following comments regarding the planned components of the projection.

TIC supports the data elements (inflows, outflows, financial obligations, annual debt service payments and major intergovernmental service interdependencies) that comprise the five components above. However, TIC disagrees with the proposed measurement attributes for those components. These concerns are discussed in TIC's response to Question 3 below.

TIC would also add a sixth component relating to the entity's infrastructure. Because infrastructure is such a significant portion of a governmental entity's ability to meet its service capacity obligations, TIC believes there should be a schedule or narrative that would indicate how the government is addressing the upgrade and maintenance of that

infrastructure. Simply projecting the outflows gives the financial statement user no ability to assess whether or not service obligations are being met. Most users will not be aware of the age of the sewer utility, the condition of the streets, roads, and bridges, the status of the technology of its television cable services, etc., and whether and how soon infrastructure needs to be replaced. Contrary to the assertion in Chapter 3, paragraph 20, which implies such information may not be currently available for most governmental entities, TIC believes enough information would be available to present, at a minimum, a narrative that would discuss the administration's plans for the replacement of key components of the government's infrastructure.

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?

TIC has some concerns about using the above framework as a basis for the government's assumptions underlying the projection. TIC believes a projection based primarily on current policy and historical trends is incomplete.

TIC also believes that insufficient guidance has been provided to properly apply the assumptions in special situations. Two examples serve to illustrate this point:

- In some situations, there may be no discernible historical trend information, implying that no specific assumptions could be developed for the projection period. For example, City A makes its decision on whether to borrow for infrastructure projects on an annual basis, but annual borrowing is not necessarily an historical trend and past history has been very inconsistent. Paragraphs 2-7 of Chapter 4 imply that the government could not project that additional borrowing would occur in the projection period since there is no clear historical trend to do so and no current policy that would authorize borrowing during the projection period.
- In other cases, the projection may become stale shortly after it is issued. For example, school districts in the state of Wisconsin are required to adopt a June 30th year-end and to issue their financial statements by a specific date. For these school districts, the actual state aid received in the first projection period could differ dramatically in either direction from the amount that was projected based on available historical information. In some cases, the projection could be out-of-date within a few months after it is issued.

TIC therefore believes that the Board should reconsider the proposed assumption to project revenues based solely on current policy and historical information adjusted by known events and conditions that affect the projection period. TIC believes the

underlying assumptions for the projection need to include certain predictive elements that would in turn allow for a more realistic estimate of sustainability over the projection period. Sustainability should be more than the government's ability and willingness to maintain interperiod equity in a static environment. To assume that today's policies and trends will continue unaltered for 5 years into the future does not seem to be a meaningful approach.

Establishing the framework for the projections based on the premise that a government's future revenues and expenditures will be rooted in historical trends and policies is too hypothetical. Governments will alter their policies to address predicted cash shortfalls or other adverse circumstances and, of course, are not bound by historical trends or current policies. TIC believes the Board should explore possible alternative assumptions that would provide for some flexibility in the model and allow the projections to be more realistic. This would, of course, add more subjectivity to the projections. While TIC would not want more subjectivity in RSI, TIC believes it is equally unacceptable to present a projection in RSI that is unrealistic. This is one of the reasons TIC opposes the presentation of projections as RSI, as discussed in more detail below.

However, if the Board decides to retain the premise of historically based assumptions, TIC strongly recommends that the cautionary language accompanying the projection be strengthened to mitigate the likelihood that inappropriate conclusions will be drawn from the hypothetical presentation. As written, the cautionary language is not adequate to place the financial projections and related narratives in the appropriate context. Although the sample cautionary paragraph on page 29 of the PV states that the projections "do not represent a forecast or a prediction of the most likely outcome" and that the assumptions used are inherently subject to uncertainties, it fails to emphasize that the assumptions that form the basis for the projection are hypothetical; and based on TIC's experience reviewing variances on single and dual-year budgets, the projected results would be highly unlikely to occur. TIC believes the first paragraph of the cautionary language should be amended to clarify the linkage among the assumptions, the projected outcomes and the perceived usefulness of the projection. TIC suggests the following example to illustrate the desired amendments:

The financial projections that follow assume current fiscal policies would be continued, with consideration of historical information as well as known events and conditions that affect the projection periods. These financial projections may be used to assess whether projected cash inflows will be sufficient to sustain public services and to meet financial obligations as they come due, assuming the government's current fiscal policies and historical trends were to continue throughout the entire projection period. Although such policies and trends would evolve and change over time, this presentation can provide insight into the fiscal sustainability of the government in a static environment. The government's projected sustainability may provide a foundation for future strategic planning initiatives.

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 this view since the proposal would introduce an unacceptable level of complexity and effort into the financial reporting process. A requirement to measure projected inflows and outflows on the cash basis would force some governments to prepare financial information based on three different bases of accounting – accrual basis for the government-wide financial statements, modified accrual for the governmental funds, as well as the current-year budget-to-actual comparisons, and cash basis for projections. To require a third method for reporting projections would overwhelm those responsible for financial reporting who already have the burden of maintaining compliance with existing standards with limited resources at their disposal. An alternative may be to outsource this function, but then the government will be incurring additional costs with limited benefits.

Having yet another reporting method to explain to elected officials and citizens would introduce unnecessary confusion into the financial reporting process. The budget approval process will become more complex as government officials struggle with understanding and then explaining the difference between a proposed budget for the following year and the required projections for the same period. Even if educational materials are made available, TIC is skeptical that such materials would reach all interested parties or would be understood consistently. Instead, TIC proposes that governments be allowed to base the projections on the same method of accounting used to prepare their budgets.

Many governments have developed a reliable system for preparing their budgets using the modified accrual method, which they also use for their governmental funds. This approach would have the added benefit of minimizing additional costs and would be easier to understand than the proposed criteria. Using the same accounting method for budgets and projections will lead to consistency between the actual-to-budget comparisons of the current year and the projections.

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

No. See the answer to Question #2.

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?

No, TIC does not support a five-year projection period. As the length of the projection period increases, the assumptions will become less relevant and less realistic and therefore less useful. If the Board proceeds with its project as proposed, TIC believes a three-year projection period would be sufficient to meet the information needs of users about the forward-looking aspects of economic condition – fiscal capacity and service capacity. A three-year presentation also would be more cost beneficial for the preparer and would eliminate the added complexity of developing a five-year projection.

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?

No, TIC does not agree with this view. TIC agrees with the argument presented in paragraphs 1 and 2 of the alternative view (Chapter 6), which contends that this information does not meet the definition of RSI in Concepts Statement 3, paragraph 42, because the reporting of forward-looking information is not essential for placing basic financial statements and notes to basic financial statements in an appropriate operational, economic, or historical context. The historical information can stand on its own without the prospective information. In addition, as noted, Concepts Statement 3, paragraph 44, further describes the types and qualitative characteristics of information reported as RSI as follows:

RSI may include explanations of recognized amounts, analysis of known facts or conditions, or other information essential for placing the basic financial statements and notes to basic financial statements in context. However, RSI does not include (a) subjective assessments of the effects of reported information on the reporting unit's future financial position....

The inclusion of the projections is in direct conflict with the Concepts Statement 3, since the projections are both subjective and represent a report on future financial position.

TIC believes the proposed projections are more closely aligned to the definition of SI in Concepts Statement 3, paragraph 46, since, for some governments, this information would be considered supporting information that is useful (rather than essential) for placing basic financial statements and notes in an appropriate operational, economic or historical context. TIC was not convinced by the Board's arguments to the contrary in Chapter 5, paragraph 10.

Aside from the theory behind where the projections should be reported, there are practical issues with the proposal. If the projections must be presented as RSI, an

unintended consequence for some governments may be delays in the issuance of the financial statements. Many smaller governments would be hard-pressed to complete the RSI, along with the historical financial statements, on a timely basis given the added complexity involved and the potential lack of personnel with the required skills. Other governments may deliberately delay issuance of the financial statements, where such choice exists, to obtain the most accurate numbers for the projections. For example, if a school district has no discernible, historical trend information as to the amount of state aid it will receive in the following year, it may decide to delay issuance of its financial statements until the amount of state aid to be received is known. At that point, the school district would have a known event upon which to base the projection. In many cases, this information may not be available until one or two months after the school district would typically issue its annual financial statements. Please see also TIC's comment below regarding the applicability of this PV to all governments (Question 7).

Governmental entities that are facing potentially significant costs from the PV are likely to either switch their financial reporting framework to another comprehensive basis of accounting (where permitted) or, if GAAP is retained, such governments are likely to omit the RSI. TIC believes neither outcome is desirable.

For all of the above reasons, TIC believes presenting the projections as RSI is unworkable. As discussed in the General Comments section above, prospective financial information prepared by a government should be reported separately from historical financial statements. Many governments already prepare long-term budgets of operations and future capital needs. Under the open records laws of most states, such information would be available to those who want it. To accommodate such users, TIC recommends adding a reference in the notes to the budgetary information telling financial statement users where long-term budgets may be obtained. Third party users may not be aware that such information is available, and it may satisfy their information needs without the government incurring additional cost.

For those entities that choose to present projections of fiscal sustainability, TIC recommends that they be published as supplementary information (SI). This approach would allow the governments, where the benefits outweigh the costs, to present the information while still allowing those where the costs will outweigh the benefits to omit the information.

TIC also has concerns about the practitioner's association with projections that are published in documents that will be available for general use. The concerns extend to the auditor who is associated with the RSI as well as the practitioner that may be engaged by the government to prepare the projection on the government's behalf. TIC has decided not to comment on specific reporting issues at this time and will monitor the ASB's activities in this area.

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?

TIC does not agree that all governments should be required to provide this information. For many smaller entities, the costs will outweigh the benefits. Smaller governments are likely to need projections on an occasional basis if, for example, they need financing to purchase equipment or other fixed assets. In evaluating the loan, the bank would request specific information from the government based on its own loan model that includes preestablished criteria. The criteria established by the GASB for projections may or may not be the same. Therefore, the projections developed under this PV may not be suitable for the primary user of a small government's financial statements and would be totally irrelevant in years when the government has no need to borrow funds for operations. Therefore, the costs incurred by smaller governments to prepare the projections under the stated criteria will be higher than any benefit derived.

TIC recognizes that forward-looking information can be useful to governments and their financial statement users. However, at this time, it is premature to assume that a one-size-fits-all model will be suitable for all governments. TIC would prefer to allow time for the practices to evolve to determine if governments of different sizes have different needs and if models could be tailored to smaller governments with simpler operations and tighter cost restraints.

In addition, because the information does not meet the definition of RSI in Concepts Statement 3, as indicated above, it appears to be inappropriate to require inclusion in the same document as historically based financial statements.

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)?

While TIC is adamantly opposed to the reporting requirements, if the Board chooses to move forward, TIC would support phase-in periods similar to those used for the implementation of GASB Statement 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*.

TIC appreciates the opportunity to present these comments on behalf of PCPS member firms. We would be pleased to discuss our comments with you at your convenience.

Sincerely,

Karen Kerber, Chair

Karen Kerber

PCPS Technical Issues Committee

cc: PCPS Executive and Technical Issues Committees