January 11, 2017

Director of Research and Technical Activities
Project No. 3-251

Dear Dave:

Thank you for the opportunity to comment on ITC “Financial Reporting Model Improvements – Governmental Funds.” My response discusses why the GASB should adopt the “long-term (total financial resources) approach.” In this connection, Board members may also wish to read the article, “GASB’s Governmental Fund Financial Reporting Model Is Seriously Flawed,” written by former GASB Chair Bob Attmore and me (Journal of Governmental Financial Management, Spring, 2015, pp. 24-30).

I will support my recommendation partly by discussing the financial reporting implications of the way governments budget for pension and OPEB obligations. Many governments budget for pensions in accordance with actuarial recommendations, but many others are significantly under-financing them, pushing expenditures applicable to the current period off to the future. A large number of governments budget for OPEB on a cash or near-cash basis. Failure of the “short-term” approaches to fully recognize expenditures and liabilities for under-financed pensions and OPEB causes incomplete and misleading General Fund financial statements.

**Question 2.1.** Governmental funds should continue to focus on financial resources. However, they should not reflect a shorter time perspective than the government-wide statements. To avoid repetition, I will discuss the shorter time perspective in response to Question 2.3.

Governmental financial statements must continue to report on funds because (a) budgets are prepared on a fund basis and (b) users of financial statements and interested citizens are concerned with budgets and funds (the General Fund, in particular). In this connection, it is important to note that the notion of “balanced budget” is a key stakeholder concern.

Because budgets are prepared on a financial flows basis, movement to an economic resources focus for reporting on the funds, with its introduction of depreciation, will needlessly
complicate use of governmental fund financial statements. Hence, governmental funds should continue to focus on financial resources.

**Question 2.2.** Yes, governmental fund financial statements must be compared with a government’s budgetary information, because accountability demands it. This is particularly important because of the propensity of some governments to under-finance expenditures attributable to the current period and ultimately payable from the General Fund.

**Question 2.3.** I suggest this question is poorly worded because it presumes that a “shorter time perspective” provides the appropriate approach for reporting on governmental funds. In any event, I urge that the GASB adopt the “long-term (total financial resources)” approach because (a) it is the only one that provides complete, accurate data for reporting on governmental funds, (b) it facilitates understanding of the government-wide statements, (c) it produces a position statement that shows both current and long-term liabilities, and (d) it produces an operating statement that can be compared readily with actual inflows and outflows on the budgetary basis of accounting.

**Nature and Magnitude of the Issue.** To provide some perspective on the nature and magnitude of the issues, here are some data regarding the financing of pensions and OPEB.

The financing norm for governmental pensions is that the obligation should be financed on a sound actuarial basis during the working lives of employees. Ignoring differences arising from differing actuarial methods and estimates, the effect of actuarial financing is roughly equivalent to what we might refer to as accrual-basis financing. Analysts consider funded ratios of 80% - 90% as reasonable. The most recent National Association of State Retirement Administrators’ Public Fund Survey, based on fiscal 2015 data, includes more than 120 of the largest systems, involves more than $4.13 trillion of actuarial liabilities and covers almost 13 million active members and 9 million annuitants. The average funded ratio of all the systems covered by the report is 73.7%. But there is a wide disparity among the pension systems in the funded ratio – 20 systems are more than 90% funded and 23% are less than 60% funded. Here are some specifics:

<table>
<thead>
<tr>
<th>System</th>
<th>Actuarial Liability</th>
<th>Funded ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wisconsin Retirement</td>
<td>$ 91.5 billion</td>
<td>100.0%</td>
</tr>
<tr>
<td>New York State Teachers</td>
<td>96.9 billion</td>
<td>92.9</td>
</tr>
<tr>
<td>North Carolina Employees</td>
<td>67.7 billion</td>
<td>95.6</td>
</tr>
<tr>
<td>Illinois Teachers</td>
<td>108.1 billion</td>
<td>42.0</td>
</tr>
<tr>
<td>Kentucky Employees</td>
<td>13.3 billion</td>
<td>21.9</td>
</tr>
<tr>
<td>New Jersey Teachers</td>
<td>55.3 billion</td>
<td>51.1</td>
</tr>
</tbody>
</table>

Review of previous years’ Surveys shows that the funded ratios for some poorly funded systems are worsening. Regarding the poorly funded systems in the foregoing table, the 2010 Survey
shows the Illinois Teachers system to be 48.4% funded, Kentucky Employees system to be 40.3% funded, and the New Jersey Teachers system to be 58.6% funded.

These statistics show that many governments fund their pension obligations at about the levels recommended by their actuaries, but that many other governments systematically under-finance their pension obligations to a significant extent. They also show that those governments that under-finance their pension obligations accumulate large liabilities. What does this mean from an accounting standards-setting perspective? It means that General Fund accounting standards that do not take account of the implications of the differences in funding practices will produce financial statements that are not comparable because governments with the same pension benefit structures that finance their obligations at different levels will record vastly different expenditures. It also means that, using the shorter-term approaches, General Fund financial statements prepared by governments that systematically under-fund their pension obligations are incomplete and can be misleading because they significantly understate expenditures and liabilities.

Like pensions, OPEB is a relatively large expenditure for many governments. The norm among governments is to finance these expenditures on a cash or near-cash basis, rather than as earned by the employees, but some governments do accumulate assets to finance their OPEB obligations to some extent. According to a Pew Charitable Trusts report (State Retiree Health Care Liabilities, dated May 2016), the 50 states combined had OPEB liabilities in 2013 of $627 billion and assets of $40 billion – for a funded ratio of only 6%. The report notes that 22 states had funded ratios ranging between 0% and 1%, while 7 had funded ratios over 30%. According to the Pew report, states with funded ratios over 30% enacted laws expressing explicit pre-funding policies. The Pew report also states that the average percentage of ARC paid in 2013 for all 50 states was 39%. Here are the reported statistics for a few selected states:

<table>
<thead>
<tr>
<th>State</th>
<th>2013 Liability ($ millions)</th>
<th>2013 Assets ($ millions)</th>
<th>Funded Ratio</th>
<th>% of ARC Paid</th>
</tr>
</thead>
<tbody>
<tr>
<td>California</td>
<td>$80,312</td>
<td>$85</td>
<td>0%</td>
<td>33%</td>
</tr>
<tr>
<td>Illinois</td>
<td>$56,330</td>
<td>- $93</td>
<td>0%</td>
<td>21%</td>
</tr>
<tr>
<td>New York</td>
<td>$69,514</td>
<td>0</td>
<td>0%</td>
<td>43%</td>
</tr>
<tr>
<td>Michigan</td>
<td>$24,555</td>
<td>$2,780</td>
<td>11%</td>
<td>78%</td>
</tr>
<tr>
<td>Ohio</td>
<td>$24,887</td>
<td>$15,605</td>
<td>63%</td>
<td>19%</td>
</tr>
</tbody>
</table>

Thus, the implications of the shorter-term approaches for the OPEB situation are similar to those regarding pensions: financial statements that lack comparability, are incomplete and are potentially misleading.
Nature of Expenditures. Before discussing the theoretical aspects of the issues, I will comment on the timing of cash inflows and outflows of General Fund revenues and expenditures as compared with the “earning” of revenues and the incurrence of expenditures. Revenues are derived mostly from taxes, fees, and intergovernmental grants. There is a relatively short period between the time these revenues are “earned” and the time most of the cash is received. As a general rule, most of the cash is received in the same year revenues are “earned,” although some revenues trickle in during the following year. The largest governmental expenditure is generally for salaries, where cash outflows occur more or less simultaneously with the incurrence of the obligation to make payment. Many other cash outlays (e.g., for supplies) are made within 30 to 60 days of the incurrence of the liability.

But the timing situation for pension and OPEB expenditures differs among governments depending largely on budgetary practices. GASB standards articulate clearly that pension and OPEB obligations arise simultaneously with the provision of services by employees because they are simply another form of employee compensation. If pensions were provided by means of defined contribution plans, I’m quite certain that the cash outflows to plan administrators would be similar to the outflows for items like supplies – paid within 30 to 60 days after the end of each quarter or year. But budgetary practices allow governments that administer their own defined benefit pension plans – if they so choose – to avoid making annual contributions to the plans commensurate with the costs of the benefits earned by employees during the year. From an accounting perspective, expenditures attributed to a particular year must be recognized as expenditures of that year, regardless of whether the cash is disbursed in that year. Unless the accounting model requires an accrual, two governments with the same situation will record different expenditure amounts, solely because of the timing of the disbursement. And, by the way, both will report “balanced” budgets, even though one is balanced only in form and the other is balanced in substance. As previously noted, the timing difference regarding OPEB is even more pronounced than it is with pensions.

Accounting Implications of the Way Budgets Are Balanced. Virtually all state constitutions and/or statutes require the states and their municipalities to prepare balanced budgets. Even where balanced budgets are not required, the balanced budget is the norm among those who are concerned with the entity’s finances. Unfortunately, the term “balanced budget” is either not defined in constitutions or statutes or defined in such a way as to enable budgets to be balanced in form (that is, in a mathematical sense), but not in substance (in an economic sense). So, governments are in a position to prepare “balanced” budgets simply by pushing appropriations and expenditures applicable to the current period off to future periods.

Governments that require balanced budgets and have statutes or financial policies requiring that pension appropriations be based on actuarial recommendations or GASB accounting
standards will be in a different budgetary situation from governments that are at liberty to severely under-finance pension benefits. The same holds true for OPEB. Therefore, to the extent that an accounting model is driven by budgetary thinking, there is a potential for the resulting financial reporting to do the same thing that budgets can accomplish – fail to recognize the existence of significant expenditures and liabilities.

 Balanced Budgets, Interperiod Equity and “Fiscal Accountability”: GASB CS1 refers to accountability, balanced budgets, and interperiod equity. Par. 56 states that “accountability is the cornerstone of all financial reporting in government.” Par. 59-61 discusses the notion of interperiod equity and its relationship to balanced budgets. I quote some excerpts from these paragraphs because they help to establish a framework for governmental financial reporting.

 “The intent of [balanced budget] laws is to require financing and spending practices that enable governmental entities to avoid financial difficulty and to ‘live within their means.’” “The Board believes the intent of balanced budget laws is that the current generation of citizens should not be able to shift the burden of paying for current-year services to future-year taxpayers.” “The Board believes the term interperiod equity may be more appropriate [than intergenerational equity], expressing the concept of yearly balance.” “In short, financial reporting should help users assess whether current year revenues are sufficient to pay for the services provided that year and whether future taxpayers will be required to assume burdens for services previously provided.”

 GASB S34 (par. 203-210), introduces the term “fiscal accountability,” applying it to governmental activities and distinguishing it from “operational accountability” as being applicable to business-type activities. Par. 203 defines fiscal accountability as “the responsibility of governments to justify that their actions in the current period have complied with public decisions concerning the raising and spending of public moneys in the short term.” Par. 205 states that: “These decisions [concerning the raising and spending of public moneys] generally are incorporated into a legally adopted budget or spending plan...and that the financial statements for governmental activities traditionally have fulfilled the role...[of reporting on]...whether resources were in fact raised and spent in the amounts and for the purposes intended.” Par. 210-213 attempts to justify continuing the traditional focus of governmental fund financial statements on fiscal accountability, as well as the continued use of the current financial resources measurement focus and the modified accrual basis of accounting in governmental fund financial reporting. Par. 213 asserts that user needs for longer-term information should be provided in the government-wide statements. I note that par. 203 refers to “in the short term” and I assume par. 203-213 represent the basis for the near-term and short-term models.
Reasons for Adopting the “Long-Term (Total Financial Resources)” Approach: I agree with the “long-term (total financial resources)” approach and consider the “near-term” and “short-term” approaches seriously flawed for the following reasons.

a. In earlier paragraphs, I described what I consider the most important reason why the current financial resources model (and the changes proposed in the near and short-term approaches) must be abandoned: Using budgetary-type measurements in accounting financial statements runs the risk of producing incomplete and potentially grossly misleading statements. I have no doubt that many governments (particularly those prepared by smaller municipalities whose pensions are administered by well-run state pension agencies) prepare budgets that are balanced in substance. But as described earlier, many governmental budgets contain appropriations for current period operations at a level that push the payment burden off to future taxpayers. In those situations, the “near-term” and “short-term” approaches produce General Fund operating and financial position statements that understate expenditures and liabilities, creating an illusion of better financial health than actually exists.

b. I believe the “shorter time” perspective is nothing more than a contrivance created for the purpose of continuing an accounting model that may have been outdated when NCGA S1 was written, was outdated when GASB S34 was written, and is surely outdated today. General Fund budgets are, in fact, short-term documents because they raise revenues and provide appropriations for only one year (two years, in a few cases), but they have significant long-term consequences if they do not provide the resources needed to finance all the obligations resulting from the year’s operations.

   Indeed, the “Messages Conveyed” sections (pp. 8 and 12 of the ITC) demonstrate why the “near-term” and “short-term” approaches lack validity. The ITC (par. 20 on p. 12) says that the short-term approach would assist in “(c) determining whether the government has available resources... to meet new or additional service needs.” But the short-term approach does not report the full cost of operations and the longer-term liabilities resulting from failure to fully finance them. So, the shorter time perspective sends an incomplete and therefore misleading message. Instead of saying “we have X amount of resources to spend on service needs,” the message that should be sent is “we have X amount of resources to spend on service needs, but before we spend them, we must consider those longer-term liabilities and the factors that caused them.”

   At the time NCGA S1 was written, there were no governmental accounting standards for pensions and OPEB and those benefits may not have been as significant and widespread as they are today. But we know a lot more about those benefits today. We now have detailed data on the nationwide financial status of pension and OPEB systems, and we know that pension and OPEB benefits have played a role in the bankruptcies of some governments and are contributing to serious financial imbalances in others. We
cannot bury the long-term financial impact on the General Fund of the outstanding pension and OPEB obligations just to provide a “shorter time” perspective. A “long-term” approach provides complete information on the General Fund’s operations and financial position, and a classified position statement provides the data necessary to distinguish between obligations that need to be paid in the short term and those that either are normally long-term (such as compensated absences and judgments and claims) or that have been pushed to the long-term by budgetary decisions (such as pensions and OPEB).

c. “Fiscal accountability,” as described in par. 203-209 of GASB S34, clearly relates to governmental budgeting. It is one thing to say that “fiscal accountability” requires reporting on budgeted revenues and appropriations, and quite another to suggest that financial accounting for the General Fund need not report items affecting current year operations that have been pushed to the future. The resulting omission doesn’t help the accountability process; it hinders the process because it omits significant information.

I consider reporting on the budget to be a necessary part of governmental financial reporting because users need to know how actual results compared with the original budget. Indeed, GASB reporting standards already require a comparison of the original budget with actual amounts on the budgetary basis of accounting. That report provides “fiscal accountability.” The link to full accountability reporting can be achieved by (a) reporting on the budget by means of a budgetary comparison statement, (b) reporting on operating results and financial position on a “long-term total financial resources” basis, and (c) describing the differences between the two sets of statements in clear, non-accounting terminology so interested citizens, legislators and financial analysts can readily understand them.

I see no logic in the assertion that “fiscal accountability” requires a shorter time perspective when reporting on governmental funds. Nor is any useful purpose served by preparing governmental fund financial statements that accrue short-term expenditures and liabilities, but not long-term expenditures and liabilities. What exactly is the point of tinkering with reporting on the budget (by making some but not all the accruals) when (a) the budgetary comparison statement already compares the budget with actual results on the budgetary basis of accounting and (b) the tinkering produces incomplete – and, therefore, misleading – information? Why should the GASB be a party to incomplete financial reporting?

I also suggest that the “shorter term” approaches produce results that contravene the notion of interperiod equity because the operating statements omit relevant expenditures applicable to the reporting period.
d. I have analyzed the financial statements of several governments undergoing financial problems and have had difficulty trying to get a complete picture of General Fund operations and position. Users of financial statements focus heavily on the General Fund. They are entitled to know the full extent to which taxpayers will need to finance future General Fund outflows for operating expenditures applicable to previous years. They should not be required to untangle under-funded pensions and OPEB expenditures from expenses that include depreciation and special revenue funds, nor should they be required to obtain the numbers by reading through lengthy notes. Adopting a “long-term (total financial resources”) approach for reporting on the General Fund will make it easier for users to understand how the fund statements relate to and roll up into the government-wide statements.

**Question 2.4.** For the long-term approach, outstanding balances on TANS and RANS should be reported as balance sheet liabilities. Outstanding year-end balances of TANS and RANS result generally from imbalances between revenues and expenditures or cash liquidity problems. Reporting them as resource inflows would inflate operating results and net position. Reporting them as liabilities calls attention to the issues. They are liabilities and should be reported as such.

**Question 2.5.** The Board and staff considered the definition of financial resources carefully prior to issuing GASB S11. The definition of financial resources is in the glossary to GASB S11. GASB S11 considers both prepaid items and supplies inventories as financial resources. The reasoning for that decision, which I agree with, is set in the basis for conclusions, par. 207 – 212, so there is no need to repeat them here.

**Question 2.6.** In my opinion, the ITC does a good job in expressing the recognition approach under the long-term perspective. I’m a bit concerned about the treatment of capital related inflows and outflows within the individual funds because I think the reader would be helped if all capital asset acquisitions and dispositions and capital related financing transactions were to flow through the Capital Projects and Debt Service Funds. The format in Illustration 8B takes care of part of my concern. The rest of my concern can be handled by reporting capital outlay and debt service expenditures that occur in the General Fund as transfers to the Capital Projects and Debt Service Funds and clearly labeled as such.

**Question 2.7.** This question does not apply to the long-term approach, so I won’t respond to it.

**Question 3.1.** I believe the format in Illustration 8B is superior to that in Illustration 8A because it separates operating expenditures from capital expenditures and debt service. However, I think it’s confusing and unnecessary to change the name of the statement and to refer to the
inflow and outflow of resources as “long-term financial resources.” Everyone knows that the General Fund raises revenues that are used primarily for current-year operating purposes; some of those resources may or may not be used for capital expenditures and debt service. There is nothing wrong with the existing title of the statement, nor is there anything wrong with the words “revenues” and “expenditures for operating purposes.”

**Questions 3.2 – 3.4.** I’m not certain whether a cash flows statement provides valuable information for governmental funds. This is because budgets are prepared on a near cash flow basis, as is reporting on the budget. Before requiring a cash flows statement, I suggest that GASB staff explore other ways of demonstrating how governments financed their activities during the accounting period. For example, it might be possible to devise a more informative means of disclosing the differences between actual inflows and outflows on the budgetary basis of accounting and actual revenues and expenditures in the GAAP operating statement – one that more clearly labels items such as the under-financing of expenditures applicable to the current period and the financing of budgetary imbalances with outstanding TANS and RANS.

Sincerely,

Martin Ives, GASB Member, 1984-1994