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Via email to director@gasb.org

RE: Invitation to Comment on Financial Reporting Model Improvements – Governmental Funds (Project No. 3-251)

Dear David:

Our comments come from higher education teaching and academic research perspectives. We speak as individuals serving on the Accounting and Auditing Standards Committee for the Governmental and Non-Profit Accounting Section and do not represent an official position of the American Accounting Association. In addition, the comments reflect the overall consensus view of the Committee, not necessarily the view of every individual member.

Across higher education, accounting majors are exposed to various amounts of governmental accounting. Some students have a semester class of governmental and non-profit accounting where governmental accounting comprises 75% of the class. Others receive a few weeks of governmental accounting as part of an advanced accounting class. Finally, there are accounting majors receiving a bachelor degree in Accounting from accredited programs that may not have any governmental accounting exposure. As this Invitation to Comment reveals, the complexities and intricacies of governmental accounting are not easily or readily understood by examining the face of the financial statements.

GASB Statement No. 34 made significant improvements to the financial reporting for governmental organizations by requiring government-wide financial statements and major fund reporting but did not address issues related to the measurement focus and basis of accounting for governmental funds. Thus, this project is an important step toward improving the usefulness of externally reported information for governmental organizations.

The following presents specific comments organized by the questions posed in the GASB Invitation to Comment, Project No. 3-251.

**Recognition Approaches for Governmental Fund Financial Statements**

2.1. Do you believe that governmental fund financial statements should continue to
present information that reflects a shorter time perspective than the information presented in the government-wide financial statements and that focuses on financial, rather than economic, resources? Why?

The ability to provide educated citizens a way to see the government activities that align with the way the governmental units are managed provides value. However, students struggle with learning this display and question the focus on the current resource flow since it differs from their prior understanding. Thus, one may conclude that the majority of users are not really aware of the different information lens through which the governmental fund financial statements should be analyzed. As we explain later, research shows that sophisticated users are able to glean information from both governmental fund and government-wide statements. There still is value in educating all financial statement users as to the reasons and benefits of the shorter time focus afforded to governmental funds, while simultaneously understanding the economic resource perspective afforded in government-wide statements. Providing appropriate heading descriptions to the governmental fund statements and reconciliation to Net Position of Governmental Activities on the same page will be beneficial for all financial statement users.

Reporting the governmental funds using a shorter time frame provides information from the perspective of inflows provided and outflows used by each fund. This useful information would not be apparent if the governmental fund reporting were changed to a full accrual, long term reporting focus. The overall health of the governmental organization should be analyzed by the government-wide statements. Omitting the long-term reporting perspective for each individual fund does not affect the ability to analyze the overall organization. However, changing from the current shorter time perspective for reporting governmental funds would reduce the information reported to external users of the financial reports. This could potentially be mitigated by requiring that each fund also provide a statement of cash flows. It is our opinion that keeping a shorter time perspective would continue to provide useful information without the need to add additional required reports.

From a research perspective, early analyses show that accrual based government-wide statements provide additional information to the near and short term focused modified-accrual fund statements. Since GASB 34 has only been in effect for sixteen or so years and statistical analyses require sufficient sample sizes there are only a few studies that examine the informativeness of modified and full accrual government financial information. Plummer, Hutchison, and Patton (2007) examine the association between default risk and various financial measures from both the government-wide statements and governmental fund statements. In their sample of 530 Texas school districts they find that financial position as reported in the government-wide statements is significantly associated with default risk but that measures of financial performance as reported in the government-wide Statement of Activities and accrual-based current liabilities do not explain default risk. Governmental fund measures of performance and modified-accrual current liabilities are associated with default risk but not governmental fund balance. When compared to one another, government-wide financial position is more informative than governmental fund balance but governmental fund
performance and modified-accrual current liabilities are more informative than government-wide performance and accrual-based current liabilities. This suggests that both measurement foci are informative to users.

Pridgen and Wilder (2012) extend the Plummer et al. (2007) study through the use of a different sample and by examining additional financial indicators. Using 409 cities, villages, and townships, the authors find that financial position, financial performance, leverage, and liquidity as well as the three categories of net assets as measured in the government-wide statements for both governmental and business-type activities are related to debt ratings. Comparing government-wide financial information (full accrual, long-term) to government fund financial information (modified accrual, near to short – term) the authors find that the full accrual information for financial position is incrementally more informative of debt ratings than that of the modified accrual financial position measure. However, they also find that the modified accrual measure is incrementally more informative of debt rating than the full accrual measure. Opposite of the Plummer et al. (2007) findings, this study finds that government-wide leverage and performance measures are incrementally more informative to governmental fund performance and leverage measures. Although the results of this study are mixed, we believe this is another finding that supports that modified accrual financial information does provide information in the presence of full accrual financial information.

Two additional studies that directly compare the information in the full accrual government-wide statements and the modified accrual fund statements are Benson and Marks (2014) and Bloch (2016). Benson and Marks examine how bond insurers use the full accrual government-wide statement data compared to modified accrual fund statement data using a sample of 274 Texas cities. They start with a model of bond insurance premiums (and also bond ratings) that uses many bond characteristics in addition to measures from the governmental fund statements. They then compare that model to a model that includes all the variables from the first model in addition to measures from the government-wide statements. In explaining bond insurance premiums, financial measures from governmental fund statements are still significant in the presence of financial measures based on government-wide statements. These results do not hold for bond ratings. Unrestricted Net Assets and Net Assets Invested in Capital Assets significantly explain bond ratings while fund balance and revenues minus expenditures do not. These results are different than Plummer et al. (2007) and provide additional evidence that modified accrual financial information provides information in the presence of full accrual financial information which supports using a near or short term focus in the governmental fund statements.

Bloch (2016) surveyed members of the National Federation of Municipal Analysts (NFMA) and from 107 responses (73 with experience before and after the implementation of GASB 34) found that analysts in general feel that the information provided by GASB 34 has improved transparency in reporting. However, survey respondents still relied on information provided in the fund financial statements more than the government-wide financial statements. This survey was conducted in 2013 after GASB 34 had been in practice for at least ten years. This shows that information that focuses on fiscal accountability is still important and used by
investors and creditors.

What we can infer from these studies is that both measurement foci in the basic financial statements, current financial resources and economic resources, are valued by users. Changing the measurement focus of governmental fund financial information to more closely align with government-wide financial information (through the long-term focus approach) may reduce the usefulness of the basic financial statements.

2.2. Do you believe that governmental fund financial statements should continue to present information that facilitates comparisons with a government’s budgetary information? Why?

Yes, we believe that providing budgetary comparison information is essential to providing useful information to users of the financial statements. Reporting the original budget and the revised budget compared to actual spending improves accountability and allows users to access the government’s proficiency in managing its resources.

Since the majority of local governments have balanced budget requirements, budgetary comparison statements remain relevant to the way the governmental units are operated. Pridgen & Wilder (2012) find that the ratio of fund balance to total fund revenue provides information incremental to ratios calculated from government-wide data. In addition, Callahan and Waymire (2014) examine the relationship between bond ratings and budgetary variances from the budgetary comparison schedules of 54 cities over four years. They find that revenue variances are significantly associated with lower bond ratings and that favorable expenditure variances are associated with higher bond ratings. This study’s findings suggest that creditors use budgetary information in their analyses. Pridgen and Wilder’s (2012) research is consistent with beliefs that transparency of management’s compliance with the budget provides an avenue for citizens to become involved in affecting change of the spending patterns within their local government.

2.3. Which of the three recognition approaches provides the most relevant information for assessing fiscal accountability of the government? Why do you consider that information most relevant?

Fiscal accountability is best demonstrated by the near-term approach. Although by displaying solely a near-term focus, decision makers and financial statement users lose sight of long-term needs or demands. The near-term approach is fundamentally different than the economic approach of the government-wide statements; thus, it needs to be starkly reflected. The precision in calling for different statements to be named and labeled distinctly appropriately highlights the differences. We commend the GASB on the inclusion of clarifying information on the face of the statements about the different recognition foci, and for providing to the reader the subsequent direction to the government-wide statements. Also the inclusion of the reconciliation on the same page is beneficial. If the GASB elects to choose the long-term
approach, there will be an important aspect of fiscal accountability reporting lost although perhaps an easier time to interpret the economic resource approach across the detailed reports from the governmental unit.

2.4. Transactions related to tax anticipation notes or revenue anticipation notes are presented differently under the three recognition approaches. In the near-term approach, borrowings on and repayments of these notes would be reported as inflows and outflows of resources on the statement of resource flows and in the reconciliation to the government-wide statement of net position. In the short-term and long-term approaches, outstanding balances of these notes would be reported as liabilities on the balance sheet, and borrowings on and repayments of these notes would be reported in the statement of cash flows. (See the discussion in Chapter 3.) Which approach to the reporting of these notes provides the most valuable information? Why?

Reporting the proceeds and payments of the anticipation notes within the same section on the resource flows statement is beneficial by providing a more transparent representation of the short term borrowing activity. Therefore, the current and long-term activity format provides more useful information in regard to the anticipation notes. In addition, the current and long-term activity format provides more useful information regarding the capital outlay activities. However, the terminology is confusing since tax anticipation notes and revenue anticipation notes are by nature, short-term financing to meet current operating obligations. We suggest using the format of the current and long-term activity report, but maintain the headings from the exiting format. The heading Other Financing Sources and Uses more appropriately describes the anticipation note proceeds and payments.

2.5. Views vary on the definition of financial resources—a concept integral to all three recognition approaches. (See the discussion in paragraphs 38–40 of Chapter 2.) What definition of financial resources provides the most valuable information? Why? Do you consider prepaid items to be financial resources? Why? Do you consider inventory to be financial resources? Why?

Terminology is always a challenge when trying to convey a consistent message to a wide variety of financial statement users. A clear definition of what represents a financial resource is definitely helpful. Paragraph 38 states “Some view financial resources to be items that can be or are expected to be converted to cash or are consumable in lieu of financial resources. Others view financial resources to be all resources that are not capital resources.” The most valuable information depends on the reader. However, consistent application and classification of items as per definition is essential. The committee agrees that prepaid items and inventory are financial resources. As prepaid items are consumed the entity can avoid the necessity of using cash at a future point in time. Inventory for sale leads to revenue inflow and inventory consumed by the entity in the production of goods or services allows the entity to avoid the outflow of cash in a future period much like prepaid items.
2.6. For the recognition approach that you believe provides the most valuable information, how would you change that recognition approach to provide information that is more valuable? How would those changes make the information more valuable?

The committee believes that the governmental funds should continue to reflect the budgeting and actual process by which managers attain fiscal accountability, therefore, a near term focus is preferable.

2.7. Paragraph 6 of Chapter 2 discusses a same-page reconciliation to government-wide information and the use of specific terminology to more clearly communicate that the information in governmental fund financial statements is of a shorter time perspective than information in the government-wide financial statements and focuses on financial, rather than economic, resources. Are these changes effective in communicating that the information in governmental fund financial statements is different from the information in government-wide financial statements? How could those differences be communicated more effectively?

The description following the heading on the governmental fund financial statements is useful in communicating that there is a difference between the short-term nature of the governmental fund reports and the government-wide statement. To add clarity, the headings could include the method of accounting for each and more clearly define the long-term reporting of the government–wide statements. For example, the description on the near-term financial resources balance sheet could be reworded as follows: “This financial statement presents a short-term view of the governmental fund activities based on the modified accrual method of accounting which excludes items of a long-term nature. For a complete portrayal of the financial position of the governmental activities on an accrual basis of accounting, see the government-wide statement of net position which includes all items of a long-term nature.”

The same-page reconciliation is beneficial to reader understanding; simultaneously there cannot be enough description as part of the reconciling items. Most governmental entities reduce the description to categories on their current CAFR and have large amounts attached to each line item. It can be easy for a reader to conclude that the reconciliation is simply a mathematical calculation to explain the link from the governmental fund to government-wide financial statements – and not realize the actual impact to the interpretation of the numbers. The current full page reconciliation allows more space for descriptions and therefore, should not be omitted. A brief, summarized same-page reconciliation is useful to highlight the differences between governmental funds and government-wide statements, but is restrictive in nature due to the space limitation.

Other Governmental Fund Financial Statement Issues

3.1. Which format for the governmental funds resource flows statement—existing format or current and long-term activity format—provides the most valuable information about governmental funds? Why do you consider the information to be more valuable?
The proposed format of current and long-term activity expands data communication for the financial statement reader/user by separating the financing and long-term activity in with other items, such as leases and transfers. Typically additional information enhances the organization’s transparency and decision-making usefulness of the financial statement. The question is whether removing the “long-term activity” expenditures from other budgeted expenditures creates more confusion for users who are used to seeing items such as capital outlay and debt service reported as outflows of resources. These users may prefer to see total fund expenditures in one category. If that is the case, continue to use the existing format.

3.2. Should a statement of cash flows be required for governmental funds? Why?

If there are changes in the format to move it to a more long-term approach, then the actual cash flow information would be appropriate and a statement of cash flows would add value to the financial statement user. If a near term approach is adopted, then there is less incremental information incorporated into this statement, and a statement of cash flows is unnecessary.

3.3. What difficulties, if any, would arise in presenting a statement of cash flows for governmental funds?

Presenting a statement of cash flows for governmental funds would create a steep learning curve. However, once mastered, the additional information may enhance the transparency and relevance of the financial reports. Although a separate statement may have users confusing the governmental fund cash flow with the proprietary fund cash flow statement unless the title is specific and placement presentation couples all governmental statements together. If the two cash flow presentations are incorporated into a combined statement, a separate column to the cash flow statement may be appropriate. Anytime that a significant change in report is made, there are learning and educational costs to preparers, users, students and educators. In addition, requiring a statement of cash flows for governmental funds would impact the future cost of preparing the CAFR in terms of both time and money.

3.4. Are the four classifications for the statement of cash flows from Statement No. 9, Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting, the most appropriate for governmental funds? If not, what classifications would be most appropriate?

The four classifications which include operating activities, noncapital financial activities, capital and related financing activities, and investing activities are appropriate for governmental funds. As stated previously, we believe the near term approach provides the most useful information for financial statement users. A statement of cash flows would not provide incremental information and therefore, should not be required for the near term approach for governmental fund reporting.
If an alternative cash flow classification is deemed to meet the cost-benefit criteria, there needs to be some consistency between statements so that users can interpret the information with some degree of familiarity. If statements with the same name for the different type of fund groups (funds held in trust, governmental business type activities, and governmental) are incorporated in the financial reporting model improvements, the underlying reality of information captured needs to be similar and any major differences easily communicated (e.g., the four classifications).

With the GASB’s effort to enhance the information and decision usefulness of government financial statements, the information provides our students with an appreciation and understanding of the multiple perspectives of the government. The students will also be provided with information to gain an appreciation of government’s near-term and long-term reporting. As educators, our task will be to facilitate the learning process.

We appreciate the opportunity to provide comments regarding the financial reporting model improvements for governmental funds. Please feel free to contact the committee Chair for any questions or clarification.

Respectfully submitted,

Accounting and Auditing Standards Committee
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References


