February 25, 2021

Via Electronic Mail

Director of Research and Technical Activities
Governmental Accounting Standards Board | Project No. 4-6P
401 Merritt 7 | PO Box 5116
Norwalk, CT 06856-5116

RE: Response to GASB Preliminary Views – Revenue and Expense Recognition

Dear Mr. Bean:

The Office of the Washington State Auditor appreciates the opportunity to give input on the GASB’s exposure draft (Project No. 4-6P). In our constitutional role as the auditor of public accounts for the State of Washington, our Office performs the financial audit of the State of Washington and annually performs or reviews over 800 financial audits of the State’s agencies and all types of local governments, along with their component units.

In general, we think the Board is on the right track with their approach to revenue and expense recognition for the economic resources measurement focus. However, we have the following significant concerns with the preliminary views:

- Scope limitations that prevent the model from being comprehensive;
- Using different recognition criteria and terminology for subcategories of Category B transactions;
- Recognition for specific subcategories are impracticable or confusing, which we see as symptomatic of the use of different criteria for subcategories; and
- Fundamental flaws with recognition for the short-term resources measurement focus and the use of “inflows and outflows of resources” terminology rather than “revenues and expenses.”

Our detailed comments by chapter are as follows.

Chapter 1

The objective of the project is to develop a comprehensive, principles-based model. We agree with this objective and for this reason are concerned regarding the exclusions from the scope of the project in paragraph 3.

If significant categories of revenues and expenses are excluded, the model could not be considered “comprehensive” and the principles could be found to conflict with other standards. Although revenues and expenses from excluded transactions listed in paragraph 3 and Appendix B might
have further detailed guidance provided by other GASB standards, we strongly encourage the Board to consider whether the model is compatible with existing recognition requirements for these items.

Logically, if existing guidance for such transactions are compatible with the model, then there should be no problem in including them. But if such transactions are not compatible with the model, then the Board should consider changes to either the model or the specific guidance to align it. If it is not clear whether the model is compatible or not, then we think it is worth considering now during the formation of the model.

For example:

- The proposed model would remove “non-exchange transactions” from governmental accounting, but Statement 84, paragraph 11b2 includes this term as criteria for determining whether an activity would be classified as fiduciary.
- The term “unit of account” is used in the preliminary views in chapter 2 but seems to be defined somewhat differently in Statement 72 in relation to (excluded) financial instruments.
- Capital asset transactions are excluded even though they often represent material amounts and would benefit from clearer standards on recognition.
- Contingent asset and liability reporting in Statement 62 paragraphs 100-112 appears to be neither included nor excluded from the scope of the project, as listed in Appendix B. However, it would seem that criteria related to estimation and likelihood would be relevant.

If exclusions are retained, then when and how would these and other potential conflicts be identified and resolved? Again, we think these important questions are worth considering now during the model’s formation. Accordingly, we recommend the Board address these exclusions now, before moving forward with the project.

Chapter 2

This chapter discusses the conceptual underpinnings of the model. We agree with the assumptions in paragraph 2. However, if recognition is based on foundational principles or assumptions, we would expect these to be articulated in the concept statements.

We agree with the Board’s preliminary view that Category A transactions should be recognized based on satisfaction of a performance obligation in that period and Category B transactions should be recognized based on compliance with time requirements in that period.

Chapter 3

We agree with the Board’s preliminary view that Category A and B transactions should be recognized according to the four-step methodology.

However, we disagree with the Board’s preliminary view that only transactions with a binding arrangement should be in the scope of the project. Although we agree transactions that do not have a binding agreement should not be recognized according to Category A or B, such revenue and expense transactions regularly occur in governments and need guidance. For example, an unpledged and unrestricted donation, or a loss arising from fraud. To provide for a comprehensive
model, we would request that guidance be included in the standard. For example, such transactions could be recognized when cash is received or paid.

Further, we find the discussion of moral or constructive obligations in paragraph 9 to be ambiguous. If this is intended to mean the probability that a term in a binding arrangement is remote, then we would prefer to see this described in terms of likelihood so as to align with existing guidance in Statement 62 paragraph 100 on contingent liabilities. Alternatively, if economic substance is intended to mean that neither the rights nor obligations are substantive, then we would prefer to see it described using the same terms as in paragraphs 18-23. Or if it is intended to be different in some way, we would prefer to see more specific guidance on obligating events, similar to GASB 49 paragraph 11.

We agree with the Board’s preliminary view that Category A transactions should be evidenced by mutual assent of the parties.

We also agree with the Board’s preliminary view that Category A transactions should include substantive rights and obligations that are interdependent. However, we would prefer the term “reimbursement-based grants” or “expense reimbursement grants” be used rather than “expenditure-driven grants.” All grants are for the ultimate purpose of being expended by the government and will be expended, so the term “expenditure-driven” is not meaningful.

Finally, we agree with the Board’s preliminary view that categorization should generally be applied at the binding arrangement level, that categorization may be assessed on a portfolio basis, and that the existing installment and cost recovery methods should not be carried forward.

Chapter 4

We agree with the Board’s preliminary view that a receivable should be recognized when an enforceable claim arises and that advances in revenue transactions should result in a liability being recognized. However, we do not see where the preliminary views address the ability to reasonably estimate amounts and the likelihood of occurrence as described in Statement 62, paragraphs 101-104. We urge the Board to consider this within scope of the project to ensure a clear and comprehensive model that does not result in confusion or conflict with other standards.

We agree with the Board’s preliminary view that revenue and receivables from Category A revenue transactions should be recognized when (or as) a government satisfies the obligation, that each distinct good or service in a binding arrangement would comprise an obligation, and that satisfaction occurs at a point in time or over time when the government transfers control. We also agree with the Board’s preliminary view that an assumption of future compliance should not be taken into consideration for recognition purposes. Although this is stated in terms of expenditure-driven grants, we see this as a general requirement that gain contingencies should not be recognized until they are realized, as described in Statement 62, paragraph 112.

We agree with the Board’s preliminary view that revenue from Category B transactions should be recognized based on compliance with time requirements or otherwise when a legally enforceable claim arises. However, we are not in favor of complicating standards by breaking Category B into subcategories with different recognition criteria. While subcategories may need requirements in standards to define how this general criteria should be consistently applied, they should not have
different recognition terminology and criteria. To this end, we urge the Board to adopt “verifiable, measurable, and in compliance with eligibility requirements” as recognition criteria for all Category B transactions. Our comments on this portion of the preliminary views also applies to expense recognition except as noted below in our specific comments regarding Chapter 5.

Specific concerns and comments on subcategories are as follows:

Derived Revenues
We are concerned that recognizing derived revenue when the underlying transaction occurs will be impractical in many circumstances and will create the need for estimates that are neither cost-beneficial nor decision-useful.

For example, in Washington, local governments receive over 100 types of derived tax revenues that are collected by the State and subsequently remitted the local governments. Underlying economic activity occurs and is subsequently reported to the State through various means, on various timelines, and using various collection and enforcement approaches. It is then subsequently remitted to local governments periodically as a lump sum. To attempt to recognize these revenues when the underlying transaction occurs would require local governments to first determine the time period the remittance is related to and then determine the time period of the underlying activity that related to those remittances. This would be further complicated by issues such as different collection timelines for different types of payers (for example, small companies that submit on a quarterly or annual basis compared to large companies that submit on a monthly basis), late collections, adjustments, and fines, all of which the local government would not be in a position to know. This would not only be a highly time-consuming process, but would require intimate understanding of the collection process for each revenue to make reasonable estimates. Such an effort would be contrary to the public purpose of having the State collect on behalf of small local governments.

With this in mind, we strongly urge the Board to also include the criteria that revenue be verifiable and measurable before recognition. This would align recognition with criteria for pledges and provide relief for those situations where it would be impracticable. It would also address the Board’s observation in Chapter 1, paragraph 9 that recognition outcomes might be different because of the unavailability of information or reliance on estimates. This observation is true and should therefore be reflected in standards by adding “verifiable and measurable” as recognition criteria.

Regulatory Fees
We have similar concerns regarding recognition of regulatory fees when an entity engages in the activity or applies for a permit to engage in the activity.

For example, in Washington, some fees are charged for submitting an application whereas others are charged based on an approved application. Moreover, in instances where an entity engages in a regulated activity without a permit, the government might not be aware of the activity until much later – sometimes many years – and the applied fee would normally be handled as punitive at that point. We are unclear how the Board’s preliminary view would work with these situations.
If the Board intends for governments to make estimates of unidentified noncompliance (analogous to an “Incurred but Not Reported” risk pool liability), then we would strongly object that this would be both impractical and inappropriate (as a contingent gain). In either case, we would prefer the general criteria of “legally enforceable” with further attributes of “measurable and verifiable” added to be more clear and helpful than the proposed criteria.

We are also concerned that recognition of receivables for punitive fees when the violation can be established by due process of law might conflict with existing requirements for contingent liabilities and gains. From the standpoint of the violator, the punitive fee is the existence of the potential violation, subject to contingent liability requirements. From the standpoint of the regulating government, the punitive fee is the legal enforceability of the fee or fine when the legal process is concluded and the final judgment is imposed. Although this results in asymmetrical recognition, the punitive fee reflects the appropriate difference between existing guidance on contingent losses and contingent gains as well as the asymmetrical information held by either party to the transaction. In any case, the standard will need to be clear as to what constitutes “establishment” of a violation by due process of law. For example, we believe it would be more appropriate for the regulating government to only recognize revenue when the process of law is concluded via a final judgment that is not appealed, rather than the start of a process when a police officer writes a ticket or a regulatory official gives notice of a fine, or the middle of the process when an initial judgment is rendered that is then subsequently appealed.

Property Taxes

We found the Board’s preliminary view on property tax recognition to be potentially confusing for financial statement users and preparers. Specifically, taking the proposed authoritative criteria of paragraphs 31-32, it would seem that once a government has approved the property tax rate or total amount for the next fiscal period, that it would recognize a receivable and deferred inflow. The authoritative criteria continues in paragraph 33, stating that revenue recognition would take place when property taxes are “imposed,” which is generally at the start of the next fiscal period. We are concerned this could be misleading and confusing for users of the financial statements if the government reports property tax receivables that are intended to fund expenses of the next fiscal period.

At a subsequent webinar on this topic, GASB staff clarified that although a government might pass an ordinance in November to establish the tax, the tax would not be considered “imposed” until January when it becomes enforceable, at which time it would be reported in the financial statements. We agree with the comments made by the GASB speaker and would encourage the Board to make this clear in the proposed standard.

Moreover, we do not see a need to introduce a new term (“imposition date”), which appears to merely substitute for “legally enforceable claim” and thus make for multiple layers of definition that are more complicated to follow than simply defining the latter term directly for property taxes.

Contractually Binding Arrangements

We disagree with the Board’s preliminary view that Category B transactions include a separate subcategory identified as contractual binding arrangement transactions, because we are not convinced that this needs to be identified as a separate category from pledges and/or general aid.
Pledges
We agree with the Board’s preliminary view that receivables should be recognized for a pledge when it is verifiable, measureable and eligibility requirements have been met, and that it be recorded as a deferred inflow if the pledge includes time requirements that have not been met. However, the requirement that the promise be probable of collection would seem to conflict with preliminary views in Chapter 6 paragraph 12-13 on collectability. We see no reason to include collectability as a recognition requirement because it already is appropriately addressed in general measurement requirements.

General Aid
We agree with the Board’s preliminary view that general aid should be recognized when payments are due if certain criteria are met that allow the resources to be verifiable and measurable. However, we are not convinced this needs to be identified as a separate subcategory from pledges since the criteria appears to be the same.

Shared Revenue
We request that the Board provide clear criteria and definitions for determining if a transaction constitutes shared revenue in contrast with a fiduciary activity. Clear guidance is needed because the difference in reporting is significant, amounts are often material, and there are numerous scenarios that governments frequently encounter that could possibly be considered shared revenue. Specifically, we find the criteria and definitions to determine which government has “imposed” the revenue to be lacking, and the discussion of “appropriations” in paragraph 50 and 51 to be unclear. In practice, revenues may be authorized by state law but required to be approved or implemented in some way by a local government, and may further be subject to adjudication, collection and/or enforcement by one or more other governments. Further complicating this analysis is that all of these aspects may be defined in various levels of specificity by state law.

In practice, we find that governments do not believe they are “sharing” revenue if they have no substantive ability to determine if they will distribute the revenue and are making the distribution as a legal or contractual obligation. Therefore, we suggest the Board limit the definition of shared revenues to those situations where the government has authority to spend the revenue directly or otherwise make substantive decisions on how to spend the revenue in furtherance of the government’s public purpose.

Chapter 5
We recommend the Board incorporate existing guidance for contingent liabilities as general criteria for recording expenses, which is that liabilities would need to be reasonably possible and measurable. In addition, we recommend clearer guidance for expenditure-driven grant expense recognition. Paragraph 20 states that the grantor would recognize a payable when the grantee has incurred allowable costs. However, due to timing and communication differences, it would not always be practicable to expect that both governments would report the same transaction in the same fiscal period. To this end, we urge the Board to adopt “verifiable, measurable, and in compliance with eligibility requirements” as the recognition criteria for all Category B transactions.
Chapter 6

We agree with the Board’s preliminary view on measuring revenues and expenses based on the associated assets and liabilities. We also agree that assets and liabilities should be measured consistently, which is one of the reasons we are concerned with the scope limitations for this project. Issues such as collectability, right of refund, discounts or allowances, variable rates or options, contingencies, offsets, allocation, and fair-value estimates should be general guidance that is consistent for all types of assets and liabilities.

Chapter 7

As we discuss in detail in our comment letters on Recognition Elements of Financial Statements and Financial Reporting Model Improvements, we find the guidance on recognition for the short-term measurement focus to be overly complicated and confusing and have significant conceptual concerns with this approach.

In contrast, adding a single additional criteria for the short-term basis that recognizes amounts that are due within 1 year would result in a basis of accounting that is both more appropriate and easier to understand, analyze, and implement in conjunction with the rest of the reporting model. Alternatively, we would find a full accrual basis to be superior to the proposed recognition model.

Terminology

We noticed that the terms “revenue” and “expense” were used throughout the preliminary views document. In contrast, the terms “inflows of resources” and “outflows of resources” were used in the proposed concept statement Recognition Elements of Financial Statements to refer to revenues and expenses for both the economic resources measurement focus and the short-term measurement focus, and the terms “inflows of resources” and “outflows of resources” were used in the proposed statement Financial Reporting Model Improvements only for governmental fund statements.

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As can be seen when attempting to reconcile the three documents for comment, using different terms for governmental fund statements would undermine the ability of a concept statement and standard to achieve the objective of a comprehensive, principles-based model. Moreover, it would further compound and elongate every reference to these concepts and principles throughout every standard.

Finally, as we read this preliminary views document with the terminology difference in mind, we continue to find that “inflows and outflows of resources” are not sufficiently descriptive or
differentiated from “cash flows” and therefore are inferior to the established accounting terms “revenues” and “expenses” to express the concepts, principles and requirements of standards.

For these reasons, we would like to reiterate the views we expressed in our responses to the other documents that the generally accepted terms “revenues” and “expenses” be used universally throughout the reporting model.

Thank you for the opportunity to provide our comments. Any inquiries may be directed to me at (564) 999-0950.

Sincerely,

Pat McCarthy
State Auditor