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director@gasb.org Projects 3-25 and 3-20

Dear Dave:

I disagree with the model proposed in the GASB PVs on financial reporting for governmental funds because the model, like the current one, produces incomplete and misleading financial reporting. I believe the conceptual foundation for the proposed model, based on a distinction between “short-term” and “long-term” transactions and events, can be readily challenged. In particular, I believe the model fails to deal adequately with pensions and OPEB, the most significant operating expenditure types affected by the use of modified accrual accounting.

I urge the Board to abandon the proposed model. Instead, the Board should develop a model for governmental fund financial reporting that uses the accrual basis of accounting within a total financial resources measurement focus; i.e., the “long-term (total financial resources)” approach, as suggested in my response to your earlier ITC. In my opinion, financial reporting based on the “long-term (total financial resources) approach” can be readily classified to report current assets, current liabilities and fund balance based on whatever measurements the Board considers appropriate.

My detailed comments on the PVs follow. In commenting on the PVs, I use illustrations regarding pensions and OPEB because of their significance and because current studies indicate that the funded status of some plans portends future financial problems for the sponsoring governments.

1. Proposed Standard Is Based on Unsound Budgeting Practices, Not Sound Accounting Principles

The basic mission of the GASB is “to establish and improve financial accounting and reporting standards to provide useful information to investors and other users of financial reports.” But the model proposed in the PVs provides only minor improvements in financial reporting; it continues to produce incomplete, non-comparable and misleading fund financial reporting.

The PVs claim that a feature of the recognition approach is its relationship with budgetary information. The “Recognition of Elements” PV states that the GASB believes (a) comparing budgetary information to financial statement information that applies a measurement focus that is more comparable among governments will provide information useful in evaluating a

government's budgetary practices, and (b) because the proposed statement of resource outflows and inflows would recognize flows from long-term transactions when they are due, similar to how many governments budget, information in the resource flows statement also may be valuable in evaluating a government's budgetary results. Thus, the GASB appears to be justifying a fund financial reporting model based upon the notion that many governments budget for flows from long-term transactions and other events when payments are due to be made.

The GASB standards on pensions and OPEB make it clear that sound accounting and financial reporting for those transactions (in government-wide financial reporting) requires recognition on an accrual basis – meaning that the expenditures should be recognized when earned by the employees. As discussed in the next section of this response, budgeting for these expenditures on an accrual-like actuarial basis is the “norm” and many governments do so or seek to do so. (To tighten its budgetary processes, the citizens of the State of Indiana approved an amendment to its constitution in 2018 that requires appropriating “the amount necessary to actuarially fund the accrued liability of all...pension funds during the budget period,” unless two-thirds of the legislators vote to suspend that requirement.) I recognize, of course, that some governments severely under-budget for pensions and virtually all under-budget for OPEB. Nevertheless, I cannot see how one can justify cash basis financial reporting for pensions and OPEB just because many governments use unsound budgeting practices for those items of expenditure.

Regarding assessment of a government's budgeting practices, I suggest that one who wishes to do so can readily refer to the numerous “Best Practices” papers issued by the Government Finance Officers Association and to “Budget Processes in the States” and other documents issued by the National Association of State Budget Officers. Further, I suggest that – if one wishes to assess a government's budgeting practices – comparing budgetary results with actual results on an accrual basis of accounting would be far more effective than the Board's proposal.

2. Establishing Pension Recognition Standards Based on “Long-Term Transaction” Designation Is Unjustified and Conceptually Unsound; it Could Also Have Negative Unintended Consequences

To accomplish its objective of “conceptual consistency,” the PV model is based on a distinction between “short-term” and “long-term” transactions and events. The PVs define “long-term transactions and events” as “those that normally are due to...require the use of cash (or other financial assets) in periods that extend beyond one year from the inception of the transaction or other event.”

Items 15 and 16 in Attachment C cite situations involving year-to-year increases in the pension and OPEB liabilities. In discussing the short-term approach regarding item 15, the PV says “This transaction would be considered long-term because pension benefits, including the interest component, normally are earned during the periods in which the employees provide

services to the government and are normally paid beyond one year from the inception of the transaction.” Similar language is used in discussing OPEB. As I understand these explanations, the PV considers pension and OPEB transactions as “long-term” because of the lengthy period of time between the earning of pension and OPEB benefits and the actual payment of cash to the employees. But the fact that many years elapse between the time pension benefits are earned by the employees and the time they actually receive the cash does not provide a conceptual foundation for classifying the employer’s pension expenditure as “long-term,” thereby justifying the cash basis of accounting. One can just as easily justify classifying pension and OPEB transactions as “short-term” because governments generally become contractually (often, constitutionally or statutorily obligated) to pay those benefits as the employees earn the benefits in each budget period.

Indeed, actuarial funding as benefits are *earned* (and resulting “short-term” financing) also is the “norm” when budgeting for pension obligations. The American Academy of Actuaries says: “All plans should have the objective of accumulating assets equal to 100% of a relevant pension obligation, unless reasons for a different target have been clearly identified and the consequences of that target are well understood.” (*Issue Brief*, American Academy of Actuaries, “The 80% Pension Funding Standard Myth,” July 2012)

The *Public Fund Survey*, published by the National Association of State Retirement Administrators (which is based on approximately 125 of the largest state and local government retirement plans, reported that the aggregate funded ratio of the plans was just over 100% in 2001. (Pension funds benefited from the fact that investment earnings were well in excess of earnings assumptions during the immediately preceding years.) For several reasons (including persistent underfunding by some governments and the impact of the 2008-9 recession on governmental revenues), the aggregate funded status declined to 72% in 2016. (Public Fund Survey, November 2017). On the other hand, the Public Fund Survey also reported that more than 76% of the plans received more than 90% of their actuarial determined requirement, indicating “a continued restoration of funding discipline beginning in fiscal year 2012.”

Significantly, sound actuarial funding has been and remains the basic budgeting standard, not only for pensions but also for OPEB. Following are excerpts from the Government Finance Officers Association Best Practice “Core Elements of a Funding Policy:” “GFOA recommends that every state and local government that offers defined benefit pensions and/or OPEB formally adopt a funding policy that provides reasonable assurance that the cost of those benefits will be funded in an equitable and reasonable manner...Every government employer that offers defined benefit pensions or OPEB should make a commitment to fund the full amount of the ADC [actuarially determined contribution] each period.”

In this same vein, The Volcker Alliance, in its December 18, 2018 study entitled *Truth and Integrity in State Budgeting: Preventing the Next Fiscal Crisis*, made the following recommendation: “States should consistently make the contribution for pensions and retiree health care plans that actuaries determine to be necessary.”

Thus, despite that fact that a relatively large number of pension plans are underfunded, the standard for budgeting is that governments should finance pension benefits as they are earned, not when they are paid to the recipients and not when the government opts to finance the benefits. Further, notions like interperiod equity and “living within one’s means” (GASB CS1) demand that pension and OPEB benefits be budgeted for as the employees earn the benefits.

The PV suggests that the financial statements it produces may provide information useful in evaluating a government’s budgeting practices. To the contrary, because the PV reporting model seeks to rationalize unsound financial reporting based on unsound budgeting practices, I am concerned that the proposal made in the PVs could have the unintended effect of providing justification for some governments to continue underfunding their pension and OPEB obligations. Indeed – taken to the extreme – I fear the proposal could provide a basis for not funding pension benefits until the employees retire.

3. Short Term Budget-Oriented Financial Reporting Ignores the Longer-Term Financial Consequences of Weak Budgeting Practices

Funds are budgetary contrivances. Budgets are legal documents and governments must, of course, maintain their internal accounting records in a manner that facilitates control over legal spending limitations, aids in ensuring that sufficient resources are available to cover expenditures, and aids in preparing subsequent budgets. Because they generally cover one year’s activities, General Fund budgets necessarily have a short-term focus, although many governments prepare their budgets within the context of rolling 4 to 5-year financial plans.

Also, most governments are required to prepare “balanced budgets.” Generally, however, budgets are considered “balanced” when revenues and amounts made available from previously accumulated fund balances equal the appropriations made to authorize expenditures. For example, North Carolina’s statute regarding local government budgets says: “A budget ordinance is balanced when the sum of estimated net revenues and appropriated fund balances is equal to appropriations.”

The net effect of the language used in budget laws (as well as political and economic considerations) is that budgetary practices differ widely among governments; depending on the circumstances, they may also differ from year-to-year for individual governments. As discussed in a later paragraph, differences vary most significantly in the financing of defined benefit pension plans. The reason governments can do that, if they so choose, is that the ultimate payout to the employee occurs – as the PVs note - many years in the future. Just because pensions were not sufficiently financed from the General Fund in the past, however, does not mean that the General Fund will not be called upon in the future to make up for previous-year underfinancing. Truthful financial reporting therefore requires that under-financed pensions be reported as liabilities of the General Fund.

Needless to say, applying differing budgeting practices to the exact same circumstances can cause significant differences in operating results and financial position. In a nutshell, *short-term*

budgeting practices can have severe long-term financial consequences. Several years ago, Central Falls, RI budgeted itself into bankruptcy because it under-financed its pension and OPEB obligations.

The executive and legislative branches of government focus primarily on the General Fund. Sound budgeting for the General Fund must consider the longer-term consequences of the current year's budget. When they read the annual General Fund financial statements, they need to see the long-term liabilities created by the fact that pensions and OPEB obligations were not fully financed in previous-year budgets. Financial analysts concerned with the long-term financial viability of the General Fund should also be able to see the longer-term effects of under-budgeted operating expenditures. This perspective was well-expressed in the following excerpt from the AICPA's March, 2017 response to your ITC:

“Several of our members support the long-term approach primarily because they have often observed governments utilizing their fund financial statements, rather than their government-wide financial statements, to inform significant decisions having longer term implications. Certain policy decisions at the governmental fund level, such as adequacy of tax rates, require consideration of the long-term sustainability of an individual fund. Thus, supporters of the long-term approach believe it informs decisions having longer term implications, provides informative disaggregation of amounts presented in the government-wide financial statements, and presents the best measure of interperiod equity.”

In short, providing a “shorter-term perspective” without showing the longer-term consequences produces an incomplete, and hence misleading, perspective. The fact that governments must maintain accounting systems to facilitate budgetary controls does not mean that *external financial reporting* on the General Fund must have a short-term budget orientation. The model proposed in the PVs already calls for some accruals to the data yielded by the budgetary basis of accounting. What is needed are the additional accruals required to make financial reporting of operating results and financial position complete and accurate.

4. Short-Term Perspective Produces Non-Comparable Results

The standard and the related concepts proposed in the PVs produce an accounting practice that fails to meet the standard of comparability. GASB CS 1, par. 68 says that: “Financial reports should be comparable.... Comparability implies that the differences between financial reports should be due to substantive differences in the underlying transactions or the governmental structure rather than due to selection of different alternatives in accounting procedures or practices. Financial reporting should help users make comparisons among governments, for example, comparisons of the costs of specific functions...”

To illustrate the lack of comparability caused by both the current financial resources fund reporting model and the PV model, let's look at the most recent report on the status of state pensions systems issued by the Pew Charitable Trusts. The Pew Charitable Trusts reports that,

for years ended in 2016, the average funded status of the state pension systems was 66%. But there was a very wide range of funding among the 50 states: the funded status of four state governments ranged from 31% to 41%, and the funded status of the pension systems of four other states ranged from 91% to 99%. The pension systems of New Jersey and Kentucky were only 31% funded, while Wisconsin's pension systems were 99% funded. A major cause of this disparity is the extent to which the several states were making annual appropriations for benefits earned by employees in the budget year, as recommended by the actuaries.

Assume now that New Jersey and Wisconsin had the exact same actuarial situation; that is, both states had the same number of covered employees and who were of the same age and earned the same salaries, used the same actuarial assumptions, provided the exact same pension benefits, etc. If both states made appropriations for the current year in accordance with their actuary's recommendations and paid them to the pension systems, they theoretically would report the same expenditure. Instead, however, the Wisconsin legislature appropriated 100% of the amount recommended by its actuary and the New Jersey legislature appropriated only 30% of the actuarial recommendation.

Based on the foregoing scenario, both under current accounting standards and the PV proposal, New Jersey's General Fund operating statement would report pension expenditures significantly less than Wisconsin and its General Fund balance sheet would not report the increase in the pension liability because both models ignore long-term liabilities. The differences between the two sets of financial reports result not from substantive differences in the underlying transaction, but rather from the differences in budgetary practices. Accrual accounting would ensure the reporting of comparable results because both states would report the same expenditure and New Jersey would report the long-term liability resulting from the difference in budgetary practices. Cash flows statements would facilitate assessment of the states' financial situations.

5. Having Developed Standards to Fully Record Pension and OPEB Expenditures and Liabilities, It's Time to Report the Truth in the General Fund

GASB S34 (Basis for Conclusions, par. 203-210) introduced the term "fiscal accountability" into governmental accounting literature, defining it 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." I don't know where that definition comes from, but I suggest the it contaminates the meaning of "accountability." More than just a few governments have "balanced" their budgets by employing such practices as deliberately overestimating revenues or underestimating expenditures, significantly and consistently underfunding their pension obligations, and using a variety of gimmicks. Reporting on compliance with such practices doesn't strike me as demonstrating accountability.

Nevertheless, the budget is one of the most significant documents produced by the government and many governments do indeed seek to use sound budget practices. I endorse

the GASB's current reporting practices where the original and final budgets are compared with the actual results on the budgetary basis of accounting. But I see no point in comparing budgetary reporting with actual results based on a standard that embraces weak budgetary practices.

GASB COD section 1500.103 (which picks up NCGA Statement 1, par. 43, as amended) states that unmatured long-term indebtedness of the government (other than long-term proprietary fund debt) is *general* long-term debt and should not be reported as liabilities of governmental funds. The fact is, however, that long-term pension and OBEB liabilities arise in part from the failure of governments to budget fully for expenditures incurred in conducting prior period operations. *Ultimately, those expenditures must be paid from the funds; hence, they should be reported as fund liabilities.* Much has been learned since NCGA Statement 1 was written and it is time for the GASB to require accrual basis accounting for financial reporting on the General Fund.

I recognize that users of governmental financial reporting are interested in knowing the year-end balance of financial resources available for next year's spending. (Actually, governments need to estimate that number long before the start of the next budget year.) I also recognize that the size of the fund balance in relation to revenues or expenditures is an important ratio in assessing a government's near-term financial health, so I would not want to see that number disappear from the fund balance sheet. I see no reason why that number cannot be embraced within an accrual-basis balance sheet. The skeletal outline of the General Fund balance sheet might be presented somewhat as follows. (I'm sure GASB staff could improve it):

- Current assets
- Current liabilities
- Fund balance
- Long-term assets
- Long-term liabilities
- Net financial position

I recall that some respondents to the ITC for this project rejected the long-term (total financial resources) approach because they felt it would duplicate the information provided in the government-wide financial statements. To the contrary, I believe it would make governmental financial reporting more understandable and more accurate because: (a) it would avoid the use of two sets of recognition standards for reporting on financial resources, (b) it would provide complete information regarding calls on the future resources of the General Fund, and (c) it would simplify the statement reconciling the fund data with the government-wide data. I recognize that my proposal would require the use of a cash flows statement, but I believe most users would welcome the information it provides.

Sincerely,

Martin Ives, GASB Member, 1984-1994