

February 1, 2019

Mr. David Bean, Director of Research and Technical Activities
Project Number 3-25
Governmental Accounting Standards Board
401 Merritt 7, P.O. Box 5116
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Submitted via email to director@gasb.org

Dear Mr. Bean:

Thank you for the opportunity to provide these comments regarding the Preliminary Views of the Governmental Accounting Standards Board (GASB, the Board), *Financial Reporting Model Improvements* (PV, the PV). The Board is to be commended for issuing this PV rather than an exposure draft and for incorporating the stakeholder feedback received relating to the Invitation to Comment *Financial Reporting Model Improvements – Governmental Funds* in this PV.

I appreciate this opportunity to respond and my comments reflect my views as a former government finance officer and a current academician responsible for teaching undergraduate and graduate level courses in governmental accounting and auditing. In addition, my comments here are consistent with and based on the comments I previously submitted relating to the Preliminary Views *Recognition of Elements of Financial Statements*.

General Comments

I am providing the following demographic information to assist in evaluating the need for and potential usefulness of the financial reporting model outlined in the PV and to put my responses in context. The following information is taken from the 2012 Census of Governments (2017 data not yet available) conducted by the U.S. Census Bureau and available at www.census.gov/govs/cog/.

- Of the 90,056 local governments surveyed, 43% and 57% represent general purpose governments (38,910 counties, municipalities, and townships) and special purpose governments (33,031 single function and 5,235 multiple function), respectively.
- 12,249 independent school districts (kindergarten/elementary through secondary) represent 24% of the special purpose governments and 14% of all local governments.
- Ten states make up 50% and 46% of the general purpose and special purpose governments, respectively. These states are California (second largest number of special purpose governments), Illinois (largest number of local and special purpose governments), Kansas, Minnesota (second largest number of local governments), Missouri, New York, Ohio, Pennsylvania, Texas, and Wisconsin.
- All of the top ten states require all or some local governments to prepare external financial statements using either all, most, or some of the required generally accepted accounting principles (GAAP).
- *Based on population, 95% of the local governments (37,132) surveyed have a population of less than 50,000 and 91% of the local governments (35,490) have a population of less than 25,000. 83% of local governments have populations of less than 10,000.*

- *93% of the independent and dependent school districts have enrollments of less than 10,000 students. 85% of these school districts have enrollments of less than 5,000 students.*
- Using the Fall 2015 enrollment of 48,571,827 data for public elementary and secondary school systems midpoint of the enrollment categories and the 2014 national average for per pupil spending of \$11,009 (Annual Survey of School System Finances, U.S. Census Bureau), this equates to school districts with budgets of approximately \$1,100,000 to \$82,600,000 for 93% of the independent and dependent school districts. Using the districts in the 85% level, budgets range from approximately \$1,100,000 to \$41,300,000.
- Most independent and dependent school districts (42%) are in the 1,000 to 2,499 (24%) and 500 to 999 (18%) enrollment categories.
- Over half (52%) of the 38,266 non-school district special purpose governments represent entities involved in natural resources (7,468), utilities (6,486), and fire districts (5,865).

This demographic information leads me to conclude the vast majority of local governments and school districts are not large and many are in fact very small. Typically, smaller governments have limited personnel with the expertise in the accounting and finance functions necessary to prepare financial statements in accordance with GAAP. In addition, it is highly likely these governments, who have a large stake in the proposals outlined in the PV, are unaware of the PV or its potential to impact their fund accounting systems for governmental and proprietary funds.

Even though a large number of local governments are small, there may still be a requirement to prepare external financial statements using GAAP. Your own research indicates less than half of the states require local governments to prepare GAAP financial statements and you estimate approximately 70% of county and local governments prepare financial statements using GAAP. This may be because many bond agreements require the issuer to prepare annual financial statements using GAAP as do a number of financial institutions providing funding to local governments. Therefore, the proposals outlined in the PV will likely have a major effect on a large number of local governmental entities.

In my experience, many state and local governments invest the majority of their human, capital, and financial resources in front line services and related capital rather than in support functions. As such, accounting and finance staff in these entities may have limited knowledge of accounting and financial reporting requirements relating to state and local governments. To compensate for this lack of internal expertise, governmental entities often engage their external auditor to assist them in preparing their external financial statements. When auditors assist in preparing the external GAAP financial statements, the effect of this nonattest/nonaudit service on the auditor's independence is required to be evaluated under professional auditing standards.

I realize the Board is an accounting standard setting body rather than an auditing standard setting body; however, the increasing complexity of governmental accounting standards is making it necessary for many small and medium-sized governments to rely more and more on their auditor to ensure their financial statements are prepared in accordance with GAAP. Due to the increasing complexity of governmental accounting standards and the improvements discussed in the PV, it may be necessary under the 2018 *Governmental Auditing Standards* (effective for financial

audits of periods ending on or after June 30, 2020¹) for the auditor to conclude management does not have the requisite knowledge, skills, and experience to effectively oversee the financial statement preparation process. In such cases, the auditor's independence is impaired and he/she is required to refuse to accept a new engagement or to resign from an existing engagement.

Few elected officials use the external financial statements for internal decision making because of the differences in the internal (typically budget-based) information and financial statements prepared in accordance with GAAP. In addition, the long period of time between the end of the fiscal period and the availability of the external financial statements usually makes the reported information obsolete for effective decision making for all user groups. Part of this delay is due to the effort involved in converting day-to-day decision based fund information to what is required by GAAP for external financial reporting. The level of the auditor's assistance in preparing the financial statements may also contribute in delaying the issuance of the external financial statements.

However, as stated in my response to the Preliminary Views *Recognition of Elements of Financial Statements*, I believe the proposed short-term financial resources measurement focus will more closely align financial reporting in governmental funds with budget philosophies and policies.

Chapter 1 – Objectives, Background, Applicability, and Scope

One of the objectives of the project is to enhance the effectiveness of financial reporting to provide information which will be useful for decision making and to assess a government's accountability. I agree with the improvement approach taken in the PV rather than a new financial reporting model.

As with initial implementation of any major standard, I believe a standard resulting from this PV is likely to take significant time and result in additional costs to preparers. I believe it will also result in auditors spending more time in the year of implementation the fees relating to which may or may not be passed on to preparers. I have discussed costs and benefits of the various proposals throughout this comment letter.

Chapter 2 – Recognition Concepts: and Application for Governmental Funds

I agree with the definition of the short-term financial resources measurement focus and the recognition concepts outlined in paragraph two and paragraph 5, respectively, of this chapter. As a former government finance officer, I know the operating budget for a governmental fund drives what governmental activities are provided, and when, based on the financial resources expected to be available during the budget period. In an effort to appease taxpayers and other resource providers, elected officials more often than not, do not focus on the long-term effect of their budgetary and other resource allocation decisions. Therefore, I believe reporting short-term transactions as they occur and long-term transactions when payments are due will be consistent with the governmental fund budgetary philosophies and policies of most state and local governments (paragraph 7). Additionally, I concur with the recognition requirements in paragraph 10 and the requirement to consider classes of transactions (rather than individual transactions or events) as either short term or long term (paragraph 13).

At times in the past the Board has ignored the role of the budget when establishing accounting and financial reporting standards for certain transactions. Today I applaud the Board for recognizing the role the budget plays in short-term accountability for governmental funds (paragraphs 30–33). The

¹ Auditors will be required to be independent as of the beginning of the period under audit or July 1, 2019.

government-wide statements, notes, and Management's Discussion and Analysis (MD&A) provide all stakeholders with ample information to make decisions with respect to accountability in the long-term. Therefore, I do not believe it is necessary to mix short and long term components of financial position at the governmental fund level such as is proposed in the Alternative Views.

Budget philosophies of elected officials and state laws differ among governments. However, I believe comparability of financial reporting among governments is not practical or realistic in some cases. On the surface, reporting short-term transactions as they occur and long-term transactions when payments are due (paragraph 11) may not appear to improve comparability among governments. Managing the budget of a governmental fund encompasses making decisions as to when financial resources will be used – that is when they will occur or be due.

Therefore, comparability will be achieved as all governments will report transactions when they occur and when payments are due even though the actual dates for these transactions will differ among governments. Additionally, recognizing short-term transactions as they occur and long-term transactions when payments are due will more closely align financial reporting with budget philosophies and policies. As a result, fund balance will provide more useful information for decision making because it better reflects what is available for spending in future periods.

With respect to the specific items noted in paragraphs 15 through 24, I have the following comments.

- Recognition of accrued interest on borrowings as an outflow of resources is not likely to be consistent with the budgeting philosophies and policies of many governments (paragraph 17 (b) and 20 (d)). As such, it may distort how accountable a government was with its current year financial resources. Even though accrued interest may be a significant unbudgeted amount, I do believe accrual of such amounts is necessary to be consistent with the short-term financial resources measurement focus proposed in the ED.
- Notes and other long-term receivables are not recognized as assets (paragraph 16 (a)) but as outflows of resources (long-term lending activities paragraph 20 (c)) when incurred with repayments due in the current period recognized as inflows of resources (paragraph 23 (d)). However, I find transaction 8 in Appendix C relating to repayments on notes receivables a bit lacking in explanation. If my understanding is correct (that is, the original outflow creating the long-term receivable is recognized as an outflow of resources), it would be helpful to discuss this original transaction in the notes to transaction 8 in Appendix C.

Chapter 3 – Presentation of Governmental Fund Financial Statements

Format of the Resource Flows Statement

In concept, I agree the resource flows statement should separately report resources arising from short-term and long-term transactions (paragraph 2). I believe the use of “short-term” and “noncurrent” will be confusing as the notes to the statements would, ostensibly, discuss the “short-term measurement focus”. Presumably the financial statement notes will discuss the short-term measurement focus similar to what is currently discussed relating to the current financial resources measurement focus. Such discussion would, ideally, include the definition of “short-term” resources. As such, the note could also discuss things not considered short-term financial resources are, by default, long-term financial resources. This would provide consistent adjectives and lead to less confusion among financial statement users. However, the illustrative resource flows statement in Appendix D nicely operationalizes the proposed format and flow of transactions is consistent with budget reports used in many governments.

Specific Terminology

I do not agree with the proposed titles for the governmental fund balance sheet and resource flows statement (paragraph 8). Not only are the titles unwieldy, they are redundant since information about the short-term financial resources measurement focus would presumably be discussed in the notes to the financial statements (as is currently discussed for the current financial resources focus). I realize there may be stakeholders wishing for better clarification of what is measured at the governmental fund level versus what is measured at the government-wide level. However, everything any user of the financial statements needs to put these statements in context is discussed (currently and presumably in the future) in the notes.

The current financial reporting model consists of government-wide statements, fund level statements, notes, and MD&A. All of this information provides all stakeholders with ample information to understand what is measured at each level and how it is measured.

I agree the governmental fund level statements should separately report short-term and long-term financial resources. However, I believe the proposed balance sheet format will be extremely confusing for the primary user groups identified in GASB Concepts Statement No. 1, *Objectives of Financial Reporting*. In addition, reporting fund balance information in this manner will likely involve additional time by preparers as this information is not typically maintained throughout the year. Auditors may also spend additional time performing audit procedures with respect to this information. Current software systems may not be able to be modified to currently track the information needed to present the proposed information which means the preparation and audit costs would recur each year.

The statement proposed for inclusion at the top of the balance sheet and financial resources flow statement (paragraph 13) is not necessary for accountability nor does it provide information useful for decision making which is not provided elsewhere in the financial reporting model. If the Board ultimately concludes this information is necessary, I would recommend it be placed at the bottom of the balance sheet and financial resources flows statement.

Chapter 4 – Presentation of Proprietary Fund Financial Statements

I agree operating revenues and expenses should be presented separately from nonoperating revenues and expenses (paragraph 3). Additionally, I am in full agreement with the Board's approach to define nonoperating revenues and expenses rather than operating revenues and expenses. Concerns raised by some stakeholders may be due to general confusion among users of all types of financial statements as to what represents operating income/expense on an operating statement and operating cash flows on the statement of cash flows. While the proposed approach will clearly define nonoperating transactions, it may not provide enough clarification to eliminate this confusion.

I can appreciate efforts to provide consistency between the definition of nonoperating revenues and expenses in the resource flows statement and cash flows other than cash flows from operations. However, I do not agree all subsidies should be reported as nonoperating revenues or expenses

A number of utilities operated by general purpose governments may provide a subsidy to the general fund which represents a payment in lieu of taxes (PILOT). These types of payments are very common and truly represent an operating expense. A non-government owned utility would likely report property/income taxes as an operating expense. Analysts and other financial statement users often compare government-owned utilities with their private sector counterparts. The proposed definition to include all subsidies as nonoperating would make such comparisons problematic. I would recommend the Board consider revising the definition of nonoperating subsidies to exclude subsidies representing PILOTs.

The proposed guidance in paragraph 7 appears to only consider subsidies received and provides a definition of subsidies which only relates to subsidies received. It is confusing to me why a definition of subsidy would only contemplate subsidies received and only those received to fund/subsidize lower rates. In light of my comments in the preceding paragraph, I would ask the Board to consider a broad definition of subsidy which encompasses subsidies received and provided. In addition, the Board may wish to discuss the reporting of interfund transfers in and interfund transfers out in the final exposure document. Often these transfers represent subsidies and providing clarification relating to these transactions could result in more uniform application of the final guidance.

Paragraph 7 requires presenting a subtotal for operating income (loss) and noncapital subsidies before presenting other nonoperating revenues and expenses. I do not agree with this presentation as other typical nonoperating revenues and expenses (for example investment income/expenses) would, in my experience, be considered when determining the level of subsidy required. Reporting this subtotal may be confusing for some users because the resulting subtotal would not likely result in a positive amount because the subsidy was based on the amount needed after other nonoperating amounts.

Chapter 5 – Budgetary Comparison Information

I agree budgetary comparison information should be reported using a single communication method (paragraph 3); however, I do not agree with the variances required in paragraph 7. The requirement to present variances between original and final budget amounts does not result in information useful for decision making nor does it reflect accountability. For most governments, the budget is a legal document whether it be the original budget or an amended budget. The required discussion of significant differences in original and final budget amounts in MD&A are sufficient to provide information about accountability. There is nothing useful to decision making with the presentation of a variance between the original and final budget amounts.

While I have never seen a government omit a column for the variance between final budget and actual amounts I don't believe such a column should be required. Granted it is a simple Excel spreadsheet formula easily copied throughout the schedule, but users of the financial statements often read amounts with brackets as "bad" even when the column heading is objective in nature. Additionally, users often do not realize what column amounts are reflected in the variance column. Using the current format it is easy for any user to see if the original and final budget differed and if either the original or final budget varied from actual amounts. In addition, significant differences in these amounts are required to be discussed in MD&A. For these reasons I do not agree with the proposed requirements in paragraph 7.

Chapter 6 – Other Issues

I agree with the Board's preliminary view expressed in paragraph 2 relating to communicating component unit information. In my opinion, the basic financial statements should focus on the primary government and this preliminary view supports my position.

The Board's preliminary view requiring governments who present a Comprehensive Annual Financial Report (CAFR) to also present a supplemental schedule (paragraph 8) of natural and functional expenses at the government-wide level (paragraph 5) is inappropriate and would be cost prohibitive. In addition, I do not believe such information is useful in evaluating accountability as internal decisions at this level of detail are made at the fund level rather than on a government-wide basis.

Many governments do not record the adjustments from the fund level statements to the government-wide statements in their financial management system. In order to compile the proposed required information would initially take substantial time and resources to modify existing financial management systems or

other financial statement preparation software and tools. Governments unable to modify their financial management system would incur significant costs each year to compile such information. In addition, the auditor has responsibilities with respect to supplemental information and including such a schedule would result in additional audit costs.

It is my understanding the Government Finance Officers Association (GFOA) is responsible for the development and administration of the Excellence in Financial Reporting Program which requires the presentation of a CAFR. As such, it would seem the GFOA is the body to establish such a requirement.

When the Board issued GASB Statement No. 44, *Economic Condition Reporting: The Statistical Section – an amendment of NCGA Statement No. 1*, and subsequent amendments, the GFOA Excellence in Financial Reporting program required participating governments to present a Statistical Section. Therefore, GASB Statement No. 44 did not over step the authority of the GFOA to establish requirements for the contents of a CAFR.

If the Board believes inclusion of this information would provide valuable insight regarding cost breakdown by function, then why is the requirement only for governments presenting a CAFR? Based on an analysis of the Excellence in Financial Reporting information, governments of all types and sizes participate in this GFOA sponsored program. However, governments successfully receiving the Award for Excellence in Financial Reporting represent a small portion of the almost 90,000 state and local governments in the United States. Requiring only a small portion of governments to present the additional natural/functional information seems punitive in nature as these governments already go above and beyond the minimum requirements established in the current external financial reporting model.

Chapter 7 – Alternative Views

The following paragraphs are taken verbatim from my response to the Preliminary Views *Recognition of Elements of Financial Statements*. However, at the end of this section of my response, I have provided new comments relating to the Statement of Cash Flows proposed in the Alternative Views.

Paragraphs five through seven

As stated previously, I am in agreement with the recognition concepts set for in the PV and therefore do not support the Alternative Views. Upon first reading of the PV I did feel as if portions of it were somewhat complex and I was not sure I fully agreed with focusing on when a transaction occurred or its original purpose. After reading the PV and Alternative Views numerous times and reviewing Appendix C in the related Financial Reporting Model Improvements Preliminary Views, I cannot support the Alternative Views. My reasons for continuing to support the PV rather than the Alternative Views are discussed in the following paragraphs.

The definition of short-term resources in the Alternative Views uses the time horizon of “within one year from the date of the financial statements” which is similar to the concept of current assets and current liabilities used by private sector entities. It is an objective measure and one which is likely familiar to most stakeholders. However, for governmental funds, the concept of “within one year from the date of the financial statements” is not likely to be consistent with budgetary practices which are in many cases driven by state and/or local laws and regulations. Reporting the items identified in paragraphs six and seven as financial assets and financial liabilities, respectively, using the concept of one year will not faithfully represent the financial condition of the government in the short-term. *Financial assets and liabilities reported on the basis of a one year period, rather than the budget cycle, will likely result in misleading information and incorrect conclusions as to how the government managed the financial resources available to it during the current budget period.*

In my experience notes and other long-term receivables arise because the government expends current financial resources which do not provide present service capacity. Therefore, notes and other long-term receivables do not appear to meet the definition of an asset. Likewise, there is no outflow of financial resources because there is no change in net assets (sacrifice one asset [cash] for another asset [note or other receivable]). In reality a government would budget expenditures based on cash expected to be available for the budget period not amounts receivable. Therefore, I believe notes and other long-term receivables meet the definition of a deferred outflow of resources because the resources to be received from the asset acquired (note or other long-term receivable) will be received in and are therefore applicable to a future budget period.

I do not agree with the items listed as financial liabilities in paragraph seven of the Alternative Views. All of the liabilities listed in paragraph seven represent amounts due in the next year or expected to be paid in the next year. Some of the financial liabilities listed represent a present obligation to sacrifice resources over which the government has little or no discretion to avoid nor can the government defer such obligations indefinitely. To the extent due within the next year, claims and judgments, tax/revenue anticipation notes, and principal on long-term debt fall into this category. While these are present obligations, the government is not obligated to sacrifice financial resources (that is make payments) on the reporting date. The government has discretion to make the payments at any time up to the due date. It is only on the due date the government has little or no discretion to avoid making payments. Therefore, these items would not meet the definition of a liability. These items do not meet the definition of a deferred outflow of resources nor the definition of an outflow of resources because net assets have not been consumed.

On the other hand, a government may have discretion to avoid paying accrued compensated absences or deferring such payment indefinitely. Unless negotiated during the collective bargaining process, the obligation of the government to pay employees accrued compensated absences is likely a moral rather than a legal obligation. While it might be politically ill advised to not honor such a moral obligation, the government does have discretion in such cases. Therefore, accrued compensated absences would not meet the definition of a liability. Additionally, they do not meet the definition of a deferred outflow of resources nor the definition of an outflow of resources because net assets have not been consumed.

Many governments budget for payments due in the next year in the next year's budget. As such, no financial resources exist at the end of the current year budget cycle to liquidate these obligations. Including them as financial liabilities (assuming a case can be made these obligations meet the definition of a liability) in the year due rather than the year incurred would not result in faithful representation and would not properly reflect accountability for governmental resources. For example, reporting financial liabilities without offsetting financial assets would decrease net assets when, from a budgetary perspective, net assets of the government were not affected.

Some governments budget in the current budget cycle for long-term debt payments due in subsequent budget cycles. In these cases, the consumption of net assets in the current period relates to an obligation due in a future period. Therefore, a deferred outflow of resources should be reported to the extent restricted, committed, or assigned financial resources exist at the end of the reporting period to pay such obligations in future periods.

Paragraphs 10 through 16

While the concept of *normally* is very subjective and may vary from state to state due to various laws and regulations over which governments likely have little or no control, it is likely to reflect budgetary philosophies and policies. As stated in my comments relating to Chapter 2 of the PV, I believe the

definition in the PV will enhance consistency and improve comparability among governments. Arguably, applying the concept of *normally* requires judgment while using the stated/contractual maturities does not. Using the concept of normally will, however, better meet the objective of accountability for short-term decisions and transactions.

Paragraphs 17 through 25 - Proposed Statement of Cash Flows

I am strongly opposed to presenting only a government-wide statement of cash flows and thus eliminating the statement of cash flows for proprietary funds. The primary reason for my opposition is this information is misleading and may lead to incorrect conclusions by stakeholders as to a government's sources and uses of cash.

Many governments issue long-term debt for both governmental and business-type activities and more often than not the government agrees to comply with certain covenants to protect the bondholders. A typical covenant restricts the revenues used as security for the debt solely for payment of the related debt. In the case of a government with outstanding general obligation and revenue bonds, the financial resources committed for the payment of the specific bond issues cannot be comingled and used for other purposes unless coverage and other similar covenants are met. Similarly, utility bonds typically secure the related revenues for payment of the bonds, operation of the utility, and maintenance of capital plant. As such, the resulting financial resources cannot legally be used for any other purpose. If a government presented a government-wide statement of cash flows, such information would not be useful for decision making because it is misleading. Additionally, such information does not result in information to determine accountability.

As always, thank you for the opportunity to respond to this due process document. Should you have any questions regarding the above, please contact me at (407) 869-9254 or lkmdennis@gmail.com.

Sincerely,

s/Lynda M. Dennis

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