Letter of Comment No. 010
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Mr. David Bean
Director of Research and Technical Activities
Project Nos. 3-20 & 3-25
Governmental Accounting Standards Board
401 Merrit 7
PO Box 5116
Norwalk, CT 06856-5116

Dear Mr. Bean:

Thank you, and the Governmental Accounting Standards Board (GASB), for providing this opportunity to comment upon the two Preliminary View (PV) documents – *Recognition of Elements of Financial Statements* and *Financial Reporting Model Improvements.* I have opted to respond to these two PVs in a single response due to the strong interrelation of the two projects – I believe that a single response will best reflect my comments and observations related to both PVs without the redundancy that separate responses would entail.

Although I applaud the board's stated goal of improving financial reporting and enhancing comparability and consistency across governments, I struggle to understand how much of proposed standards presented in the PVs would achieve that goal.

Governmental Statements

Both PV documents indicate that the financial resources measurement focus lacks conceptual consistency and that the proposed short-term measurement focus would provide conceptual consistency. This assumption is used as a driving reason behind these proposed standards; however, at least within the context of the examples provided within the PVs, this is a somewhat fallacious assumption.

The intent behind the financial resources measurement focus is to present a picture of what assets are available to pay liabilities soon – expenditures, regardless of purpose, are of great concern because they decrease the amount of available assets to pay for subsequent period activity. Within the focus, long-term items are highly relevant to the extent that they impact the available fund balance that may be used in the subsequent period.

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While it is true that applying the current financial resources measurement focus present[s]… [assets] that are either long-term or not expected to be collected in sufficient time to be available to be used to satisfy obligations of spending o the reporting period." (paragraph 4 of *Financial Reporting Model Improvements*), this is a failure of the governments preparing the financial statements, rather than a failure of the focus itself.

1. When using the current financial reporting measurement focus, only current (e.g. able or expected to be converted to cash or settled in cash (or equivalents) within 1 year of statement date) items should be presented;
2. Using the modified accrual basis of accounting, the requirement is that an item is accrued when it can be measured (at least reasonably) and is available to finance expenditures of the current period – if an item is determined unavailable, it must be offset with a deferred inflow or outflow.

It may be true that many governments fail to apply the measurement focus and basis of accounting consistently; however, that is a failure to adhere to authoritative guidance, not a failure of the guidance itself, and should, therefore, not be considered grounds to drastically change said guidance. Those items that are currently allowing governments to use their own judgment to determine recognition and availability could be easily remedied by providing authoritative guidance, which specifies non-negotiable timelines related to recognition and availability; this would force a greater level of comparability between governments as financial statement users would know that each financial statement is prepared using the same timelines.

As indicated in the PVs, existing guidance does not address complex transaction; however, there is no reason why the GASB cannot develop such guidance within the current framework. It would be a comparatively simple process to establish guidance specific to complex transactions in this manner vice creating an entirely new framework.

The reason for not using a full accrual/economic resources focus for governmental fund financial statements is that the health of a government or fund is most readily and efficiently assessed by reviewing resources that are available for spending during the next period. Regrettably, the use of the proposed short-term perspective fails to present a clear and accurate picture of available resources. Classes of transactions that are deemed long-term, which become due shortly after period end would be ignored under the proposed guidance; this could result in resource availability being grossly over- or under-represented if large long-term transactions are due shortly after period end. (Note: this is also an issue within the current framework with regards to long-term debt).

Per the PV, "*Due* is used in this measurement focus to refer to the date at which payment is scheduled or, if not scheduled, expected to be made." This definition opens the door to governments choosing due dates in order to present financial statements that "look good" to constituents and financial statement users, rather than statements that present an accurate picture of financial health. This causes the short-term financial resources statements to become highly unreliable for making financial decisions, which begs the question of why governments would

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expend valuable and limited resources to produce a product that is, ultimately, not useful outside of a political talking point.

At face value, the concept of treating all classes of transactions the same rather than based on the specifics of the transaction seems to be a good idea; however, using "normal" across governments creates a great deal of risk due to differences in individual governments. For example, according to the PV, "grants normally are collected within one year from the inception of the transaction" (*Financial Reporting Model Improvements* – Appendix C.7); while I agree that most grants do meet this assumption, there are many, especially those dealing with capital projects, that are not collected for far longer than one year. To consider all these long-term grants to be short-term risks overstating available financial resources; likewise, to consider all grants long-term risks greatly understating financial resources. Again, this risk of over- or under-statement severely impacts the creditability and therefore usefulness of the statements.

Within the PV itself, there is inconsistency built into the new methods. *Financial Reporting Model Improvements* – Chapter 2, ¶ 17 indicates that accrued interest payable would be recognized as a liability; however, long-term debt is not recognized unless due and unpaid (Chapter 2, ¶ 18). In accordance with Chapter 2, ¶ 11 b. an item is long-term if they are normally due in periods that extend beyond one year. The interest on a long-term liability would extend over a period of greater than one year and should therefore not be considered short-term and would be recognized based upon the due date. If we are, in fact, supposed to consider the interest separately from the debt itself, would it not also be more consistent to consider an invoice separately from the underlying event? Is it not true that the majority of invoices are due within less than one year of receipt?

Financial Reporting Model Improvements – Chapter 2, ¶ 26 indicates that net position (fund balance) is the residual amount (deficiency) available for spending at the end of the reporting period; I submit that the total exclusion of all items considered to be normally long-term, even if the due date is one day after the reporting date creates an unacceptable level of risk of unfair presentation.

The use of current and noncurrent in the Statement of Resource flows may lead to confusion and misinterpretation of the financial data. Throughout accounting, current is widely recognized to refer to assets or liabilities that are expected to be received as cash, used up, or paid within one year of the reporting date. Within the PV, the term is used to express whether an inflow/outflow is related to a short- or long-term item. It would greatly enhance clarity if the information on the Resource Flows statement was simply referred to as "inflows", "outflows" and then for the capital/long-term debt items, "net flow of resources related to capital assets and long-term debt."

Financial Reporting Model Improvements – Chapter 3, ¶ 5 provides many of the arguments for retaining the current Statement of Revenues, Expenses and Changes in Fund Balance, and ¶ 6 states that, "The Board concluded that the most persuasive argument for the existing format is that it is closest to the presentation of typical budgetary schedules. The Board did not find arguments presented above to be persuasive." This seems to be in contravention to GASB Concept Statement

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1, which clearly states that one of the primary uses of financial statements is to "compare actual financial results with the legally adopted budget" (*Objectives of Financial Reporting,* Summary, i.). It therefore seems that deciding that keeping a format similar to budgetary schedules is not persuasive to be contrary to the concept statement.

The inclusion of the verbiage "This financial statement presents a short-term view of governmental fund…" and the expression "short-term" in and of itself may create a misconception that the financial statements are presenting all known information that is known as of the statement date that will impact the financial position within a limited period following the statement date. This is, of course, not an accurate interpretation as the statements explicitly excludes items that are considered "long-term" regardless of how imminent the due date may be or of how drastic an impact the item may have upon the financial position. If this occurs, it would result in statement users making financial decisions, fully believing they have all relevant available information in hand, that they might not otherwise make if they were aware of long-term transactions that may be recognized shortly after the statement date.

Proprietary Statements

Overall, I believe that the changes proposed to the Proprietary Fund Statement of Revenues, Expenses and Changes in Net Position are useful and will provide statement users with a clearer view of the financial result of operating activities. Despite this, there are two areas of this proposed change that I believe need further consideration.

During a conference call related to the Field Test of the Preliminary View, it was presented that intergovernmental transfers-in to a proprietary fund would be considered "other" activity and would not be considered a subsidy. It is my opinion that the nature of the transfer should be considered to determine whether it is, in fact, a subsidy to the fund. Within my government, transfers to proprietary funds may be used to cover operating expenses, and therefore should be considered a subsidy.

The other concern relates to proprietary funds established specifically to provide and/or service loans and financing. GASB Statement 9, ¶ 19 does recognize that "cash flows from operating activities also include transactions of certain loan programs."; the PV also references GASB 9; however, it does not clarify whether ¶ 19 would still apply. During a field test conference call, the question was raised, and the response was to clarify that if an item matches any of the four nonoperating criteria (*Financial Reporting Model Improvements* – Chapter 4, ¶ 3) it will always be considered nonoperating. If program loan cashflows are not considered operating, I believe there will be many proprietary funds that report either no or very limited operating income.

Budgetary Comparison

I fully agree that the budgetary comparison information should be included as required supplementary information (RSI) and that the original budget, final budget and actual activity

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should be presented. This will provide information that is beneficial to statement users and allow users to assess how well their governments are able to project revenues and expenses and adhere to their budgets. If anything, I believe a more detailed comparison should be required which include year-over-year comparisons of the variances between original, final and actual. This would allow users to determine whether the government is consistently using reasonable forecasts for future inflows and outflows or if they are retroactively adjusting the budget to meet actual performance each year.

Schedule of Government-Wide Expenses by Natural Classification

As presented, the PV provides very little guidance on how to appropriately determine what is considered a natural classification. The vast differences between governments creates a situation where there will be a substantial variance in what each considers to be a natural classification, which will, in turn, limit or prevent comparisons between governments. Further, because the statement presents only expenses, without disclosing corresponding revenues, statement users may reach false conclusions when attempting to compare governments. For example, two governments may show a drastic difference in personnel expense, leading the reader to believe that one is wasteful and bloated – without the other side of the equation (revenues) the reader may not realize that the high personnel expense is due to the size of the government, and it is, in fact, operating more efficiently than the government with low expense.

Alternative Views

Should GASB ultimately decide to move forward with a short-term financial resources measurement focus, it is my belief that the modification of the short-term focus defined in the alternative views would be the more appropriate model. The modified definition would more accurately present the resources available for subsequent period spending because it recognizes all transactions, regardless of type, which will be received, paid or used within a defined period (one year).

This method has the distinct advantage of replacing the vague and readily debated concept of “normally” with the objectively definable date of availability. It is my belief that this will create financial statements which are more consistent across governments, and therefore more easily compared and understood.

Although I consider the alternative view to be preferable to the majority view, this is not to say that I believe the alternative view is the optimal path forward. The alternative view, essentially, would provide a second copy of the current portion of the government wide statements (governmental fund column). The only change would be that major funds would be segregated into their own columns. If this is truly the intent of the alternative view, it would be simpler and more effective to mandate that the governmental funds of entity wide statements be split into major and minor fund columns. That would have the added benefit of allowing financial statement users

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to review both current and noncurrent information of each major fund individually, rather than combined with all other governmental funds.

Summary

As indicated above, I applaud GASB's intent of improving financial reporting by creating greater consistency and comparability across governments. It is my position, however, that this can be achieved in a far less complicated and costly manner by consolidating and clarifying existing accounting principles and guidance applied to the financial resources measurement focus and modified accrual basis; this could be further improved by establishing authoritative guidance on recognition periods for revenues and expenses rather than continuing to allow governments to establish whatever period they choose.

Thank you for your consideration of my comments. Please contact me at ndavies@pa.gov or 717-425-6624 with any questions.

Sincerely,

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