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Martin Ives
47 Lexington Drive
Croton-on-Hudson, NY 10520
martives@optimum.net

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Director of Research and Technical Activities
Project 3-20 (Proposed Concepts Statement – Recognition of Financial Statement Elements)

I strongly disagree with the Board's proposed concepts statement, primarily because it continues to exclude – in fund financial reporting – significant long-term liabilities arising from pension and OPEB transactions and events. As a result, fund financial reporting will continue to report significantly incomplete and non-comparable data. I do, however, agree with the reasons for the dissent and with the thrust of the alternative approach expressed in the Board Member's Alternative View (hereafter referred to as Dissenting Board Member).

Before discussing my reasons for disagreeing with the Board's proposal, I'm making some brief comments on NCGA standards and GASB S34:

a. NCGA S1, the result of the GAAFR Restatement Project, claimed to be a "modest revision to update, clarify, amplify, and reorder GAAFR…" Par. 4 of its explanation of principles said: "Adherence to GAAP is essential to assuring a *reasonable degree of comparability* (italics mine) among the financial reports of governmental units." NCGA S1 also said GAAP was needed because compliance with legal provisions could cause conflicts with reporting on a budgetary basis. In response to constituent inquiries, NCGA S4 interpreted the intent of NCGA S1 regarding judgments and claims and compensated absences. NCGA I3 did the same with regard to property taxes. The net effect of NCGA S1, S4, and I3 was a "near-term" accrual regarding revenues and expenditures. Long-term liabilities of governmental funds were reported in the General Long-Term Debt Account Group (GLTDAG), offset by the infamous "Amount to be provided…"
b. GASB S34 added a set of government-wide financial statements, wherein the governmental funds were aggregated into "governmental activities" and reported on the accrual basis of accounting. The General and other governmental fund statements, however, were to be presented "using the current financial resources measurement focus and the modified accrual basis of accounting, as the terms are discussed in NCGA S1, as amended" (par. 79). Long-term liabilities resulting from General fund operating transactions were omitted from the General fund statements.

1. Shorter-Term Perspective Produces Significantly Incomplete, Non-Comparable Results

In the Board's proposed concepts statement, the short-term budget (usually for one year) morphs into a "shorter-term perspective" for financial reporting on the General Fund and other governmental funds. Like the GASB S34 model, the shorter-term perspective omits liabilities for operating transactions and events that occurred during the year but will not be paid in the short term. Those liabilities result from decisions made in preparing the budget and by events that may occur during the budget year. Leaving the resulting expenditure and liability out of the fund financial statements makes the statements significantly incomplete and non-comparable. Pensions and OPEB are significant items that often create longer-term liabilities: For example:

- Many governments budget consistently for all or most of the actuarial requirement for pensions, but some consistently under-finance the requirement. The December 2019 Pension Fund Survey, published by the National Association of State Retirement Administrators (NASRA), shows the aggregate funded level of 120 large pension plans to be 72.6%. Some plans (e.g., Wisconsin RS, are at or almost at 100% funded, while others (e.g., Illinois Teachers and Chicago Teachers) are funded in the 40% - 50% range and have been at that level for many years.
- Most governments budget for OPEB on a pay-as-you-go basis, but some have trust funds to accumulate resources to finance future payment of benefits.
- Events occurring during the year, such as the current pandemic, may create revenue shortfalls and/or unforeseen expenditure increases, resulting in budget amendments that decrease certain planned expenditures. Appropriations for pensions (and advance-funded OPEB) are logical candidates for such amendments.

The 2019 CAFR issued by the State of Illinois (which has underfunded its pension systems for many years) provides an indication of the magnitude of the issue regarding completeness of the fund statements. Reported current liabilities of the General Fund was $15.6 billion and reported liabilities of the total governmental funds was $20.9 billion. According the government-wide statements, the non-reported long-term liabilities of the governmental activities included pension liabilities of $138.6 billion and OPEB liabilities of $54.5 billion. (The pension and OPEB liabilities greatly exceeded the governmental activities' bonded debt of $31 billion.)

To illustrate the issue regarding non-comparability of financial statements, assume two similar entities with pension plans, one with a policy of fully funding it (and contributes $1 million to the pension trust fund) and one that funds only 40% of requirement (and contributes $400,000 to the trust fund). Fund financial statements that convey the facts in a comparable manner for both entities would use the accrual basis. Both reports would show expenses of $1,000,000; but the first entity would report no liability and the second would report a liability of $600,000. That is what the current model reports in the government-wide statements, but not in the General Fund statements, because the second entity does not report the additional expenditure and the liability in the fund statements. Hence, the General Fund statements of the two entities are not comparable.

Although funds are defined as having only current liabilities, underfunded pension benefits and OPEB, when paid, can be paid only from General Fund resources and, to some extent, from

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special revenue funds. Therefore, regardless of the definition of a governmental fund, accurate, complete, comparable *financial reporting* on the funds requires that the liability be reported as a fund liability. One may argue that the pension and OPEB liabilities are reported in the government-wide statements, but – depending on the circumstances – it may be impossible to find the amount applicable to the General Fund.

In urging the adoption of accrual-basis reporting for the General Fund, I do not mean to downplay the significance of certain data currently provided by General Fund reporting, in particular, the standardized measure of fund balance. Fund balance is needed to compute the "budgetary cushion" – the ratio of available fund balance to total revenues or expenditures. This ratio helps government officials and analysts assess whether the entity has sufficient resources to meet short-term economic contractions and emergency expenditure needs. But the fund balance can be reported through appropriate design of the statements. Also, the size of the fund balance can be influenced by not appropriating funds to meet current-year obligations like pensions. Hence, effective financial analysis requires that fund balance be assessed within the context of longer-term obligations like pension and OPEB liabilities.

To summarize, I fully agree with the Dissenting Board Member's assertion that the Board's proposal "fails to address the most significant limitations of the current financial accounting and reporting model;" namely, the exclusion of long-term obligations (notably pension and OPEB liabilities) from the general fund statements.

Unless long-term liabilities arising from operating transactions and events are recognized in the fund statements, I see no particular benefit to the Board's proposal. Practice inconsistences regarding revenues noted by the Board in par. B8 can be readily remedied without moving to a "shorter-term perspective." I also see no reason why the Board cannot achieve the improvements it seeks by adopting accrual-basis accounting for governmental funds.

2. Proposal Has Misleading Language Re: Accrual Accounting and Interperiod Equity

Some of the language used in the proposed concepts statement could seriously mislead the reader. I refer specifically to references to the terms "accrual basis of accounting" and "interperiod equity."

Par. 9 of the proposal says: "Under an accrual basis of accounting, elements of financial statements arising from short-term transactions and other events are recognized as they occur and elements of financial statements arising from long-term transactions and other events are recognized when payments are due." The proposal refers to the MFBA as "short-term measurement focus and <u>accrual basis</u> of accounting." (underlining is mine) As discussed in Comment 1, accrual basis accounting requires reporting of long-term liabilities arising from operating transactions such as pension benefits and OPEB. For purposes of this proposed concepts statement, the Board changed the characterization of pension benefits and OPEB to cause a large part of a potential accrual to be non-accruable (Comment 3, below). Hence, what is accruable for government-wide reporting is not accrued for fund reporting. In my opinion, stating that the Board's proposal regarding fund reporting results in the "accrual basis of accounting" is grossly misleading and must be dropped.

Interperiod equity (the notion that financial reporting should help the reader determine whether current-year revenues were sufficient to pay for current-year services) was a major consideration in the GASB's adoption of Concepts Statement 1. As the Dissenting Board Member points out, interperiod equity cannot be achieved with the short-term approach because reporting on interperiod equity requires making certain accruals (e.g., for pensions and OPEB) that are lacking in the short-term approach. These accruals are significant for many governments whose pension systems are severely underfunded and whose OPEB obligations are financed pay-as-you-go. As the Dissenting Board Member notes, interperiod equity can be achieved "only with financial statements that take a long-term recognition approach." In my opinion, the proposed amendment to Concepts Statement 4 regarding interperiod equity is completely unwarranted and will sow confusion among users of governmental statements.

3. **Proposed Reporting Model is Based on Conflicted Characterization of Transactions and Could Have Unintended Consequences**

The proposed fund reporting model relies partly on characterizing pension and OPEB transactions and events (transactions 9 and 10 of Appendix C of Project 3-25) in a manner that conflicts with the characterization of those transactions for government-wide reporting. Although pension and OPEB transactions and events may have long-term *consequences*, they are not long-term *transactions*, because: (a) they arise out of current period exchanges between the employer and the employees, and (b) most governments, recognizing that pension benefits apply to the current period, finance them in the current period.

<u>Characterization of Transactions</u>

Par. 9 of the proposed concepts statement says "elements of financial statements arising from long-term transactions and events are recognized when payments are due." Par. 11 defines long-term transactions and events as "those for which the period from inception to conclusion is greater than one year." The illustrations in Appendix C of Project 3-25 define the pension and OPEB transactions as "long-term transactions" because "the period from inception (the dates employees provide services to the government) and conclusion (the date the final pension benefit/OPEB is expected to be paid) is greater than one year."

The OPEB illustration uses a pay-as-you-go plan, so the resource outflow in the General Fund is only for benefits currently due and payable; no liability is reported for OPEB benefits earned by the employees during the year. Based on the OPEB illustration, I assume that if an entity appropriates, say, only 40% of the actuarial required contribution for pension benefits, no accrual would be made for the difference between the amount appropriated and the actuarial requirement unless the pension plan itself had insufficient resources to meet current-year benefit payments. Hence, the Board's proposal regarding pension benefits and OPEB is essentially cash based.

The characterization of pension benefits and OPEB for financial reporting on the General Fund as long-term is completely opposite from that for reporting in the government-wide statements. To illustrate, I quote the accrual-basis language used in par. B17 of GASB S75:

> "…OPEB and pensions are components of exchange transactions – between an employer and its employees – of salaries and benefits for employees' services. OPEB and pensions are provided to an employee – on a deferred-payment basis – as part of the total compensation package offered by an employer for employee service each financial reporting period. Even though the employer and employees have agreed that a portion of the total compensation for those services, in the form of OPEB, will be paid later (when the employees are no longer in active service), the employer receives full value from the employment exchange each period in the form of employee service …..The event that gives rise to the obligation (in this case, the provision of service by the employee) has occurred…."

What the GASB will have done if this proposal becomes a statement is to provide two completely different justifications for recognizing and measuring the same transaction or event in different ways. For government-wide reporting, the GASB says that recognition is triggered by an exchange transaction that occurred during the current year. For General Fund reporting, however, the Board characterizes the transaction as long-term because benefits will be paid long after the service was rendered. In my opinion, the Board's proposal is flawed because a transaction cannot be characterized simultaneously as both short-term and long-term.

<u>Pension Benefits are Financed Generally in the Year Service Is Rendered</u>

Most often, pension benefits cost governments more than OPEB and, as a general rule, pension benefits are financed each year as employees work, not after they retire. The 2019 NASRA survey, which I referred to earlier, covers 120 state and local retirement systems with total assets of $3.62 trillion. (Membership of those systems comprises about 85% of the entire state and local government retirement community.) As I noted earlier, some of those systems are poorly funded. But the average funded status is 72.6%; 16 of the plans are funded 90% or more, and 22 are funded between 80 and 89.9%. The systems could not be funded at those high levels unless the entities had, for many years, considered pension benefits to be current expenditures resulting from current exchange transactions.

<u>Proposal Could Encourage Underfunding Pension and OPEB Obligations</u>

I am concerned that the Board's proposal has the potential for causing a significant unintended consequence; namely, the future underfunding of pension and OPEB obligations.

Funds are fundamental to the administrative processes of government. The governmental budget process is based on the use of funds. Chief government executives and their budget directors are concerned with funds. Interested citizens are aware of the nature of the General Fund. Governmental managers and interested citizens are also aware of the need for "balancing the budget." I know from personal experience that mayors whose budgets are required by law to be balanced on a GAAP basis are aware of the effect of GASB standards on their budgets.

My concern here is that the discussion of pension benefits and OPEB provided on page 60 of the companion standards proposal could have the effect, however unintended, of causing some governments to further underfund their pension obligations and to continue their non-funding of OPEB obligations. Budgeting is basically a matter of divvying up scarce resources among competing program needs. I am concerned about what a mayor might say when the budget director tells him or her: "For reporting on the General Fund, the GASB considers pensions and OPEB to be long-term transactions, not payable until the employees retire. So, why should we continue to fund the pension system and OPEB Trust Fund? Why not fund those benefits on a cash basis each year as the benefit payments are due to be paid?"

The current pandemic will surely put state and local government budgets under increased pressure. I suggest that the potential for diminished funding of pension systems resulting from this proposal is a major cost to pay for an accounting standard that will yield little, if any, benefit compared to what is currently in place and, more importantly, what is really needed.

Conclusion

In my opinion, the Board has attempted to rationalize a model that cannot be rationalized. I believe the Dissenting Board Member's proposal provides a practical, sensible solution, maintaining the historical perspective regarding reporting on the funds while at the same time telling the truth through a model based on accrual accounting.

In this connection, I strongly disagree with Par. B.16 of the Board's proposal because the reasons for dismissing what is essentially the Dissenting Board Member's proposal are not persuasive. The Board finds three reasons for dismissing the proposal: (a) the approach is overly complex for most stakeholders; (b) it will create confusion regarding which of the three bases is the most "representationally faithful;" and (3) it will require added costs. As to (a), people who read governmental financial statements are reasonably sophisticated and the approach is no more complex than many other accounting standards. As to (b), the Board had no difficulty explaining why both government-wide and fund statements were useful and should have no difficulty explaining why accrual accounting provides a truthful measure of governmental fund results and status. As to (c) additional costs should be minimal because accrual adjustments are needed for the government-wide statements.

Sincerely,

Martin Ives, GASB Member 1984-1994