Letter of Comment No. 017
File Reference: REC
Project No. 3-20
Date Received: 01/14/2021

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Re: Project No. 3-20

January 12, 2021

Dear Director Bean,

Thank you for the opportunity to comment on Project No. 3-20.

Your "Financial Reporting Model Improvements" proposals enshrine short-run manipulative opportunities that help government officials to claim they are "balancing" their budgets, even as they run up debt for future citizens and taxpayers.

You claim "fiscal accountability" and "interperiod equity" drive the short-term perspective underlying your proposals for the funds statements, even though they enable underfunding retirement benefit plans, and treating borrowing proceeds as revenue, as means for "balancing budgets."

In defining your proposed "short-term financial resources measurement focus and accrual basis of accounting," you state:

> 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.

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But you appear to allow funds "balances" to include cash proceeds from long-term borrowing transactions immediately, as they occur at the inception of the transaction, without recognizing the liability that generated the asset in the funds statement. The financial statement reader can't judge the entity's position based on the funds statement, or changes in the funds statement from year to year.

The term "interperiod equity" appears only once in Project No. 3-25, "Financial Reporting Model Improvements." The Alternative View summarizes its meaning as adopted in Concept Statement 1 in the following terms:

> That is, "financial reporting should provide information to determine whether current-year revenues were sufficient to pay for current-year services."

But in your Project 3-20 and Project 3-25 pronouncements, you allow for the accumulation of debt outside the funds statements, potentially tricking the user in the name of "equity." Decision makers can dig their entities deeper into debt while showing cash budgets that are balanced or positive, with longer-term consequences for future citizens and taxpayers.

Consider an entity that issues a long-term bond, and uses the proceeds to fund required current-period pension or other post-employment benefits (OPEB) contributions. Your proposed treatment appears to be at odds with interperiod equity, not guided by it.

Accrual accounting calls for the recognition of revenue when it is earned, not necessarily when cash is received -- and especially not when cash is borrowed. Accrual accounting calls for the recognition of debt as it is incurred, not only when "payments are due." Granted, long-term borrowing, pension, and OPEB debt now appear in the government-wide Statement of Net Position, but it seems to be a pretty big stretch to claim that the funds statements are guided by "accrual accounting."

The Alternative View makes a number of compelling arguments, particularly when it cites Concept Statement 1 and its directive that "financial reporting should provide information to determine whether current-year revenues were sufficient to pay for current-year services." When long-term borrowing proceeds boost reported funds "balances" in the short-run, the change in the funds balance becomes misleading.

The Alternative View provides a persuasive example in its description of the treatment of a five-year note vs. a one-year note, both of which have principal due in the coming period. Under your methods, the funds statement for the year-end before the principal was due would include the debt for the one-year note, but not the five-year note, even though they both have the same implications for near-term funds management. This arbitrary construct derails your proposals from achieving your stated goals.

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Consider an entity with a large increase in required payments on long-term obligations in the coming year. As the Alternative View illustrates, your proposed treatment would undermine the ability of users to rely on the funds statements even for your own narrow and incomplete view of "fiscal accountability." In the words of the Alternative View (paragraph B.123):

> "The Board member that expresses the alternative view believes that an accounting and reporting model that is at best decision useless, and at worst misleading, is indefensible."

I recall asking a legislator in a large city (a member of the legislature's finance committee) how the city could claim to "balance its budget every year according to state law," yet still have accrual revenue fall short of accrual expenses by a billion or more dollars a year. He instantly said, and with pride, "we can borrow the money." You should not allow accounting terminology that allows such dangerous thinking. You can appreciate how such thinking gets state and local governments in trouble, even if the legislators cannot. You should not allow terms like "balanced" to be used when the economics are so misused.

Please remodel your proposals. The financial statements for governmental funds should reflect the present value of all liabilities, not just those due in the current period, and should reflect expenses as they are incurred, not just when they are paid. Then, budgets geared to governmental funds statements could be based on a firmer, accrual-based foundation.

I request to testify at your upcoming hearings, either in Chicago or virtually.

Sincerely,

Bill Bergman
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