

## M E M O

To: Members, Government Accounting Standards Board c/o [director@gasb.org](mailto:director@gasb.org)

Re: GASB Exposure Draft for Project Nos. 3-20 and 3-25, Financial Reporting Model Improvements, Comments and Request to Make Oral Presentation at Your Public Hearing/User Forum

From: Scott Bernstein, Founder and Emeritus President, Center for Neighborhood Technology

Date: February 26, 2021

I write to comment on GASB Exposure Draft for Project Nos. 3-20 and 3-25, Financial Reporting Model Improvements Draft, and to request an opportunity to testify at one of your upcoming field hearings. A short summary of recommendations is provided on page 9 below.

I applaud the Board's commitment to producing reliable and consistent statements of financial position, and to producing information in a form that can be used by (a) finance and accounting professionals, (b) public officials, and (c) stakeholders and the public at large.

In that regard, I believe that what's being proposed in the Exposure Draft serves (a) best but leaves room for improvement for with regard to audiences (b) and (c).

There are two principle reasons this is the case.

The first is that the rubric you've used of "short term focus" can be misleading; it signals a bias toward current term considerations when I believe you've intended it to signal a commitment to accounting for expenditures and liabilities when they're taken on, whether they only are experienced in the current period or as is increasingly the case, over longer periods of time. Three examples of such longer-term commitments include accounting for the full costs of human capital, including both Ordinary Post Employment Benefits and other obligations, accounting for the impaired costs of capital, such as might occur due to environmental contamination or to exceptional events such as extreme weather, which as we know is occurring more frequently, and in general accounting for the costs of long-lived capital assets, including facilities and infrastructure.

As the Board has done a thorough job on OPEB, my comments are focused on the effects of weather and climate change and accounting for these on State and local government finances, and on accounting for infrastructure.

### **Economic Disruption, Severe Weather and Climate Change**

It's no accident that the word "resilience" is now used in conjunction with State and local government policy and planning. Both economic and environmental volatility can be labeled as "exceptional" events, but the frequency of occurrences is increasing.

In the case of the economy, 13 years after the crash or "great recession of 2008," there are significant areas of the country that have still not recovered. In the case of the current economic fallout of the pandemic, what might appear to be a so-called "V-shaped" recovery masks a change in economic

fundamentals. A good example is in traffic levels. In Chicago, research shows a plummeting last March of overall traffic levels with a return within 2 months to pre-pandemic levels; by November of 2020 it became clear that this “recovery” masked a drop in passenger traffic, even as mass transit use plummeted, and a growth in the amount of traffic devoted to long distance supply chains and to various forms of delivery-on-demand. Uncertainty and extended periods of public health-driven mandates, including work-from-home and distancing, have been disastrous for smaller and independently owned businesses, leading to large scale closures, and even calling into question the future of downtown areas. In Washington DC it’s reported that 60 percent of the workforce is working from home, while in Boston the Chamber of Commerce reports 70 percent of its members’ workforces are doing so.

These changes are fundamental, and no one know how much of this will stick, but it is affecting State and local revenues profoundly. It’s also turning public systems into potentially stranded assets, as in the case of public transportation systems and airports. Most cities and their business leaders intone that “our airport is our economic engine,” but what if most of that engine is more permanently stuck in low gear?

The Exposure Draft does a public service by providing useful examples of how to use the principles of 3-25 to account more responsibly in statement presentation; but it leaves largely to the reporting entities the task of how to responsibly report narratively in the Management’s Discussion and Analysis for such fundamental and disrupting economic emergencies.

Similarly, State and local government have the responsibility of planning for environmental change. Severe weather has been tracked generally for over a century, and in increasingly granular detail since 1996, when the National Weather Service started providing historical data aggregated by county for the county, including detailed narrative information on roughly 60 separate types of severe weather events. While the longer-term trends are the stuff of climate change, the discrete events and their frequency of occurrence give government and insurers, both public and private, the data needed to provide early warning of exposure. Rational planning dictates planning ahead, but the formal signals given by labeling the frequency of return occurrence have absolutely been misleading in the last half century, e.g. in Chicago, “100 year floods” occurring 2-3 times per decade, nationally, even “20 year floods” occurring every 13 years. In a novel and refreshingly candid lawsuit, Farmer’s Insurance stated following a record flood in 2013, that there is an implied social contract between insurers and governments that either does or doesn’t make financial risk management feasible, citing that all counties and local governments now participate in the preparation of the region’s climate action plan and therefore should have been accelerating implementation of flood-preventing investments. Studies show that more people are exposed to flooding outside of the flood plain maps that determine insurability, due to runoff of stormwater; but the funding available to manage stormwater favors treating every drop of rain as a waste product the second it hits the ground. This creates infrastructure choice lock-in, with disastrous results: a multi-billion dollar system suggested in the 1950s, decided on in the 1960s, initially financed in the 1970s, and christened in the 2000s...is still not complete, and failed to prevent either backflows to Lake Michigan or local flooding or mammoth regional flooding in 2019 when early Spring rainstorms and snowmelt simultaneously inundated the system, prompting the system operator to state that they now realize that simply adding sewer and reservoir capacity will not be adequate for peak storm periods—in English, it took a long time, over a half-century, to acknowledge that this long-lived capital asset might be obsolete, especially considering the increased frequency of severe and extreme storms.

A responsible narrative would disclose knowledge of such events, which are hardly unique to Northeastern Illinois, and further disclose local and state and even inter-governmental commitments to adapt to the situation. Why should a bond rating agency, knowing of these risks, give a good rating to a unit of government simply because the entity is statistically following GAAP rules, but is clearly putting its people, its assets and its economy in harm's way?

I attended a meeting once in the San Francisco Bay Area of leading venture capitalists and venture startups, one of who asked the investors, why are you so difficult in screening and providing the capital we need? The answer given, we'd rather invest in a Grade A implementer with a Grade B or C idea than the other way around.

No state or city government is yet a Grade A implementer, but all cities are at risk of mis-labeling legacy approaches to changing circumstances; so the question of what commitments to realistic planning are being made by a reporting entity are surely worthy of some guidance in the preparation of an MD & A narrative, and eventually, so is the question of whether a city or state is doing a good job of seeking, taking and acting on advice in these matters.

Leading climate change scientists speak of "the myth of stationarity," which is the assumption that all assets and activities a few decades or more from now will be in the current locations. This too is a legitimate concern when accounting for long-lived assets and the stranding of these assets. Trends in building larger schools leads to risk of excessive travel and access costs when demographics change; as another example, infrastructure capacity varies by diversity of load for the services provided (water, drainage, sanitation, energy, traffic, bandwidth) and when land use change so do these balances.

In one sense, the world has woken up to the history of how credit policies discriminated in favor of newer places at the expense of older ones, known as redlining. The world is also struggling with what the fix is to this legacy- what might response environmentally driven infrastructure investment encompass, aka "greenlining?" Accounting rules don't directly make public policy, but they can either help or impede good policy implementation.

### **Accounting for Infrastructure**

The tangible networks defining and occupying the public realm are no small part of the assets and operations of State and local government; some urban historians believe they they've always been one of the highest costs, and one of the most difficult parts for which to provide adequate revenues.

There is no authoritative and comprehensive accounting for the value of these assets; an analysis of the 2007 Bureau of Economic Analysis asset accounts in the National Income and Product Accounts showed that growth in infrastructure investment was not keeping up with economic depreciation. The most recent estimate of the urgent "gap" needed to bring those networks up to professionally recognized condition and performance, from the American Society of Civil Engineers, is \$5 Trillion, a figure used often in conjunction with current policy debates about the "infrastructure bill," which the new Congress has just started taking up this week.

The investment in these tangible assets can be thought of as the physical asset equivalent of the OPEB issue or of Social Security Trust Fund solvency. It's somewhat trickier, because not all of these assets are under the direct authority or span of control of the reporting entity, and public capital assets are usually not bought and sold. It's likely that much of the road capacity in a "local" government jurisdiction carries

a county and/or State sign, signifying ownership of and control by that larger entity. Services known as “utilities” are most often, for example, in the case of electricity, natural gas or telecommunications, provided by investor-owned entities who are licensed and franchised as exclusive providers within a territorial framework, and therefore their asset accounting doesn’t show in a CAFR for communities in states requiring one, nor in State reports done on behalf of communities otherwise. Utilities providing water, stormwater and sanitary sewer services are most often, but not exclusively operated as public utilities, whether separately incorporated as a municipal utility or as a cooperative service or offered through a city department and accounted for in an Enterprise Fund. Water and sewer services, according to analysis of reports from the Consumer Expenditure Survey of the Bureau of Labor Statistics, are the fastest growing bill for utility services in the United States; increasingly, these services are being offered by for-profit entities, in which case their oversight and regulation, as in the case of investor-owned energy utilities, is through a State’s public utility commission.

Whatever their ownership or extent of public control, life is not possible without these services. While it’s true that focusing utility and infrastructure investment in demand reduction is smart and prudent, the apparent incentives for most capital spending is to invest on the supply side, with a constant barrage of calls for increased capacity in highways, water withdrawals, stormwater and energy capacity resulting. Interestingly, there is a vibrant industry devoted to promoting reduced demand for electricity and natural gas, and for over 30 years one result has been a virtual halt to the construction of large baseload powerplants, in favor of investing in energy-uses’ efficiencies, both through demand reduction and through distributive resources, in effect, in both cases a switch from a smaller number of large assets to a larger number of smaller ones, respectively. Something similar has developed around all of these legacy services, as economics and smarter technology and common sense have taken hold. Questions are routinely raised: e.g. on stormwater and flooding, do we bottle rainstorms and treat them as waste, or do we catch raindrops where they fall and put them to work? Do we drive more traffic to the limited access highways and then widen them to try and reduce congestion, or do we expand street networks recognizing most trips are short and offer options for carrying passengers and goods in a shared vehicle framework for the longer hauls?

Questions such as these are firmly baked into everyday planning and public works policy and practice but reading the average MD&A or financial statement you might never know it.

After adoption of Statement 34 by GASB, there was a flurry of interest in using financial reporting to encourage adoption of and reporting of best practices; one respondent was Fitch Ratings, which even took such disclosure into account in their municipal issue ratings (2001).

But what is commonly reported in accordance with Statement 34, is that the reporter is compliant with it, that the information used in preparation has taken account of its concerns with the remaining useful life of the asset, and whether the entity is using depreciation against historical cost or the so-called “modified method.” Some examples of why this is deficient compliance include without being limited to—

1. Environmental regulation can easily impose costs beyond the capacity of a public agency to afford, particularly when an agreement to meet these rules is stated in terms of a particular technology or means of compliance. This clearly occurred in the case of Jefferson County (Birmingham) AL, when a \$4.3 Billion Clean Water Act violation settlement led to one of the nation’s largest historical bankruptcies.

2. Replacement actions due to infrastructure failure could be reduced by more careful consideration of what happened and what options are available. A failure of stormwater infrastructure during a record 2013 rainstorm in Dearborn MI was blamed on faulty construction; analysis by a team during a planning charette requested by that city's sustainability and planning offices demonstrated that peak runoff from too much paving was the likely culprit, leading to a strategy for investing in more permeable alleys, streets and parks, which needed upgrading anyway.
3. Chief elected officials at both state and local government levels are finding to their embarrassment that agreeing to highway widening undercuts other agreements made to increase pedestrian safety or to reduce both health harming "criteria" air pollutants and greenhouse gases, and that in independent reviews, strategies to achieve the latter are within their reach, and usually more affordably than the strategy being pursued by State transportation agencies. Often such widening is happening in areas where these safety and health impacts fall disparately on the backs of the area's poorer and minority populations. In many cases, the highways in question are literally past their expiration dates; in an increasing number of instances, they are being demolished and replaced with boulevards and accompanying improved street networks that meet a "complete streets" specification, which also provide right of way for non-motorized transportation, such as walking and bicycling, or connections to improved mass transportation.

What these examples have in common is that nowhere in the financial statements is there an adequate explanation of what's occurred. The useful life of assets is given in terms of asset class, such as roads and highways, sewers and so forth; but it would be more useful to know what the distribution of service dates and remaining useful life along with some certification of inspection, maintenance and upgrade is available. If the reporting government is compliant, then such data exists and both could and should be made available; if it doesn't, how can they be compliant?

That so many governments have endorsed the call for a multi-trillion dollar public investing in the infrastructure investment gap does not endorse the intended predominant use for replacement of aging assets with more of the same; could we push a magic button today and replace all of these, we'd have \$5 trillion of state of the art 1930s systems thinking.

Two significant trends help illustrate the nature of the decisions faced continuously by State and local government. The first is the anticipation and management of growth or shrinkage; the second is the economic resilience fallout from disruptive events such as the 2008 Great Recession, extreme weather events, and the current pandemic.

### **Growth and Shrinkage**

Dane County WI is the home of Madison WI, it's largest city and the state capitol. The county is required to assess "future urban development" to determine targets for capital improvements. As part of their regional planning commission's sustainability planning, they determined the cost for servicing standard civil infrastructure demand from growth at two different levels indexed to household density, at a low end of 4.4 dwellings per acre and a high of 8.9 dwellings per acre, respectively. To do this they assembled a minimum of 3 bids each made on actual infrastructure needed to provide roads, water, sanitary sewer and stormwater management on a sample of developments entitled and constructed. A novel method of measuring typical street lengths correlated with neighborhood compactness allowed

regression analysis to determine costs for these services of miles per street, aggregated to the level of development specified.

The results were presented via two scenarios for accommodating growth of 10,000 persons, in each case in 4,000 housing units. The lower density was typical of subdivision development in suburban form; the higher density typical of urban form. The investment cost of providing these services at the lower density was \$161 million, while at the higher density it was reduced to \$102 million. On a per unit basis, the cost reduction was from \$40,250 to \$25,550 or \$14,750; on an aggregate basis the reduction amounted to \$59 million. Further economies were identified from innovations such as use of permeable surfaces to reduce stormwater runoff.

This story also provides an example of a metric that could result from requiring that service benchmarks be used, in this case in the form of capital costs per household. In the example given, further economies could have resulted from reducing demand for road, water resource and stormwater management capacities.

### **Disruption**

As noted above, what might otherwise be labeled “exceptional” events can happen and apparently are happening with increased frequency. I gave the example of the bankruptcy of a common scale of return frequencies for severe storms, which critique could also be leveled on excessive heat events and wildfires, or energy service outages, such as the very recent event in Texas.

All of these affect the finances of state and local governments. Extraordinary emergency expenses can be incurred with or without reimbursement by State and federal agencies, and commitments made during emergencies are notorious for being made due to what’s most available or expedient, as opposed to most improved, best practices or least cost. During the Gulf Coast hurricanes’ aftermath, it was shown that the cost incurred by FEMA in providing temporary trailers for emergency housing exceeded the costs for providing modestly sized and well-placed homes, a result of providing very low expected useful life for the trailers, rendering them in effect as disposable products. Not co-incidentally, this insight helped launch the current markets for “tiny homes” and Accessory Dwelling Units, a transformation that has yet to fully play out. The effect of switching from a temporary trailer to a permanent home is significant, both in terms of providing a lasting net benefit to a community and its occupant households, and to its economy. Choices such as these could and should be reported.

Similarly, during the current pandemic the entire population of State and local governments has had to learn how to adapt to changing circumstances. In some cases States are helping provide investment capital to local governments; more often local governments are learning how to use authority to make more of their infrastructure assets- who lives in a community that isn’t attempting re-purposing outdoor right of way from transportation and parking to outdoor restaurant, recreation or “parklet” format, or from higher-capacity motorized vehicle throughput to safer and more human-scaled pedestrian orientation?

In Illinois, a study of traffic levels by the Chicago Metropolitan Agency on Planning demonstrates that while a V-shaped plunge and recovery in traffic levels during March-April of 2020 occurred and reached pre-lockdown levels, sensor readings show that the gross level of traffic masked a significant plunge in passenger vehicles traveling in favor of goods movement—both larger scale long-distance movements

of the sort now regularly referred to as “keeping the supply chains open,” and the significant shift to delivery-on-demand. This clearly is a shift in the economic fundamentals: so much of State and local revenues are based on activities away from home, and so a shift from “people to jobs, goods and services” to “jobs, goods and services to people” has blown serious holes in budgeted assumptions. On the investment side, it has renewed investment activity on the part of municipalities in “municipal wi-fi” and predictably in pushback and pre-emption actions by States who may depend on significant revenues from larger market-based providers.

Downtowns may recover to a certain extent; but equally likely is that real estate assets will need to adapt, e.g. today’s commercial office centers become mixed use facilities housing people, amenities, and offices together. Those changes and where they occur will result in patterns of “load diversity” much different than experienced just over a year ago. Successful adapters will avoid these assets: both tax-generating buildings and associated infrastructure, from becoming stranded (non-revenue generating or non “used and useful”). The economic incentives in downtowns for making “work from home” and “telecommuting” permanent are very strong- one estimate is that the full cost to an employer for providing an employee workspace is between \$5,000 to \$10,000 per employee per year. The pre-pandemic response was to increase net internal employee density per square foot; with social distancing, that is no longer feasible, nor should it be allowed. One employer with whom I spoke, in downtown Boston, is rebating part of the money saved into enhanced employee benefits such as ergonomic home office furnishing and services, reliable broadband, and also into a distributed network of meeting centers at transit station areas. While nationally, the estimate is that “only” 36 percent of people can work from home, that figure varies significantly within and between locations.

It's likely that shifts in preferences for locations and development patterns will increase the demand for shifting the pricing of infrastructure, whether paid by fees or taxes, from average to location-determined marginal costs. Accomplishing that reasonably and fairly is no small task, but impossible given current financial reporting based only on average costs.

As mentioned above, climate change has already triggered relocation and domestic migration. Not only will this result in “winners and losers” in terms of housing and business real estate and the related financial impacts of providing real estate, but as demonstrated the costs of providing necessary public services, a large part of which are in the form of long-lived assets, will result in winners and losers as well. In both cases this should require additional disclosures in the MD&A. “Winners,” which are being popularly labeled “receiving,” “welcoming” or “destination” communities, will discover the need to provide services efficiently and most affordably. If they are “legacy” cities with underutilized or stranded asset capacity, a “fix it first” policy, such as exists for transportation investing in federal law and within certain states, would be appropriate prior to committing to brand new infrastructure capacity; but even if there is little such capacity, the need is there for cities attempting to accommodate growth to use limited public resources wisely. If they are “losers” or “sending” cities, a more troubling disclosure is still called for. Both types of situation call for innovations in capital planning and in capital asset reporting, in turn calling for guidance in the structuring of a narrative such as is required in an M D & A disclosure.

### **Summary Recommendations**

1. **Help Governments Report Currently Known Facts Usefully and Prospectively.** The MD&A will always be the most publicly understood part of the CAFR or its equivalent; GASB should provide guidance on best practice in its provision, including examples and methods of communication of its

general availability. Guidance provided on “unusual and infrequent events” should affect the content of the MD&A, particularly in item (5), Currently Known Facts, especially when there is proven risk for repeat events on a continuing basis. In an increasingly disruptive environment, state and local government must report not only on a retrospective, but a prospective basis as well. The Exposure Draft is silent on protocols for reporting prospectively, and so I recommend correcting this.

2. **Relabel “Short-Term Measurement Focus” to “Real Time Accrual.”** Re: Application of the Short-Term Financial Resources Measurement Focus and Accrual Basis of Accounting in Governmental Funds—I’ve observed considerable confusion between the Board’s use of “short term measurement focus” to intend that this denote a commitment to counting obligations when they occur—e.g. a liability is committed for long-term assets upon commitment. The Board should strongly consider an alternative way of labeling this focus that maintains a commitment to accrual-based GAAP principles but avoids the unfortunate “short-term” rubric, perhaps with a phrase such as “real time accrual.”
3. **Adopt Disaggregated, Right-Sized Asset Reporting.** Government officials and the public at large are most interested in financial information for it’s use in decision support. The data provided in a CAFR report is highly aggregated but does provide a basis for addressing the level of service provided for the money committed. Officials and citizens deserve, as you point out, reliable and consistent accounting; but these highly aggregated totals provide no basis for knowing if the purposes to which funds were committed was a good deal or not. The Board has considered providing guidance on the publishing of service measures at appropriate scale; this provision would “right-size” financial reporting to a scale that could be used in public review, public engagement, and broad public reporting, allowing it to better accompany proposals for specific projects under consideration for approval or enhancement. If standardized, it would also facilitate and lower the cost of acquiring information for performance measurement and benchmarking, and for identification of best practices and best practitioners.
4. **Adopt a rule requiring disclosure of remaining service life by individual asset, as opposed to only by asset class.** The nature of capital assets is that they’re long lived. Cities do already acquire service life information and report it by asset class according to Statement 34. Providing public access to disaggregated information is the equivalent of running an expected expiration date for such decisions as budgeting for maintenance, enhancement, replacement, or asset retirement. This type of labeling would extend the value of knowledge already paid for and acquired.
5. **Require state and local governments to disclose their policies on and commitments to asset preservation, aka “fix it first.”** Since the passage of the federal Intermodal Surface Transportation Efficiency Act of 1991, state and local governments have become accustomed to disclosing their infrastructure investment and renewal policies through asset management plans. It is necessary and reasonable that the MD&A narrative disclose the reporting entity’s approach to the conservation and life extension of these very essential and very expensive assets; for example, is there a “fix it first” commitment in law? Is there a web site that provides access at the asset level to condition and performance data and to the estimates of remaining useful life? If the entity is committed to modernization and experimentation with novel and potentially more economical means of providing services, are these intended only for demonstration purposes, or is there a commitment to providing such innovations at scale? When significant economic potential is identified, is there an effort to put this knowledge to

work, e.g. by pricing infrastructure hookups to marginal costs by such factors as location and urban form?

6. **Require disclosure of intergovernmental, joint control of both assets and asset classes.** Much public policy on alternatives for improved budgeting and operations of capital assets would be better informed by a clear explanation of existing authority to make such choices, which in turn is influenced by the nature of overlapping and joint authorities. It often makes sense to select alternatives that operate at a level of a single block or dwelling; while for other policies significant benefits clearly accrue at larger scales, requiring effective multi-agency and public-private cooperation. Governments may have inherited legacy infrastructure based on historical assumptions of economies of scale that no longer apply, or may be able to demonstrate economies due to unbundling of such services networked together for more effective and less costly service; e.g. much of the use of “green infrastructure” for stormwater management is based on such strategically targeted methods to reduce peak loads and localized flooding more effectively than can be achieved by more traditional methods alone. GASB Statements 34 and 62, taken together, would be more frequently utilized in the presence of understandable guidance on how State and local governments can better and more innovatively accelerate their commitments to performance-based, multi-jurisdictional programming, and when governments know how to disclose that commitment most understandably.

I thank you for the opportunity to comment on your Exposure Draft of Projects 3-20 and 3-25 for a new Financial Reporting Model.

I hereby also request an opportunity to testify at one of your upcoming hearings scheduled within the Exposure Draft.

Sincerely,

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