Letter of Comment No. 102
File Reference: REC
Project No. 3-20
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Mr. David Bean
Director of Research and Technical Activities
Governmental Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Project Nos. 3-25 and 3-20, Exposure Drafts — *Financial Reporting Model Improvements* and *Recognition of Elements of Financial Statements*

Dear Mr. Bean:

Deloitte & Touche LLP is pleased to respond to the GASB's two exposure drafts (EDs), *Financial Reporting Model Improvements* (ED 3-25) and *Recognition of Elements of Financial Statements* (ED 3-20). Given that the EDs' topics are interrelated, we have combined our comments into one letter.

We commend the GASB on its efforts to continue to improve financial reporting through its multiphase reexamination project. However, we have ongoing substantial concerns about the reporting model under which the GASB requires governments to present both fund-level and government-wide financial statements. Such presentation is very difficult for an average financial statement user to read and understand, and it is our continued belief that fund-level financial statements should be excluded from the basic financial statements because they do not provide sufficient incremental benefit to the broad user community. As times change, user needs also change, and the information contained in financial statements must reflect such needs. We have seen other standard setters, such as the International Public Sector Accounting Standards Board (IPSASB), move to a full accrual accounting reporting model in response to user needs in recent years, and we continue to recommend that the GASB follow suit with a single-perspective reporting model for all governmental and business-type activities.

However, if the GASB chooses to retain a dual-perspective reporting model, we believe that (1) fund-level financial statements should be presented separately when requested or as

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supplementary information given their limited use and narrow focus and (2) only incremental revisions should be made to the current reporting model for governmental funds (i.e., the current model's familiar concepts, terminology, and format should be retained). The proposed model, which requires use of the "short-term financial resources measurement focus and accrual basis of accounting," is conceptually inconsistent. Its exceptions, inconsistencies, and lack of clarity are no less challenging than those under the current model, and its benefits to users, preparers, and auditors would not outweigh the costs associated with its implementation. Accordingly, we believe that there is no justification for replacing the current model with the proposed model.

Moreover, the GASB is currently working on its revenue and expense recognition (RER) project (Project No. 4-6P), which also addresses the financial reporting model and elements of financial statements. That project and the two EDs are so interrelated that finalizing the EDs separately could cause extensive duplication of effort and frustration for governments whose resources are already stretched beyond their capacity. It simply does not make sense to address the three projects in separate stages.

Accordingly, we believe that the GASB should consider establishing a single project to simplify governmental accounting and reporting rather than multiple separate projects that may further complicate existing standards, which already challenge even the most sophisticated governments with the best resources and systems. A simplified model would also more closely align with models established by other standard setters such as the IPSASB or the FASB. Further, it would benefit multiple parties, including (1) users of the financial statements, who would more easily understand the statements; (2) preparers, who are often strapped for resources related to time, dollars, and talent; and (3) educators, who already struggle to fit government accounting into their curricula.

While we believe that fund-level financial statements are not a necessary part of the basic financial statements and, at a minimum, any projects with changes to the reporting model should progress at the same pace as the RER project, we have reviewed the EDs and provide our significant comments in Appendix A and our suggested edits and clarifications in Appendix B, which follow.

If you have any questions concerning our responses, please contact Reem Samra at +1 214 840 7376 or Tracey Guidry Cooley at +1 512 226 4440.

Yours truly,

Deloitte & Touche LLP

Cc: Robert Uhl

Appendix A

Dual-Perspective Financial Statements

Government-wide financial statements contain information that is important to users such as the citizenry, legislative and oversight bodies, and investors and creditors. According to GASB Concepts Statement 1, the basic characteristics that governmental financial reports should possess are “understandability, reliability, relevance, timeliness, consistency, and comparability.” The complexity associated with a dual-perspective reporting model affects both the timeliness of the preparation of government financial statements and the relevance and understandability of such information. We believe that simplifying the presentation, understandability, and preparation of financial statements should be the GASB’s topmost priority and that such simplification would make government financial statements more timely, relevant, and readable while relieving some burden from under-resourced governmental accounting preparers.

Fund-level financial statements contain information that is narrow in scope. They are used internally by government management (and those charged with governance) as a management tool as well as to demonstrate compliance (e.g., to note whether resources were used for their intended purposes). For users who need such information, governments could respond by providing fund-level statements separately in response to specific requests, as segment information, or as supplementary information. But governments should not be required to include them as part of the basic financial statements.

Basis of Accounting

We do not support the presentation of governmental funds by using a short-term financial resources measurement focus and accrual basis of accounting. As we previously commented, we believe that the GASB should adopt a single-perspective full accrual accounting reporting model. However, if a dual-perspective model is retained, only incremental changes should be made to the existing current financial resources measurement focus and modified accrual basis of accounting.

Governmental Funds

Transactional-Based Determination

Under the proposed short-term financial resources measurement focus and accrual basis of accounting, governmental entities determine whether a transaction is short term or long term on the basis of the time from the transaction’s inception to its conclusion rather than on the date of the financial statement report (report date). The use of a period of availability is no longer required. Elements of financial statements arising from short-term transactions are recognized as they occur, and elements of long-term transactions or other events are recognized when payments are due.

Application of the short-term financial resources measurement focus and accrual basis of accounting to account balances, classes of transactions, contracts, and financial statements seems to be principles-based at first glance; however, several rules and exceptions in the EDs concern us. First, because the model is applied to individual transactions, the burden on finance departments to evaluate each transaction is exponentially greater than that under the current reporting model. Second, there are a number of specific rules and exceptions to them that must also be applied to certain transactions, which compounds the complexity of the proposed model's implementation and impairs its ability to be understood. Third, the model does not permit (1) the use of a facts-and-circumstances approach for unusual or complex transactions or (2) require the evaluation of transactions that have been amended. As a result, the possibility of misleading reporting or intentional manipulation of financial statements is increased.

Finally, application of the accrual basis of accounting to the short-term financial resources measurement focus is an extremely difficult concept to explain, even to the most sophisticated and experienced governmental accounting professional. We worked with several user groups to understand these EDs, and the unanimous consensus was that having multiple financial statements that present the accrual basis of accounting for differing measurement focuses will result in enormous educational challenges for all users, including those charged with governance. Our experience has been that even in a routine year, government professionals and auditors spend a moderate amount of time explaining the structure, accounting, and reporting of government financial statements to those charged with governance (audit committee members, board members, council members, etc.). Introducing a new measurement focus to which accrual accounting is applied differently from how it is applied to business-type activities only further complicates the already overcomplicated governmental financial statements. We believe that accrual accounting applied to anything other than the economic resources measurement focus will not be understood or easily applied.

Exceptions, Inconsistencies, and Necessary Clarifications

Other Events

Paragraph 13 of ED 3-25 states, in part:

> Whether a transaction or other event is short term or long term is determined by the period of time that elapses between the inception of the transaction or relevant component part thereof or other event and the conclusion of the transaction or relevant component part thereof or other event as discussed in paragraphs 14–18.

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However, since an "other event" (paragraph 17) is not a defined term, it should be defined in the standard. We also suggest that the Board add examples of nonstandard or unusual transactions that occur in practice since the illustrations in Appendix C are overly simplified. For instance, the Board should add examples for transactions that cross year-end, for financial statements that include deferred inflows and deferred outflows, and for more complex transactions such as property tax revenues with levy and collection dates that cross years or pension plan transactions in which the government does not make the annual required contribution. In addition, examples of more realistic transactions (throughout paragraphs 19–25, Appendix C, and the exhibits) would be helpful.

Binding Arrangement

Paragraph 15 of ED 3-25 states, in part, "A binding arrangement can be written, oral, or implied by the government's existing practices; examples include legislation, contracts, and grant agreements." We note that in paragraph 5 of Chapter 3 in the Board's Preliminary Views document for the RER project, there is a more expanded explanation for *binding arrangement*. Normally, we would expect such definitions to be referenced to other standards; however, since the RER project is not being completed simultaneously with this ED, the Board should clarify what is meant by "existing practices" because the examples would encompass only formal written arrangements as a result of legislation, contracts, and grant agreements.

Reevaluation of Transactions

Paragraph 18 of ED 3-25 states, in part, "Once a transaction and other event is classified as either short term or long term, it should continue to be reported in that classification for financial reporting purposes even when there are changes in the existing binding arrangement's terms and conditions." An inability to reevaluate and reclassify transactions when changes occur may lead to misleading financial reporting or even manipulation through contract amendments and revisions. We believe that it will be difficult for governments to distinguish where to draw the line between a change in an existing binding arrangement and a new binding arrangement. In addition, the example in paragraph 18 could be supplemented by illustrations reflecting more commonly encountered transactions, such as the scenarios in Appendix C, as well as the accounting for such transactions.

Rules-Based Approach

Paragraph 19 of ED 3-25 implies that all inventory and prepaid expenses are short term in principle. The nature of inventory in government is not equivalent to that in private companies. In governments, "inventory" generally converts either to supplies or to a capital asset, not to a salable item. Prepaid expenses may be related to an agreement that is greater than one year (construction or other contracts). In such cases, recording these by using a rules-based approach and requiring them to be short term could obscure the true substance of the transaction.

Similarly, the requirement that all investments should be reported as assets because they are considered financial assets that are available to be converted to cash may, depending on the facts and circumstances, result in exceptions to the application of a rules-based approach in practice. Not all investments (e.g., investments recorded in permanent funds) are available to be converted to cash.

The GASB should consider whether these examples consistently meet the definition of “financial assets” in paragraph 32 of Concepts Statement 6 or paragraph 12 of ED 3-25 or whether further clarification is needed. Further, exceptions are already built into this model in paragraphs 20 and 21 with long-term debt issued for short-term purposes, which requires the reporting of tax and revenue anticipation notes with maturities beyond one year. All of these exceptions move the model away from a principles-based approach and toward a rules-based approach.

Need for Examples

The examples in paragraphs 19–25 and Appendix C need to be more comprehensive and take into account, for example, retainage payable, property taxes (those collected in advance or levied in advance), escrows, customer deposits, and deferred inflows or outflows. In addition, they should address binding agreements that are entered into in one fiscal year and completed in the next (i.e., they should illustrate cross-fiscal-year activity and the related accounting).

Proprietary Funds

Statement of Revenues, Expenses, and Changes in Fund Net Position

We do not support the proposed presentation of the proprietary fund statement of revenues, expenses, and changes in fund net position and believe that it is not universally meaningful to all business type activities (BTAs). Not every type of proprietary fund or BTA will view as important the information obtained from the proposed requirement in ED 3-25 for all proprietary funds to separately (1) identify “noncapital subsidies(detailed),” (2) arrive at a subtotal of “operating income (loss) and noncapital subsidies,” (3) identify “other nonoperating revenues and expenses (detailed),” and (4) arrive at yet another subtotal of “income loss before unusual or infrequent items.” While this presentation may be helpful to certain proprietary funds or BTAs, for others, these classifications are effectively forced and will not represent the way the proprietary fund or BTA operates. We therefore propose that that the use of these categories and subtotals be optional.

Transfers and Subsidies (All Funds)

In the governmental funds statement in paragraphs 26 and 32 and Exhibits 4, 5, and 8 of ED 3-25, while all interfund activity is reported as short-term, it is not all classified as current. In

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proprietary funds statements, transfers must be reported as capital or noncapital. We do not believe that there is any measurable value to the user in separately identifying transfers as either (1) current or noncurrent or (2) capital or noncapital. Paragraph 40 of GASB Concepts Statement 4 states:

> Governmental financial presentations often include financial statements of reporting units, such as governmental activities, business-type activities, and major funds, that are subcomponents of a governmental unit, the entity to which these definitions of elements of financial statements apply. Activity between reporting units of a governmental unit should be reported as internal balances and transfers along with the assets, deferred outflows of resources, liabilities, deferred inflows of resources, net position, outflows of resources, and inflows of resources of these reporting units. These internal balances and activities will not meet the definition of elements of financial statements; however, they are reported for purposes of fairly presenting each reporting unit.

Therefore, we believe that transfers should not be classified as current or noncurrent. In addition, on the basis of the definition of "interfund activity" in Concepts Statement 4, we do not believe that subsidies, as defined in paragraph 32 of ED 3-25, should include resources provided to or from other funds.

We recommend that the Board (1) treat transfers as a separate section or (2) group transfers in a section with other nonoperating revenues (expenses) and transfers in (out).

Timing and Process

RER Project

In January 2018, the GASB issued an Invitation to Comment, *Revenue and Expense Recognition*, which we responded to in an April 27, 2018, letter. The related Preliminary Views document for the RER project was released in June 2020, and we responded to that document in a February 26, 2021, letter. We reiterate our belief that the RER project is such an integral part of the Board's projects on the recognition of elements of financial statements and on financial reporting model improvements that it is critical for the three projects be deliberated simultaneously. It is not possible for preparers, users, or auditors to fully understand the implications of these projects in isolation.

The detailed guidance in ED 3-25 on specific transactions is subject to change as the RER project is further deliberated. However, the projects should be in the same phase of the due diligence process.

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Appendix B
Other Comments

Management's Discussion and Analysis

We agree that Management's Discussion and Analysis (MD&A) should (1) provide an easily readable analysis of the government's financial activities on the basis of currently known facts, decisions, and conditions; (2) discuss the current-year balances and results in comparison with those of the prior year; and (3) avoid unnecessary duplication and boilerplate language. We appreciate the GASB's efforts to improve the usefulness of MD&A but contend that certain paragraphs in ED 3-25 are inconsistent with the GASB's intent to make the analysis in MD&A less "boilerplate." In multiple instances within the ED, such as in paragraph 8(a), information that must be included MD&A already has to be included in the notes to the financial statements; thus, a user could simply be referred to the related note.

In addition, we believe that the requirement in paragraph 8(c) to include an analysis of nonmajor funds is unnecessary and would result in (1) a long and confusing assessment given the differences in bases of accounting of these funds and (2) dilution of the truly important information provided in the analysis. Further, the example provided in Exhibit 1 goes beyond the proposed requirements in paragraphs 4–8 of ED 3-25. We strongly recommend that if an example of MD&A is provided, it adheres to the final standard's requirements.

We also disagree with the guidance in the next to last sentence of paragraph 4 of ED 3-25, which states that *"MD&A should be written in a manner that can be understood by users who may not have a detailed knowledge of governmental accounting and financial reporting."* Further, paragraph B6 (taken from paragraph 21 of Concepts Statement 3) addresses boilerplate information and indicates that information should not be excluded merely because it is difficult to understand. It states, in part:

> To effectively interpret these messages, the user is responsible for obtaining a reasonable understanding of government and public finance activities and of the fundamentals of governmental financial reporting, for studying the messages with reasonable diligence, and for applying relevant analytical skills.

We recommend that the GASB revise the wording in the next to last sentence of paragraph 4 of ED 3-25 to reflect the responsibility of the user, as indicated in paragraph B6 of ED 3-25 and paragraph 21 of Concepts Statement 3.

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Communication of Major Component Unit Information

We believe that the current reporting requirements for major component units are sufficient. Governments that wish to provide additional detail could be given the option to present combining component unit statements, but only as supplementary information. We are opposed to the Board's proposal related to requiring additional major component unit reporting because of its potential to dilute the basic financial statements' focus on the primary government.

Budgetary Comparison Information — Presentation of Budget Variances

We support the presentation of budgetary comparison schedules as required supplementary information (RSI). The different bases of accounting, level of detailed reporting, and nature of the information presented appropriately lends the budgetary comparison schedules to RSI reporting. While original and final budget figures are helpful to the user, we do not believe that it is necessary to require the inclusion of a calculated variance column that presents the change between the original budget and the final budget as a part of the schedule. Adding a column to the schedule causes visual clutter and does not provide meaningful information since significant changes are already discussed in the notes to the RSI.

Transition

The ED proposes that, like GASB Statement 34, the implementation will be phased in first by large governments and then by smaller governments. The threshold for phase 1 is governments with total annual revenues of $75 million or more (annual revenues based on a fiscal year beginning after June 15, 2022). While we agree that it would be prudent to roll out such a significant standard in phases, a threshold of $75 million, which is less than the threshold of total annual revenues of $100 million for Phase 1 governments identified in GASB Statement 34 (which became effective 20 years ago) is much too low and should be reconsidered. We recommend that the Board consider using the GASB Statement 34 Phase 1 model plus inflation as a guide for the large government phase.

Suggested Comments and Edits to Specific Paragraphs

Our comments related to specific paragraphs of ED 3-25 and suggested edits (in **boldface**) are noted below.

Management's Discussion and Analysis

Paragraph 5 — . . . The analysis should ~~assist users in understanding~~ **provide information about** why balances and results reported in the current year's financial statements changed from the prior year . . . .

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Paragraph 8(c) — This paragraph states, in part, "That analysis should include a discussion of significant *policy changes* (such as changes in tax rates or fees, or the imposition of a hiring freeze) and important economic factors (such as changes in the tax or employment bases) that significantly affected operating results for the year, as applicable" (emphasis added).

We recommend that the examples of policies be revisited to include items that are truly policy changes and not changes in laws or economic factors and conditions.

Paragraph 8(e) — We suggest revising the following sentence in this paragraph to make the requirement optional for governments for which such forward-looking information is not available (particularly the information required under paragraphs 8(e)(2)(a) and 8(e)(2)(c)): "Examples of the types of information that ~~should~~ could be included in that description, if applicable . . . . "

Presentation of Governmental Funds Financial Statements

Measurement Focus and Basis of Accounting

Paragraphs 14, 15, and 16 — Much of the information included in paragraphs 14, 15, and 16 appears to be theoretical and would be more suitable in the RER project document or in a Concepts Statement than in the *Financial Reporting Model Improvements* Standard.

Arrangement of paragraphs 14 and 15 and the definition of "binding arrangement" — Paragraph 14 includes a discussion of the term binding arrangements, which is not defined until paragraph 15. These paragraphs should be reordered so that the definition precedes the discussion of the related transactions and subsequent use of the term.

Paragraph 18 — We recommend the following edit to the last sentence in this paragraph: "However, if a new binding arrangement is entered into (for example, a loan arrangement is entered into to replace an account payable), that transaction should be ~~classified~~ reassessed and reported."

Deferred Inflows of Resources and Outflows of Resources

Paragraph 34 — Incorporating our recommendation in the section above, we also propose the following edits to this paragraph:

> . . . A separate column~~s~~ for the variance between ~~(a) original and final budget amounts and (b)~~ final budget amounts and actual ~~budget~~ results are ~~required~~ recommended to be presented. . . . The analysis should include any currently known reasons for those

> variations that ~~are expected to~~ have a significant effect on budgetary fund balance or to produce significant differences from current period budgetary results.

MD&A boilerplate information — Paragraphs B5 and B6 — These paragraphs contradict each other regarding whether there is a requirement to explain the structure of the financial statements in MD&A. Paragraph B5 indicates, in part:

> The only MD&A requirement in this Statement that generally would result in the same presentation for all governments is the requirement to present a brief discussion of the basic financial statements, including the relationship of the statements to each other, and the significant differences in the information they provide.

However, paragraph B6 acknowledges that Concepts Statement 3 states, in part:

> [T]he user is responsible for obtaining a reasonable understanding of government and public finance activities and of the fundamentals of governmental financial reporting, for studying the messages with reasonable diligence, and for applying relevant analytical skills.

Given that users are presumed to be informed, there should be no requirement in MD&A to explain the basic structure of government financial statements. The specifics of the entity's financial report will be included in the notes to the financial statements, which users can be referred to.

On-behalf payments for fringe benefits and salaries and direct vendor financings — Paragraphs B50 and B51 — Since these paragraphs include guidance on specific transactions and accounts, we believe that the information included in the paragraphs should be added to the standard or, at a minimum, that related examples should be added to Appendix C.

Exhibits 5 and 15 — There are discrepancies between the two exhibits. In Exhibit 5, capital outlay is classified as noncurrent, and in Exhibit 15, it is classified as current. Further clarification is required for situations in which current activity generates these types of outflows. For example, certain capital-type items will never result in a capital asset since they do not meet the government's capitalization threshold.

In addition, some transfers in Exhibit 5 are classified as current and some as noncurrent, whereas in Exhibit 15, all transfers are classified as noncurrent. Either the reasons for the differences should be explained or the classifications should be made consistent.