



Deloitte & Touche LLP
Ten Westport Road
PO Box 820
Wilton, CT 06897-0820

Tel: +1 203 761 3000
Fax: +1 203 834 2200
www.deloitte.com

March 16, 2012

Mr. David R. Bean
Director of Research and Technical Activities
Governmental Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Project No. 13-3 — Preliminary Views, *Economic Condition Reporting: Financial Projections*

Dear Mr. Bean:

Deloitte & Touche LLP is pleased to comment on the GASB's Preliminary Views (PV) *Economic Condition Reporting: Financial Projections*.

We support the Board's objective to improve the information available to users for assessing a governmental entity's economic condition and fiscal sustainability. The PV proposes to include forward-looking information as required supplementary information ("RSI"). As noted in GASB Concepts Statement 3¹, RSI is information that is "essential for placing basic financial statements and notes to basic financial statements in an appropriate operational, economic, or historical context". We do not agree that the financial projections described in the PV are essential for placing the basic financial statements in an operational or economic context. Therefore, we do not support issuance of the PV in its current form as final guidance.

We believe that the nature of financial projections is significantly different from the nature of the historical financial statements and other historical information included in a government's annual external financial report. Furthermore, we have significant concerns about the reliability of the projections and the costs of preparing them. Our most significant concerns about the proposal are elaborated below, followed by a proposed alternative to the PV's proposal.

Financial Projections May Not Be Reliable

GASB Concepts Statement 1² states that financial reporting is reliable when "information presented [is] verifiable and free from bias." We therefore question whether the proposed financial projections can be considered reliable if they are not verifiable (i.e., because of the forward-looking nature) and may not be free from bias (either intentional or unintentional). The PV points out that projections are a necessary part of many accounting estimates that are included in historical financial statements. However, such accounting estimates relate to the effect of

¹ GASB Concepts Statement No. 3, *Communication Methods in General Purpose External Financial Reports that Contain Basic Financial Statements*.

² GASB Concepts Statement No. 1, *Objectives of Financial Reporting*.

Page 2
March 16, 2012
Project No. 13-3

transactions or events that have occurred or the valuation of an asset or a liability that exists at the reporting date. The financial projections proposed in the PV include the impact of many transactions that have not yet occurred and commitments that have not yet been made; accordingly, they are inherently more subjective than accounting estimates included in the financial statements.

We acknowledge the PV states that “financial projections should be (a) based on current policy, (b) informed by historical information, and (c) adjusted for known events and conditions that affect the projection periods.” We agree that governmental entities should take known events and conditions into account when preparing financial projections. However, given the significant uncertainty in a governmental entity’s future economic conditions and environment (e.g., changes in administrations, the willingness of the government to take particular actions, changes in policies, and economic cycles), projections beyond one or two years may be highly subjective and therefore may be unreliable, significantly decreasing their usefulness to users.

The subjective assessments of *how* historical information and known events and conditions should be taken into account when preparing financial projections appear to contradict the guidance in paragraph 44 of GASB Concepts Statement 3 which states that “RSI does not include (a) subjective assessments of the effects of reported information on the reporting unit’s future financial position” (this apparent contradiction was also highlighted by the dissenting Board members as described in Chapter 6 of the PV). Moreover, there are many practical concerns with such assessments, including (1) because the assumptions are subjective, the financial projections of entities with similar operations could lack comparability (i.e., two prudent individuals analyzing the same historical information could use significantly different assumptions in preparing the projections) and (2) the motivations of elected officials and management may introduce bias into the assumptions, which could result in misleading financial projections. If the Board does decide to require governmental entities to present financial projections as RSI, we encourage the Board to evaluate the above concerns and develop more guidelines on determining the assumptions entities should use in preparing these projections so that these assumptions are more consistent and less subjective.

We are also concerned that users may not have the requisite knowledge to distinguish between financial projections and financial forecasts. Because projections are based on known events and conditions that exist at the time of the projection, some may consider them to be less subjective than forecasts. However, this perceived lower level of subjectivity does not outweigh a financial projection’s potentially unrealistic depiction of the future operations and financial health of a governmental entity. Because some users may not fully understand that financial projections are inherently different from financial forecasts, they may place too much reliance on financial projections. Therefore, we recommend that the Board not require entities to present financial projections in reports that include historical financial statements.

Cost-Benefit Concerns Associated With Providing RSI

The benefits of providing information to users of financial reports should justify the related costs. Accordingly, we encourage the Board to consider input from preparers regarding the incremental costs of providing the proposed RSI. We believe that for entities that do not currently prepare similar prospective financial information, preparing the proposed disclosures may prove challenging. Many preparers are likely to encounter difficulties in producing this information because of significant resource and system constraints. Therefore, to prepare the proposed financial projections, such entities may need to increase personnel, pay for external assistance,

Page 3
March 16, 2012
Project No. 13-3

and upgrade their systems. Furthermore, the time needed to prepare the projections may cause further delays in the issuance of the financial statements, making them less relevant to users.

In addition, preparers would incur additional costs in connection with the incremental procedures that external auditors would be required to perform on the RSI in accordance with AICPA AU-C Section 730.³ For example, an auditor would need to consider whether an entity's assumptions are consistent with other information that the auditor has about the entity. The incremental procedures performed by the auditor would not only increase the entity's overall audit costs but also would most likely affect the timeliness of audit completion and the entity's issuance of its audited financial statements. We encourage the Board to carefully weigh the benefits of requiring the financial projections against the costs of preparing them.

Considerations Related to an Auditor's Report on RSI

Paragraph 3 of AU-C Section 730 requires the auditor to (1) describe in its report whether RSI is presented in an entity's basic financial statements and (2) "communicate therein when some or all of the [RSI] has not been presented in accordance with guidelines established by a designated accounting standard setter or when the auditor has identified material modifications that should be made" to the RSI to comply with such guidelines. Under paragraph 5 of AU-C Section 730, auditors must perform certain limited procedures when reporting on RSI, including (1) asking management about the methods used to prepare the information, (2) comparing the information for consistency with management's responses, the basic financial statements and other knowledge the auditor has obtained, and (3) obtaining written representations regarding the information. Such procedures, particularly comparison of the information for consistency, may be difficult for the auditor to perform given the subjectivity of the assumptions used in preparing the proposed financial projections. In addition, there is potential for diversity in practice among auditors regarding the effort required to perform the procedures required by AU-C Section 730 (e.g., different auditors may do varying levels of work).

Although AU-C Section 730 does not require auditors to express an opinion on the RSI, auditors do have some responsibility regarding the information. Less sophisticated users may assume that the auditor provided a greater level of assurance on the RSI than is intended under generally accepted auditing standards. The risk of this occurring is increased for the proposed financial projections given the level of subjectivity involved in making the projections (e.g., financial statement users may not understand the complexity of the projections and that it is therefore more likely that the required auditor procedures may not uncover a material departure or omission).

Given the subjectivity in calculating the proposed financial projections, we do not believe that auditors should report on such projections in accordance with AU-C Section 730 because of the difficulty in applying the required procedures. If the Board determines the proposed financial projections to be RSI, the Board should consider developing guidelines to make the assumptions used in the projections more consistent and less subjective. We believe that this would improve the auditor's ability to perform the required procedures in accordance with AU-C Section 730 and would reduce the likelihood of diversity in practice.

³ AICPA Statement on Auditing Standards No. 120, *Required Supplementary Information*, has been recodified as AICPA *Professional Standards*, AU-C Section 730, "Required Supplementary Information". AU-C Section 730 will supersede AU Section 558, "Required Supplementary Information," effective December 15, 2012. We refer to AU-C Section 730 throughout the letter since this will be the applicable standard by the time any resulting GASB standard becomes effective.

Other Observations

Applying the PV's proposal to present financial projections as RSI in a governmental entity's financial statements may lead to unintended consequences. For example, financial projections could undermine negotiating positions on labor contracts. Because the entity must use only historical experience and known events in preparing the projections, the entity may be required to assume that the trend in the level of compensation and benefits remains consistent with historical periods and prior contract renewals, which could adversely affect the parties' negotiating positions.

For governmental entities that sell securities to the public, if actual results differ significantly from the projections, third parties may assert that the projections were misleading or inaccurate and violate the SEC's antifraud provisions, creating legal exposure and related litigation costs for the entity. This legal exposure may apply to the external auditor as well.

GASB Alternative View

We agree with the two GASB board members' views discussed in Chapter 6 of the PV regarding why financial projections and related narrative discussions should not be presented as RSI. However, under their alternative view, certain historical information that is currently located in an entity's statistical section — and usually presented only in a comprehensive annual financial report (CAFR) — would be reclassified from optional supplementary information to RSI in all general purpose external financial reports. We do not support classifying such statistical information as RSI because we do not believe that such information is “essential for placing the basic financial statements . . . in an operational or economic context.” In addition, much of this information is already available to users through other sources.

Alternative Approach

As previously stated, we do not support the PV's proposal to require that financial projections be presented as RSI. Rather, we suggest that the Board consider the below alternative in addressing how a governmental entity could improve the transparency about its future fiscal sustainability and economic condition. This alternative would require a governmental entity to present limited information relevant to fiscal sustainability along with other forward-looking information in its MD&A.

Chapter 1 of the PV indicates that the Board is significantly concerned that current financial reports do not contain adequate information regarding the “financial stress facing some government entities due to deteriorating financial condition.” The Board could consider requiring entities to provide, in narrative form in MD&A, some expanded forward-looking information related to fiscal sustainability. Currently, the MD&A requirement in GASB Statement 34⁴ principally focuses on presenting an analysis of the results of operations. Statement 34 also states that MD&A should contain “a description of currently known facts, decisions, or conditions that are expected to have a significant effect on financial position or results of operations.” The Board could expand this requirement to include a specific discussion about the entity's sources of

⁴ GASB Statement No. 34, *Basic Financial Statements — and Management's Discussion and Analysis — for State and Local Governments*.

Page 5
March 16, 2012
Project No. 13-3

liquidity and financial resources in the near term, including identification of any known trends, commitments, events, or uncertainties (e.g., trends or changes in social, economic, or demographic conditions) that are likely to have an impact on the entity's ongoing ability to (1) generate resources and (2) meet financial obligations and service commitments (i.e., fiscal sustainability). In addition, we believe that if a material deficiency in liquidity or financial resources is identified, the entity should also indicate any actions the entity has taken, or proposes to take, to address the deficiency.

The Board could also consider requiring entities to include in their MD&A information regarding present contractual obligations and the future periods in which such obligations are expected to be paid. Such information could include many of the same elements as those described in the PV as Components 3 and 4.

If this information is placed in MD&A, users may pay more attention to it because MD&A precedes the basic financial statements. Further, because this information would be provided in a narrative form, it may be easier and less costly for governmental entities to prepare such information and it would allow the entity to provide a more qualitative discussion and description of the forward-looking information. Such an approach would also allow the entity to tailor the information it discloses on the basis of the extent to which the government may have difficulty in meeting its fiscal obligations. In addition, if the information is presented principally as a narrative discussion in the MD&A and not in a tabular format similar to the financial statements, it is less likely that the involvement of the external auditor will be misinterpreted by financial statement users.

Another source of information that would help financial statement users understand the entity's fiscal sustainability is the annual budget for the subsequent year or years. In most cases, by the time the annual financial statements are issued, the subsequent year's budget has been made publicly available. As suggested in the PV's alternative view, the Board could consider requiring entities to identify, in the general-purpose external financial report, where a user can obtain the entity's most recent annual budget.

See the appendix below for our detailed responses to the PV's questions for respondents.

Deloitte & Touche LLP appreciates the opportunity to comment on the PV. If you have any questions concerning our comments, please contact Karen Wiltsie at (203) 761-3607.

Yours truly,

Deloitte & Touche LLP

cc: Robert Uhl
W. Michael Fritz

Appendix
Deloitte & Touche LLP
Responses to Questions for Respondents

1. The Board's preliminary view is that there are five components of information that are necessary to assist users in assessing a governmental entity's fiscal sustainability (Chapter 3, paragraph 2):

- *Component 1 — Projections of the total cash inflows and major individual cash inflows, in dollars and as a percentage of total cash inflows, with explanations of the known causes of fluctuations in cash inflows (Chapter 3, paragraphs 4–9)*
- *Component 2 — Projections of the total cash outflows and major individual cash outflows, in dollars and as a percentage of total cash outflows, with explanations of the known causes of fluctuations in cash outflows (Chapter 3, paragraphs 10–14)*
- *Component 3 — Projections of the total financial obligations and major individual financial obligations, including bonds, pensions, other postemployment benefits, and long-term contracts, with explanations of the known causes of fluctuations in financial obligations (Chapter 3, paragraphs 15–20)*
- *Component 4 — Projections of annual debt service payments (principal and interest) (Chapter 3, paragraphs 21–23)*
- *Component 5 — Narrative discussion of the major intergovernmental service interdependencies that exist and the nature of those service interdependencies (Chapter 3, paragraphs 24–26).*

Do you agree with this view? Why or why not?

No. As stated in the body of this letter, we believe that financial projections do not qualify as RSI because they are not essential for placing basic financial statements in the appropriate operational, economic, or historical context. Furthermore, we have significant concerns about the reliability of the projections and the costs of preparing them.

2. The Board's preliminary view is that financial projections should be (a) based on current policy, (b) informed by historical information, and (c) adjusted for known events and conditions that affect the projection periods. Current policy includes policy changes that have been formally adopted by the end of the reporting period but that will not be effective until future periods (Chapter 4, paragraphs 2–7). Do you agree with this view? Why or why not?

We do not agree that entities should be required to present financial projections as RSI. However, we agree that any financial projections the Board decides to require should only include policy changes that have been formally adopted, even if they are not effective until future periods. This would strike a balance of allowing the entity to make the best use of information that is available to it

Page 7
March 16, 2012
Project No. 13-3

without requiring the entity to make predictions about the future economic environment and other factors outside its control.

3. The Board's preliminary view is that inflows and outflows should be projected on a cash basis of accounting, and financial obligations should be projected on an accrual basis of accounting (Chapter 4, paragraphs 8–12). Do you agree with this view? Why or why not?

We do not agree with this view. Because historical financial statements are prepared on an accrual or modified-accrual basis, there may be significant inconsistencies between the financial projections and the financial statements that it accompanies. This inconsistency between the financial projections and the historical financial statements may not be sufficiently understood by users and would impair the comparability of the financial projections and the historical financial statements.

Also, by reporting inflows and outflows on a cash basis, an entity would ignore expenditures that are accrued but not paid and would treat debt proceeds as cash inflows. This would reduce the usefulness of the projections as evidence of interperiod equity.

4. The Board's preliminary view is that the identification and development of assumptions for making financial projections should be guided by a principles-based approach. Such an approach would set forth principles that require assumptions to be based on relevant historical information, as well as events and conditions that have occurred and affect the projection periods. Furthermore, these assumptions should be (a) consistent with each other (where appropriate) and with the information used as the basis for the assumptions and (b) comprehensive by considering significant trends, events, and conditions (Chapter 4, paragraphs 13–16). Do you agree with this view? Why or why not?

If the Board moves forward with requiring financial projections as RSI, we support the Board's decision not to be overly prescriptive in specifying a method for identifying and developing assumptions for making financial projections. However, we believe that the Board should provide more guidance to promote comparability among similar entities and less subjectivity in the selection and application of the most suitable assumptions for the financial projections reported. The PV refers to the principles included in SAS 57, *Auditing Accounting Estimates (superseded by AU-C 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures)*. However, that guidance requires the auditor to consider the applicable financial reporting framework relevant to the accounting estimate. Various financial reporting standards require an estimate to be a "best estimate", the "most likely outcome", and/or "consistent with management's intent to take particular actions". Other accounting standards prescribe acceptable methods and sources of information to be used to estimate, for example, fair value of a financial instrument. Further, we recommend that the Board reinforce that entities should provide a full and transparent disclosure of all key assumptions used when making financial projections.

5. The Board's preliminary view is that annual financial projections should be made for a minimum of five individual years beyond the reporting period for the purpose of external reporting (Chapter 4, paragraphs 19–23). Do you agree with this view? Why or why not?

Page 8
March 16, 2012
Project No. 13-3

We do not agree with this view. Given the significant uncertainty in a governmental entity's economic conditions and environment (e.g., changes in administrations, changes in policies, and external events), projections beyond one or two years may include such a degree of subjectivity that the information loses its usefulness. In addition, requiring entities to make financial projections for longer than their typical budget cycle may lead to constantly changing projections. The continual update of financial projections may ultimately undermine the credibility and value of the information that an entity would report.

We note that current professional standards addressing uncertainty about the ability of an entity to continue as a going concern requires consideration of the "ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements" (AU-C Section 570.02⁵) or "all available information about the future, which is at least, but is not limited to, twelve months from the end of the reporting period" (IAS 1.26⁶). The time frames cited in these standards likely reflect a view of the difficulty of reliably estimating outcomes for a longer period of time.

6. The Board's preliminary view is that all of the components of fiscal sustainability information are essential for placing the basic financial statements and notes to the basic financial statements in an operational or economic context and therefore should be required and communicated as required supplementary information (Chapter 5, paragraphs 7–12). Do you agree with this view? Why or why not?

We do not agree. Please see our views on this issue in the body of this letter.

7. The Board's preliminary view is that all governmental entities should be required to report financial projections and related narrative discussions (Chapter 5, paragraphs 13 and 14). Do you agree with this view? Why or why not?

We do not agree with this view. If the Board does require governmental entities to report financial projections as RSI, the Board should consider whether the costs that smaller or special-purpose governments would incur to produce such information outweigh the benefits to users.

8. Do you believe that a phase-in period for implementing the reporting requirements for financial projections and related narrative discussions would be appropriate (for example, requiring governmental entities over certain dollar thresholds to implement first)? If so, what phase-in criteria would you recommend (Chapter 5, paragraph 14)?

If the Board does require financial projections as RSI, we believe that a phase-in period for implementation would be appropriate, similar to phase-in periods in other standards such as GASB Statement 34, which required larger governmental entities to implement the standards

⁵ AU-C Section 570 – *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.

⁶ IAS 1, *Presentation of Financial Statements*.

Page 9
March 16, 2012
Project No. 13-3

before smaller entities. This will give governments with fewer resources time to plan for the resources needed to prepare such information.