VGFOA **Virginia Government Finance Officers' Association**
'Developing Governmental and Financial Leaders'

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March 7, 2012

Director of Research and Technical Activities - Project No. 13-3
Governmental Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Subject: Response to Preliminary Views of the Governmental Accounting Standards Board: Economic Condition Reporting - Financial Projections

Dear Mr. Chairman and members of the Board,

The Virginia Government Finance Officers' Association (VGFOA) appreciates the opportunity to work with the Governmental Accounting Standards Board (GASB) in the due process of improving accounting and financial reporting standards.

While there are a few elements of the Economic Condition Reporting project that the VGFOA finds potentially useful (e.g. some form of additional disclosure to consolidate numerous data points normally contained in a financial report related to interdependency), overall, we strongly object to the underlying premise of this project.

The conclusions the GASB has reached, as published in the Preliminary Views document, would significantly alter the traditional understanding of "Financial Reporting". In fact, the conclusions which the GASB has stated in its preliminary views on this project are inconsistent with GASB Concepts Statement 1 (GASBCS1), as well as with the definition and objectives of "Financial Reporting" that are nearly universally accepted across many industries and standard-setting bodies.

GASBCS1, par. 3 – "Financial reporting helps fulfill government's duty to be *publicly accountable*." The concept of accountability infers a view of financial reporting that is retrospective in nature. A government cannot be held accountable for revenues that have not yet been raised, taxes that have not yet been levied, services that have not yet been provided, or costs that have not yet been incurred, and preceding all of those results, decisions that have not yet been made; therefore, projections have no role in fulfilling the objective of demonstrating accountability. Further, GASBCS1, par. 76 states that accountability is to be "the paramount objective from which all other objectives must flow."

GASBCS1, par. 4 – "Financial reports and financial statements are *end products* of the reporting process." The concept of financial reports as an end product of the reporting process is undermined if projections become a required element. Instead, one year's financial reports become the starting point of the subsequent year's reporting process, as management is potentially influenced in its decision-making process (both fiscal and policy decisions) by trying to meet the expectations published in its projections of a prior fiscal year.

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GASBCS1, par. 32 – "Financial reporting by state and local governments is used in making economic, social, and political decisions and in assessing accountability, primarily by:

a. Comparing actual financial results with the legally adopted budget
b. Assessing financial condition and results of operations
c. Assisting in determining compliance with finance-related laws, rules, and regulations
d. Assisting in evaluating efficiency and effectiveness."

GASBCS1, par. 35 – "Trend analysis helps investors and creditors project future revenues and predict possible allocation of those revenues." None of the uses identified by GASBCS1, par. 32 contemplate the concept of fiscal sustainability as outlined by the GASB in its Preliminary Views. The closest use defined by GASBCS1 to the concept of fiscal sustainability, "Assessing financial condition", squarely places the responsibility of trend analysis and projections on the *users* of financial reports, rather than the preparers (par. 35). Further, the traditional view of this use of financial reporting is understood to be referring to the fact that financial reports should present information both as of a specific date (financial condition), as well as for a specific period (results of operations). There is nothing inherent in this financial reporting objective to indicate that preparers should present information that goes beyond the current report period.

For these reasons, the VGFOA does not agree with, and strenuously objects to, the underlying premise of the GASB's Preliminary Views on Economic Condition Reporting, and is very concerned about the direction of this project.

That being said, as you requested, we are providing these additional comments regarding your preliminary views on economic condition reporting, specifically addressing the questions posed by the Board.

Question # **Questions and Comments**

1 ***Question*** - 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 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?

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Comments – The VGFOA does not agree with this view. While the five components of information identified by the GASB may be quite useful in assisting users wishing to assess a governmental entity's fiscal sustainability, GASB Concepts Statement 1 does not list such an assessment of *fiscal sustainability* as a primary use of financial reports. In fact, even where GASBCS1 does contemplate the need of investors and creditors for "information about…likely future financial resources" (par. 35), it directly places the responsibility of such projections on the users of financial reports, rather than the preparers, stating that "[t]rend analysis helps investors and creditors project future revenues and predict possible allocation of those revenues." The VGFOA does not believe that economic condition reporting fits within the framework provided for in GASBCS1.

Further, the VGFOA believes that certain elements of the five components of information pertaining to fiscal sustainability are already being provided by many state and local governments in other formats.

For example, Components 1 and 2 are items addressed through the budgets and/or fiscal plans published by most state and local governments, which are usually readily available. To require this information in the CAFR or other financial reports calls for redundancy and repetition of functions, and goes against the objectives of financial reporting identified in GASBCS1. The CAFR reports the financial position and activities on a specific date and during a given period. The GASB has not attempted to exert any influence over the budgeting and planning aspects of state and local governments in the past, and there is serious question as to whether the authority to do so exists under its current charter. The GASB might propose that the CAFR make reference to how these documents can be obtained, similar to how it requires references to obtaining component unit documents in the notes to the financial statements. These documents would assist users in assessing a governmental entity's sustainability.

Components 3 and 4 are already addressed in the notes to the financial statements, which are integral to the financial statements. The only difference indicated in the preliminary view is that the five-year projection would include the requirement to report the amount of debt that is authorized, but unissued *as of the financial statement due date* rather than the date of the financial report. The GASB could add this requirement to the notes to the financial statements. (Example: On June 15, 2012, the Town Council authorized the issuance of $XX million in bonds. These bonds remain unissued as of June 30, 2012. The Town expects to issue these bonds within the next six months). Further, if the sale of bonds happens prior to the issuance of the financial statements, this would already be disclosed as a subsequent event, under current standards.

Additionally, while providing users with information about intergovernmental service interdependencies would be helpful, some of this information is already provided to the users in the notes to the financial statements (related party disclosures and joint venture disclosures), as well as Management's Discussion and Analysis. The VGFOA suggests that GASB provide a possible outline of minimum disclosure requirements needed to meet the objective of Component 5.

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2 ***Question*** - 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?

Comments – While the VGFOA disagrees in principle with the idea of including projections in financial reports, and believes that GASBCS1 places the responsibility of deriving such projections on the users of financial reports, the VGFOA agrees with this view and suggests that this language be added to the MD&A section as informative information for the user to base their opinions on when assessing the financial health of municipalities. In order for financial projections to be relevant and meaningful, any known events or facts should be incorporated as much as possible with some qualified standards of deviation of errors. In addition, any correlation or value at risk analysis should be performed. Projections are only as good as the assumptions included. In addition, the CAFR should include a warning or disclosure for the reader to consult their financial analyst and/or financial advisor for decisions on valuation of municipalities, similar to disclaimers for the public to consult their tax advisors for financial decisions that may affect their tax base.

3 ***Question*** - 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?

Comments – As already outlined in our response, the VGFOA strenuously objects to the projection of cash flows being a required element of financial reporting. Aside from the reasons already cited, we believe that inclusion of this information would introduce a plethora of problems for state and local governments, such as a requirement to report information that cannot be relied upon by users and is subjective to the extent of management's assumptions. Further, we believe that adding a cash basis report to the CAFR would further confuse users, as the CAFR would contain three different bases of accounting – cash basis, modified accrual basis, and accrual basis. The VGFOA believes that the users of financial reports should be able to make their own assessments of sustainability by reading financial reports already required and voluntarily produced by government entities; the CAFR should provide the objective information necessary for a user to make their own projections and assessments. However, governments should not be compelled to make projections upon which users may rely. Providing information as discussed above would allow a user to make their own projections and assumptions about sustainability.

Projection of future inflows would require a locality to make a projection of the basis upon which a tax may be levied. In the case of real property taxes, a projection would have to be made on 5 years of assessed values. While projecting assessed value is one thing, predicting the tax rate upon which such assessed property will be taxed is not as easy. Setting the tax rate in any given year is subject to tax payer opinions, political leanings of

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the entities Board/Council, state officials, and proposed legislation. Since projection would be based on current policy, it would be inaccurate to assume that tax rates will remain constant over the projection period as the tax rates often fluctuate in response to fluctuations in the underlying bases and also in keeping with the political agendas of the decision makers and the economic environment of the times. Further, this projection is nearly impossible when federal dollars are involved.

A better measure of sustainability would be projections of the underlying value upon which a tax levy would be applied. For property taxes, that would be assessed value; for sales taxes, that would be total retail sales in the locality; for income taxes, that would be projections of median or average income throughout the locality; for utility taxes, that would be projected growth in utility bills. Cash flows from these items would ultimately be based on the tax rate set, for which external factors can change in any given year and for any given reason. The user of the financial statements should be able to make their own assessments about the sustainability of the revenue base by being able to draw conclusions about its trends. Also a projection does not take into account that a decline in a revenue base might cause an entity to seek alternative revenue sources or raise the taxes levies on a particular base. Further, change in legislation may also affect the cash inflow or outflows accordingly. None of these items can be predicted successfully because of their interdependency.

In relation to future outflows, the GASB recognizes the difficulty and cost it would impose upon localities to measure and project the need or demand of public services and therefore the current levels of service or levels established in an existing policy should be incorporated into the projections of major cash flows (Chapter 3 , par. 14). This seems counterintuitive because projecting cash flows at current levels would mean that fluctuations would be mainly inflationary and due to outflows from debt service. Outflows from debt service are already provided in the notes to the CAFR.

The VGFOA believes that after failed attempts to accurately project the future inflows and outflows and need for an explanation of these variances, there would be a decline in the number of users referring to the data, making the information useless.

4 ***Question*** - 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?

Comments – While the VGFOA agrees with the Board's theory that the identification and development of assumptions for making financial projection should be guided by a principles-based approach that includes historical information or events adjusted for recent known facts (e.g., expected debt issuance), we do not feel that this information should be a required element of financial reporting, and that this direction is a major departure from the framework provided for in GASB Concepts Statement 1. In addition

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to this more foundational objection, there are some practical objections as well. First, projections would be based on management's discretion, and different localities may approach projections quite differently, one being conservative and one being aggressive. Though the assumptions will be discussed in the narrative document, this level of subjectivity should not be included in a government's financial reports, the purpose of which is to provide reliable information for its users. If the Board feels that the need for financial projection greatly benefits users in making assessments of a locality's sustainability, then the Board should indicate some specific principles to be shared by all, so that there is comparability amongst localities. Second, another significant concern is the reliance that users will place on this data and the extent to which the locality and/or the auditor could be held accountable based on these projections. While the projections would be preceded by a disclaimer or warning, including them in the financial statements may open the locality to scrutiny in terms of performance being in line with the projected outcomes. Further, what recourse would the user of the financial statements have for relying on a projection that is/was inaccurate? Will the projections open auditors and/or management to lawsuits? Finally, including these projections may result in a government's decision-makers focusing more on trying to meet the projections that were reported rather than doing what is best for the locality at the time.

5 ***Question*** - 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?

Comments – As stated before, the VGFOA does not believe that cash flow projections should be a required element of financial reporting. Users should review other information, such as budget documents, to make their own conclusions about economic sustainability. However, if the Board does decide to include this information, the VGFOA disagrees with a minimum of five individual years beyond the reporting period. Due to the volatility and uncertainties that are involved in these projections, presenting five years of information is excessive. In these current economic times, a longer the projection allows for more volatility and uncertainty, which increases the unreliability of the data. The VGFOA suggests a minimum of three individual years beyond the reporting period.

6 ***Question*** - 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?

Comments – The VGFOA does not agree. Information for making assessments about a locality's sustainability as well as projections if necessary should be presented in the statistical section. Much of the underlying basis for cash inflows is already presented in the statistical section as historical data. Further, including the data as required supplementary information requires auditors to express a small level of assurance on this information and to compare the data to the financial statements for consistency. This is overly burdensome on the auditors and may result in the auditor's inability or

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unwillingness to issue an opinion on the financial statements over potential disagreements with the municipality's presentation or assumptions. It also exposes auditors to greater risk and therefore increase audit procedures over these projections, which will in turn lead to higher audit fees. This preliminary view has the potential to add significant costs to the price on an audit due to the volume and nature of the information being requested as well as the inability of the auditor to gain comfort with the information being presented. The VGFOA suggests that the Board consider altering the statistical section (which is unaudited) to include an area for projections of the underlying basis upon which taxes are levied and a cash flow analysis since this information is already presented historically in this section. Alternatively, if the Board decides to keep it in the CAFR, we suggest the Board adopt a new section for the CAFR to be labeled "Projection Section" that would remain unaudited.

7 ***Question*** - 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?

Comments – While the VGFOA objects to the direction the GASB appears to be taking with this project, if the preliminary view is the direction in which the Board proceeds, then the VGFOA suggests requiring governments with $100 million or more in revenues to comply. Requiring smaller entities to comply would place an undue burden on these entities.

8 ***Question*** - 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)?

Comments – While the VGFOA objects to the direction the GASB appears to be taking with this project, if the preliminary view is the direction in which the Board proceeds, the VGFOA agrees with the phase-in period for implementing the reporting requirements. However, the Board should consider not requiring smaller entities with less than $100 million in revenue to comply, rather making it optional. Further, the Board should allow enough time for entities to implement the requirements.

While some users of governmental financial reports may find it useful to have this information, financial projections are subject to volatility and uncertainty. The VGFOA does not believe that this information should be a required element of financial reporting. We appreciate the opportunity to comment on this Preliminary View and to work with the GASB for improving financial reporting for governmental entities.

Thank you for your consideration.

Patricia A. Weiler
VGFOA President