September 29, 2022

Mr. Alan Skelton
Director of Research and Technical Activities
Project No. 3-41
Governmental Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Mr. Skelton:

Members of the American Institute of Certified Public Accountants (AICPA) State and Local Government Expert Panel have reviewed the Governmental Accounting Standards Board (GASB) Exposure Draft (ED), *Certain Risk Disclosures,* and are pleased to offer our comments. Overall, we appreciate the Board's efforts to provide users of government financial statements with essential information about risks related to a government's current vulnerabilities due to certain concentrations and certain constraints common in the governmental environment. We fully support the concept of an early-warning disclosure. However, we have several significant concerns that appear in the following section. Our remaining comments and recommendations are in the "Other Comments" section of the letter below.

<u>Significant Concerns</u>

Reconsider Disclosure Criteria in Paragraph 6b Requiring Predictions

We strongly recommend that the GASB limit the disclosure requirements in paragraph 6b to events associated with a concentration or constraint that have actually occurred as of the issuance date of the financial statements and eliminate the disclosures proposed for events that are "more likely than not to begin to occur within 12 months of the financial statement date or shortly thereafter (for example, 3 months)." This recommendation is based on our concerns about (1) asking governments to predict the future and the resulting inconsistency and lack of comparability between governments; (2) a conflict with GASB Concepts Statement No. 7, Communication *Methods in General Purpose External Financial Reports That Contain Basic Financial Statements: Notes to Financial Statements (an amendment of GASB Concepts Statement No. 3)* (GASB Concepts Statement No. 7); and (3) auditing challenges. All of these concerns are elaborated on below. However, given these concerns, we recommend the Board revise paragraph 6 as follows:

> A government should apply the disclosure requirements in paragraphs 7 and 8 if all of the following criteria are met:
>
> a. A concentration (paragraph 4) or constraint (paragraph 5) is known to the government prior to the issuance of the financial statements.
>
> b. An event associated with the concentration or constraint ~~either~~ has occurred ~~or is more likely than not to begin to occur within 12 months~~ as of the issuance date of the financial statement~~s date or shortly thereafter (for example, 3 months)~~.
>
> c. It is at least reasonably possible that within three years of the financial statement date, the event will cause there to be a substantial effect on the government's ability to (1) continue to provide services at the level provided in the current reporting period or (2) meet its obligations as they come due.

Lack of Consistency and Comparability Between Governments Will Result. In our view, by limiting the required disclosures to known events, that have occurred as of the issuance date of the financial statements, the required disclosures will result in more consistent and comparable information that is more meaningful to financial statement users. Such disclosures would also still fulfill the Board's overall objective to serve as an early-warning mechanism assuming the "event" is appropriately scoped (see related comment below "Clarification of "Event" Needed for Consistent Application"). To illustrate this concern, consider a common scenario whereby certain governments within a state are highly dependent on state aid. The state has, from time to time, significantly reduced the state aid. Paragraph 6b would require those governments every year to predict whether or not the state will reduce state aid the following year. Given the subjective nature of such an assessment, not all governments with the exact same set of facts and circumstances will reach the same conclusion. Therefore, similar governments within the same state will have varying disclosures, resulting in significant inconsistencies.

Predictions Not Appropriate for Notes to Financial Statements. The requirement in paragraph 6b for governments to assess whether an event associated with a concentration or constraint "is more likely than not to begin to occur with 12 months of the financial statement date or shortly thereafter (for example, 3 months)" does not align with GASB Concepts Statement No. 7 because it is asking governments to predict the future. Paragraph 10 of GASB Concepts Statement No. 7 indicates, "predictions about the effects of future events on future financial position" is a type of information that is not appropriate to be included in the notes to the financial statements. Therefore, the aspect of paragraph 6b involving predictions underlying possible future events is not appropriate for inclusion in the notes.

Auditability Challenges. We are also concerned about the challenges of auditing disclosures about possible future events. Due to the subjective nature of the disclosures when an event is "more likely than not" to begin to occur, we are concerned that it will be difficult to obtain audit evidence supporting the disclosure. Further, we are equally concerned about how an auditor would be able to ascertain the completeness of the disclosures that would be required.

"More Likely Than Not" Threshold Should be Revised to "Probable"

If the Board does not accept our recommendation to delete the requirement in paragraph 6b to disclose whether an event associated with a concentration or constraint "is more likely than not to begin to occur with 12 months of the financial statement date or shortly thereafter (for example, 3 months)," we suggest replacing the "more likely than not" threshold with "probable." We believe this would increase the likelihood that a disclosed event would actually occur in the future and that the higher bar would remove some of the subjectivity (i.e., be easier for a government to predict) and enhance consistency and comparability in disclosures between governments. We disagree with the Board's conclusion in paragraph B26 and the alternative view in paragraph B52, which indicates that a threshold of probable would produce disclosures that could be well past the early warning stage. Instead, we believe this change will still meet the intent of the ED to provide financial statement users with early warning signs about potential events and circumstances and also assists governments in identifying risks to disclose.

Clarification of "Event" Needed for Consistent Application

Paragraph 6b requires governments to predict whether an event associated with a concentration or constraint has occurred or is more likely than not to begin to occur with 12 months of the financial statement date or shortly thereafter (for example, 3 months). We are unsure of how to define an "event" for purposes of paragraph 6b and we believe the lack of clarity will cause confusion and inconsistency in practice. For example, consider a scenario where a government's principal employer announces they are considering moving their operations out of the government's jurisdiction sometime in the future. Is the "event" the announcement about the possibility of relocating, or is the "event" when the company actually decides to move to another location or, alternatively, when the company actually relocates? The lack of a definition for the term "event" will lead to inconsistent application and disclosure. We suggest the Board clarify the meaning of "event" and provide examples and more complex illustrations to promote consistent application.

Disclosures Should Only be Required for Government as a Whole

Paragraph 8 indicates, "disclosures required by paragraph 7 generally should be made for the primary government, including its blended component units" and further indicates "if a reporting unit has a concentration or constraint that is specific to that reporting unit relative to other reporting units and that has a substantial effect on that reporting unit but not on the primary government, the government should apply the criteria in paragraph 6 and provide the information required by paragraph 7 to that reporting unit."

We suggest limiting the required disclosures in paragraph 7 and the evaluation of the criteria in paragraph 6 to those that have a substantial effect on the government as a whole. Our concern with applying the criteria in paragraph 6 at the reporting unit level is that it likely will add additional disclosures that, in some cases, may not be meaningful and will not accomplish the objective of providing essential information. This result would complicate the understandability of risk disclosures, rather than provide additional value to the reader.

Consider Illustration 1 in Appendix C which provides an illustrative disclosure of a concentration of a principal resource provider. Assume this illustration was revised such that the activity is within a governmental fund and, given the failed financing, the City's general fund will be covering the debt service payments going forward. Further, assume that the financial impact to the general fund is not substantial. Due to the requirement in paragraph 8 requiring disclosure if there is a substantial effect on the reporting unit but not the primary government, even though the overall financial statement risk has been mitigated by funding from the general fund, the City would be required to apply the criteria in paragraph 6 and provide the disclosure required by paragraph 7. We believe such disclosure would not accomplish the Board's objective of an "early-warning" regarding the government's ability to provide services or meet its obligation.

<u>Other Comments</u>

Provide Additional Clarification on a Government's Ability to Control Spending

To ensure consistent application of a final standard, we recommend the Board clarify the meaning of "limit a government's ability to **control spending**" as used in paragraph 4. Specifically, paragraph 4 states:

> Governments are exposed to risks that are based on concentrations that create a lack of sufficient diversity related to an aspect of a significant revenue source or expense. Those concentrations may limit a government's ability to acquire resources or to control spending.

While paragraphs B15 and B16 attempt to explain and provide examples related to concentrations and constraints, we had difficulty interpreting the meaning of "to control spending" and are concerned this terminology could be misinterpreted.

Based on our understanding, the Board previously considered including the following category description for concentrations:

> A risk to the government based on a current condition that creates a lack of (1) diversity related to an aspect of a significant revenue or (2) flexibility in managing a significant expense.

While this description was not included in the ED, we believe the addition of the phrase "lack of flexibility in managing a significant expense" would provide more clarity than the current proposal. Thus, we suggest the Board include the following edits for clarification:

> Governments are exposed to risks that are based on concentrations that create a lack of sufficient diversity related to an aspect of a significant revenue source or expense. Those concentrations may limit a government's flexibility to manage expenses, ability to acquire resources, or ability to control spending.

Removal of Limitation on the Type of Constraints

We found the proposed guidance in paragraph 5 of the ED difficult to understand. We understand and appreciate the constraints that are common in the governmental environment, and the examples in paragraph 5a-d are helpful. However, we were confused by the limiting language within paragraph 5 that specifies only two types of constraints—those imposed by an external party and those imposed internally, by formal action of a government's highest level of decision-making authority—as we believe other constraints may exist that would be equally pertinent. For example, a government may have practical constraints regarding user fees for public transportation and be unable to increase the fees to a level beyond what users would be willing or able to pay. We recommend, to provide clear and concise guidance, that the Board revise paragraph 5 of the ED as illustrated below to eliminate the potential limiting language:

> Governments are exposed to risks that are based on constraints common in the governmental environment that may limit their ability to acquire resources or to control spending. ~~Those constraints may be imposed by an external party or by formal action of a government's highest level of decision-making authority~~.

Provide Additional Clarification for Events for which the Government is Aware

We recommend the Board be more explicit in paragraph 6 regarding the envisioned scope of the disclosure. Paragraph 6a indicates governments should disclose a concentration or constraint that is known to the government prior to the issuance of the financial statements. Additionally, paragraph 6c indicates governments should disclose events associated with the concentration or constraint. Paragraph B20 further clarifies "governments should not be required to search for a wide range of potential events that might result from each of the concentrations or constraints it faces…a government should not be required to disclose risks unless it becomes aware that an event or potential event related to an existing concentration or constraint may lead to a potentially substantial effect." We believe the current disclosure criteria in paragraph 6 would not limit the scope of a preparer's responsibilities to events for which the government is aware.

To improve the understanding of the disclosure criteria relating to events for which a government is aware, we suggest the Board expand paragraph 6a and 6b to clearly state the government is not required to search for a wide range of potential events or disclose risk unless it becomes aware that an event or potential event related to an existing concentration or constraint may lead to a potentially substantial effect, similar to the discussion in paragraph B20.

Provide Additional Clarification for Mitigation Efforts

We recommend the Board be more explicit in paragraph 7c regarding mitigation efforts. Paragraph 7c indicates the notes should include a "description of actions taken by the government prior to issuance of the financial statements to mitigate the substantial effect." As discussed in paragraphs B41 and B42, a government should only disclose the mitigation efforts that actually commenced prior to the issuance of the financial statements and not include the governments planned efforts to mitigate the risk associated with a disclosed event. To improve the understanding of the disclosure criteria relating to mitigation efforts, we suggest the Board expand paragraph 7c to clearly state the government should only disclose the mitigation efforts that actually commenced prior to the issuance of the financial statements and not include the governments planned efforts to mitigate the risk associated with a disclosed event, similar to the discussion paragraphs B41 and B42.

Consider the Impact of the Interrelationship of the Certain Risk Disclosures Project and Other Upcoming Projects

In December 2021, the GASB added a project to its current technical agenda with an objective of (a) defining going concern and severe financial stress within the governmental environment and (b) identifying the characteristics a government might exhibit indicating it is in severe financial stress or there is substantial doubt about its ability to continue as a going concern. We question whether the Board has considered whether the concepts in these various projects are so interrelated that certain aspects of one project may influence the Board's view on the other projects. We recommend the Board answer this key question before proceeding with the Certain Risk Disclosures standard as it would not be productive for a final standard to be issued and then later need revision based on future deliberations on the Going Concern Uncertainties and Severe Financial Stress Projects.

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The AICPA appreciates the opportunity to comment on the ED. This comment letter was prepared by members of the AICPA's State and Local Government Expert Panel and was reviewed by representatives of the Financial Reporting Executive Committee who did not object to its issuance. Representatives of the AICPA would be pleased to discuss these comments with you at your convenience.

Sincerely,

Michelle Watterworth
Chair
AICPA State and Local Government
Expert Panel

Mary M. Foelster
Senior Director
AICPA Governmental Auditing and
Accounting

cc: State and Local Government Expert Panel
Dan Noll