AICPA

February 26, 2021

Mr. David R. Bean
Director of Research and Technical Activities
Project Nos. 3-20 and 3-25
Governmental Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Mr. Bean:

Members of the American Institute of Certified Public Accountants (AICPA) State and Local Government Expert Panel have reviewed the Governmental Accounting Standards Board (GASB or Board) Exposure Drafts (ED), *Financial Reporting Model Improvements* (FRM ED) and *Recognition of Elements of Financial Statements* (Elements ED), and are pleased to offer our comments on both of these documents.

We appreciate the Board's time and efforts to improve key components of the financial reporting model as well as the extended time to assimilate the guidance in the EDs and submit comments. We spent substantial time analyzing both EDs and prepared the comments in this letter based on our general understanding of the proposed model concepts as described in both EDs.

However, we believe the proposed short-term financial resources measurement focus is significantly flawed because of the transactional-based recognition terms and will result in governmental fund financial statements that are not decision useful. We have significant concerns the proposed model will result in (1) a lack of comparability of financial statements among governments; (2) interperiod equity that is not representationally faithful; and (3) increased risk of fund balance manipulation. Therefore, we strongly recommend that GASB reconsider the short-term financial resources measurement focus based on the notion of when transactions are normally due, along with providing more guidance surrounding the concept of normally due to facilitate consistent reporting among governments.

We also have significant concerns about the separation of the financial reporting model (FRM) project from the revenue and expense recognition (RER) project and the potential issuance of a final FRM standard well before deliberations are completed on the RER project. Because many of the concepts in both projects are so interrelated, we strongly recommend the Board either recombine the two projects or postpone issuance of a final FRM standard until deliberations on the RER project have been completed. We also strongly recommend the effective dates for the final FRM and RER standards be aligned.

Our most significant comments are included in the next section of this letter. The "Other Comments" section below includes editorial comments and other matters that could improve the clarity of standard.

SIGNIFICANT COMMENTS

Short-Term Financial Resources Measurement Focus Flawed

Transactional-Based Recognition Criteria Result in Financial Statements That are Not Decision Useful

The proposed reporting model for governmental funds in the FRM and Elements EDs is based on whether the contractual terms of an individual transaction or other event is short-term or long-term, which is determined by the period of time between the inception and conclusion of the transaction or other event. We believe a recognition model that is based on transactional terms is significantly flawed and results in the inability of users to assess a government's fiscal accountability. Further, such a model enables manipulation of amounts reported in governmental funds based on the structure of the arrangement, rather than the substance of the transaction, and negatively impacts comparability of financial statements among governments. If the Board proceeds with the model as proposed, the end result will be governmental fund financial statements that are not decision useful.

Use of contractual terms to determine recognition erodes consistency of accounting within a class of transactions, which negatively effects the comparability of financial statements among governments. Grants, special assessments, and liabilities, including debt, are all examples of transaction classes susceptible to inconsistent recognition. For example, consider a settlement agreement for employee back pay related to a union contract. One government opts to pay employees in one lump-sum in the current year while another chooses to pay employees in equal installments over three years. The contractual payment terms result in different recognition in the governmental fund financial statements of each government for the same transaction. One government would recognize it as a short-term transaction and record accrued payroll liability and the related outflow of resources in the current year while the other would recognize it as a long-term transaction and record no liability and the outflow of resources as due over three years.

Specificity of the contractual payment terms allows manipulation of those terms to achieve desired results. For example, an entity could structure a contractual payment to be due in twelve months and one day versus twelve months or less to avoid recognition in the governmental fund financial statements. Further, paragraph 18 of the FRM ED indicates that once a transaction or event is classified as short-term or long-term, the classification does not change even when there are changes in the terms or conditions. The ability to modify a contract after initial classification with no effect on recognition exacerbates the opportunity for a government to influence the recognition of transactions such that the amounts reported in governmental fund financial statements do not appropriately represent the government's actual fund balance available for spending in subsequent periods.

Short-term financial resources measurement focus with contractual recognition terms also obfuscates interperiod equity. To illustrate, consider a June, 30 2021, year-end government that imposes a special assessment on July 1, 2020, with final payment due September 30, 2021. The special assessment is for snow removal services for July 1, 2020, through June 30, 2021. The transaction is long-term because the period from inception (July 1, 2020, imposition date) to conclusion (September 30, 2021, due date) is greater than one year; therefore, the inflows of resources are recognized when due (i.e., fiscal year ended June 30, 2022). This example results in the government providing a service in one year, with the inflows of resources being recognized in the subsequent year, thus distorting the notion of interperiod equity.

Lack of Conceptual Foundation

We are aware that the FRM project was taken on in part because the current financial resources measurement focus and modified accrual basis of accounting have been criticized for lacking a conceptual foundation. Therefore, one of the key purposes of this project is to improve governmental fund financial statements by providing a conceptually consistent basis for recognizing transactions. However, we question the conceptual strength of the short-term financial resources measurement focus, as it also incorporates inconsistences and exceptions in what is proposed to be a conceptual underpinning of the governmental funds reporting model. For example, paragraph 19 indicates that prepaid expenses are short-term assets, regardless of the period from inception to conclusion. However, there are examples where prepaid expenses likely would not be short term (for example, prepaid bond insurance). Similarly, paragraph 20 requires that long-term debt issued for short-term purposes be recognized as a liability which is a divergence from the theoretical model. Paragraph 26 is another example that requires interfund balances and transfers to be treated as short-term events.

While we understand the need for some of the exceptions outlined above, given the proposed transactional model, it calls into question whether this proposal is really more conceptually sound than the existing current financial resources measurement focus and modified accrual basis of accounting.

Recommendation

We strongly recommend the Board abandon the short-term financial resources measurement focus proposed in the FRM ED. Instead, the Board should reconsider the short-term financial resources measurement focus based on the notion of when transactions are normally due, similar to that proposed in the related Preliminary Views (PV) document. However, consistent with our previous comment letter on the PV, such an approach would only be workable if the Board provides detailed guidance on which transactions are normally due within one year for similar classes of transactions to facilitate consistent reporting among governments.

If the Board does not proceed with our recommendation of an approach based on normally due along with the related necessary guidance, we believe the best path forward would be for the Board to maintain the current governmental funds reporting model. If that path is taken, we would recommend the Board take on a less comprehensive project to address the specific concerns that stakeholders have with the current model, such as addressing period of availability and the issuance of long-term debt for short-term purposes.

Combine Financial Reporting Model and Revenue and Expense Recognition Projects

FRM and RER Projects Too Closely Interrelated for Separate Issuance

We have significant concerns about the separation of the FRM project from the RER project and the potential issuance of a final standard on FRM well before deliberations are completed on the RER project. In general, we found we did not fully understand all the nuances of the proposed short-term financial resources measurement focus in the FRM ED until after reading Chapter 7 of the *Revenue and Expense Recognition* Preliminary Views (RER PV) document and we are concerned that certain aspects of one project may influence the Board's views on the other project. For example, we did not realize the implications of "component parts" of a revenue transaction until reading the discussion in Chapter 7, paragraph 4 of the RER PV.

Combined Field Testing Needed

Field testing was performed on the FRM project and field testing for the RER project is currently in progress. However, it is our understanding that the field testing for the RER project is being conducted based on the current financial resources measurement focus and modified accrual basis of accounting and will not lend insight into the interaction of the FRM and RER projects together. Without a field test that encompasses both due process documents together, the Board will have no way of knowing what potential issues have not been identified.

Implementation Efficiencies Gained by Coordinating Issuance

Finally, many hours of education, training, and analysis of transactions will be required to implement FRM, both when it is first issued and then again when governments are required to reapply these concepts in connection with the implementation of the RER standard. Aligning the implementation dates will not only reduce confusion but will aid in streamlining the overall implementation.

Recommendation

For all of the above reasons, we strongly recommend the Board either recombine the two projects or postpone issuance of a final FRM standard until deliberations on the RER project have been completed. Further, we recommend aligning the effective dates for the FRM and RER standards. Given there is no urgent practice issue driving an immediate need to implement the FRM standard, alignment of the two projects will ensure all issues are identified and result in efficiencies in implementation.

Present Transfers Together in Separate Sections of the Respective Activity Statements for Governmental and Proprietary Funds

Governmental Funds

Although we generally are supportive of the separate reporting of flows from current and noncurrent activities in the governmental fund statement of short-term financial resource flows, we disagree that transfers should be reported within these sections. Transfers represent an internal subsidy from one fund to another. We believe that separating these internal activities into current versus noncurrent transactions is not relevant to users and will result in arbitrary and subjective evaluations by governments solely to comply with GAAP. In our experience, governments generally consider transfers in terms of broad purposes and not for specifically identified costs. This point is reinforced in the basis for conclusions of the FRM ED. Paragraph B55 indicates that field participants found this classification of transfers challenging, particularly when a single transfer has a current and noncurrent component. Therefore, we recommend transfers be reported in a separate section of the statement after net flows from noncurrent activities. For situations where the entity is also reporting unusual or infrequent items, we recommend the transfers be reported immediately following that section.

Proprietary Funds

While we are supportive of the separate reporting of noncapital subsidies and other nonoperating revenues (expenses) in the proprietary fund statement of revenues, expenses, and changes in fund net position, for similar reasons discussed above for governmental funds, we disagree that transfers should be reported within these sections. Accordingly, we recommend transfers be reported in a separate section of the statement after "other nonoperating revenues (expenses)."

Limit Reporting of Non-Capital Subsidies for Proprietary Funds to Those Received from External Sources

Although we generally are supportive of the new intermediate operating measure "operating income (loss) and noncapital subsidies" in the proprietary fund statements of revenues, expenses, and changes in fund net position, we disagree it should include internal subsidies (transfers). Instead, we believe an intermediary operating measure is only decision useful to users if it is based on operating subsidies received from third parties. Such an intermediary measure has several advantages. First, it helps users to better understand the rate setting process and extent that charges for services are covered by fees (operating revenue) and subsidies received from third parties (for example, intergovernmental revenue and taxes). Second, it may alleviate confusion of the governing boards and citizenry of business-type activities that are established to be subsidized by recurring external funding sources. For example, transit agencies and community colleges are often established through state statutes with the power to levy property taxes to subsidize the cost of operations. However, users are often confused by the significant loss from operations and misinterpret this as poor financial operation or fiscal distress.

We also recommend the Board clarify what types of revenues should be considered a subsidy. For example, clarification should be provided as to whether derived tax revenues and imposed nonexchange transactions should be reported as a subsidy.

OTHER COMMENTS

Consider Changes to Terminology Used for Statement of Short-Term Financial Resource Flows

While we continue to be supportive of separating transactions between current and noncurrent activities, we believe users may be hampered in understanding the nature of the transactions within these sections because the terminology being proposed does not adequately describe the nature of these sections. Given that noncurrent activities are limited to debt and capital and we are not supportive of separating transfers, we encourage the Board to consider using the caption "Net Flows From Debt and Capital Activities" instead of "Net Flows From Noncurrent Activities" in order to ensure clarity.

Additionally, while we understand and appreciate GASB's underlying reasoning for suggesting the terminology "inflows" and "outflows" to replace "revenue" and "expenditures," we believe GASB should retain the existing terminology. Moving away from terminology that is well understood by governmental financial statements users and preparers and aligns more closely with terminology utilized in other financial reporting frameworks will only add further confusion to those less familiar with governmental fund financial statements. In addition, the terms inflows and outflows connotes more of a cash-basis measurement, which does not align with the measurement and basis of accounting being proposed.

Suggested Changes to Management's Discussion and Analysis

On an overall basis, we support the changes GASB is proposing to management's discussion and analysis (MD&A). However, we believe the Board should go further in reducing duplication and boilerplate information. For example, the first three pages of the MD&A presented in Exhibit 1 continue to present boilerplate information for the financial statements. Instead, we recommend the Board eliminate some of that boilerplate by instead requiring a reference to notes in the financial statements, such as the measurement focus, basis of accounting, and financial statement presentation note. Additionally, we recommend the Board provide more than one MD&A illustration in the final standard. Providing multiple illustrations may prompt more creativity in the MD&A since preparers will have access to alternative presentations.

We also recommend the Board make the following changes to the proposed reporting requirements for MD&A:

- Limit the requirement in paragraph 8c(2) to major funds. The analysis of the nonmajor funds in aggregate does not provide value and detracts from the focus on major funds. It also contradicts the notion that immaterial information does not require disclosure.

- Change the requirement in paragraph 8d(2) to include all long-term liabilities such as pension, other post-employment benefits and asset retirement obligations. Discussion and analysis concerning activity, policy changes, and economic factors related to all long-term liabilities would assist users in understanding the detailed and lengthy information disclosed in the notes to the financial statements.

Provide Additional Guidance on Presentation of Unusual and Infrequent Items

We support the change to unusual *or* infrequent items as it aligns with non-governmental entity requirements. However, we recommend the Board provide additional detailed presentation guidance for the unusual or infrequent item section of the financial statements to promote comparability across governments as we believe more transactions will now meet the criteria for reporting. GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements,* provides definitions for unusual as well as infrequent items, but there is no detailed guidance about presentation. For example, should both inflows of resources and outflows of resources be presented in this section, and should they be netted in a single line item? We believe guidance suggesting disaggregated information would be more useful to stakeholders. Additionally, we recommend the Board provide practical guidance on what constitutes unusual or infrequent items for a governmental entity.

Consider Impact of State Statutory and Local Reporting Requirements in Establishing Effective Date of New Standards

In addition to our previous comment on the interrelationship of the FRM ED and the RER PV effective dates, we recommend the Board consider the final effective dates carefully in light of legislative challenges we anticipate some governments will face due to the need to revise laws and regulations for the final standard. For example, the amendment changing special revenue funds to special resource funds may require law changes.

We also appreciate the phased in approach to implementation, but suggest the dollar amounts that distinguish between a phase I versus phase II government be increased to give more governments an additional year to implement. The dollar threshold in the proposed phased approach are lower than those used in GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments,* which was over twenty years ago. Given inflation, we believe these amounts are too low.

Request for Additional Examples and Illustrations

Regardless of the model that the GASB moves forward with, we encourage the GASB to include additional example transactions and illustrations that would be useful to preparers and users of the financial statements. Illustrations should be provided for special-purpose governments, including business-type activities only, and more complex examples that demonstrate the application of the proposed model, such as advance funded grants, debt refundings, incurred but not reported, retainage payable and pledges and contributions. We believe the examples and illustrations would be more valuable if they are robust and include "real life" complications, such as those that cross fiscal years, include deferred inflows of resources and deferred outflows of resources, and illustrate the concept of "component parts."

* * * * * * * *

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

Michelle M. Watterworth
Chair
AICPA State and Local Government
Expert Panel

Mary M. Foelster

Mary M. Foelster
Senior Director
AICPA Governmental Auditing and
Accounting

cc: State and Local Government Expert Panel
Dan Noll