



March 16, 2012

Mr. David R. Bean
Director of Research and Technical Activities
Project No. 13-3
Governmental Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Mr. Bean:

The American Institute of Certified Public Accountants (AICPA) has reviewed the Governmental Accounting Standards Board (GASB) Preliminary Views (PV), *Economic Condition Reporting: Financial Projections*, and is pleased to offer its comments. The PV presents the Board's overarching view that current annual financial reports do not provide adequate information to users regarding the financial stress facing some governmental entities due to deteriorating financial conditions. Additionally, the PV proposes a related solution to this perceived inadequacy by suggesting that financial projections be reported as required supplementary information (RSI). We disagree with the Board's overarching view. To the contrary, the members assisting us with this letter are not aware of an existing pervasive problem by users in assessing fiscal sustainability based on current annual financial reports. This position is based on our members' experience working with preparers, oversight bodies, and other users. As a result, we also disagree with many of the key positions taken by the Board in the PV. However, we do agree with certain aspects of the Alternative View as further described below.

One of our specific areas of disagreement, which is further described in our response to Question 6 below, relates to the Board's conclusion that all of the components of fiscal sustainability information meet the definition in GASB Concepts Statement No. 3, *Communication Methods in General Purpose External Financial Reports That Contain Basic Financial Statements*, for RSI (i.e., that it is essential for placing the basic financial statements and notes to the basic financial statements in an operational or economic context). Instead, we believe that this information more closely aligns to the definition of supplementary information (SI) in GASB Concepts Statement No. 3 (i.e., it is useful to placing basic financial statements and notes to basic financial statements in an appropriate operational, economic, or historical context). Other areas we take exception with include the use of the cash basis inflows and outflows for certain projections, the usefulness of the projections in light of underlying subjectivity, and that the projections should be required for all governments.

Our answers to the specific questions posed in the PV are in the "Response to Questions" section of this letter. These responses are provided to assist the Board as it moves this

project forward. However, we ask that the Board keep in mind our overarching concern with categorizing this information as RSI as it contemplates our individual responses. We have also provided additional comments in the “Other Comments and Recommendations” section below.

RESPONSE TO QUESTIONS

Question 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:

- *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 fluctuation in cash inflows.*
- *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.*
- *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 fluctuation in financial obligations.*
- *Component 4 – Projections of annual debt service payments (principal and interest).*
- *Component 5 – Narrative discussion of the major intergovernmental service interdependencies that exist and the nature of those service interdependencies.*

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

As further described in our response to Question 6, we believe that the 5 components identified by the Board would be useful (i.e., not essential) for assessing fiscal sustainability for the purpose of placing the basic financial statements and notes to the basic financial statements in an appropriate operational, economic, or historical context. However, improvements are needed to certain of the components as follows:

Components 1 and 2. Chapter 3 of the PV discusses the Board’s view that Components 1 and 2 would provide users with the information needed to assess the current and future ability of a governmental entity to obtain necessary resources and to honor current service commitments and meet its financial obligations as they come due. While we believe Components 1 and 2 are helpful in making this assessment, basing these projections on a cash basis raises a number of concerns which are further described in our response to Question 3.

Component 3. We believe this financial obligation information would be most beneficial for general-purpose governments and less beneficial for some reporting entities such as those described in our response to Question 7.

Component 4. We believe there is a disconnect between the research that indicated users' interest in an entity's ability to meet financial obligations and the limited scope of Component 4 which only focuses on projecting annual debt service payments. We recognize that unfunded actuarial accrued liabilities related to pensions and other postemployment benefits (OPEB) are included as part of the financial obligations in Component 3 and that Component 2 includes the projected outflows related to pensions and OPEB. However, we are concerned that the anticipated annual payments associated with pensions and OPEB are not entirely apparent in Component 2. As discussed in paragraph 10 of Chapter 3, projections of major individual cash outflows may be presented by program or function or by object (for example, salaries and wages). If a government presents Component 2 by program or function as Illustration 2 in the Appendix to the PV demonstrates, the annual payments associated with pensions and OPEB will not be identifiable. If a government presents Component 2 by object, it would seem that if deemed major, these payments would be presented in a separate line item. However, because there is no such a separate line item in Illustration 3 in the Appendix to the PV, we are uncertain regarding the Board's intent. Given the potential significance of these annual outflows, we recommend that the Board consider expanding Component 4 to cover both annual debt service payments and pension and OPEB payments or establish a separate component for pension and OPEB payments. Making this change would ensure these payments are apparent, regardless of the method chosen for Component 2. Including these projected annual payments would also further improve the transparency regarding an entity's pensions and OPEB.

We are also unclear what the Board intends to include in Component 4. Paragraph 23 of Chapter 3 discusses the various disclosures required by GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, and contrasts those requirements to the inclusion of authorized but unissued obligations within Components 2 and 3. However, it never specifically defines what should be included in Component 4, nor was an example of Component 4 included in the illustrations provided in the Appendix to the PV. The Board should clarify in future due process documents whether Component 4 would include future principal and interest relating to debt obligations that have been authorized but not yet issued at the end of the reporting period and an example of this Component should also be provided. We are also unclear whether it is the Board's intent to reiterate certain of the note disclosures required by GASB Statement No. 38 in Component 4 as RSI. If so, we would not support such duplication of information between the notes and RSI and recommend that the information be included in one place or the other, but not both.

Component 5. Four of the proposed components (i.e., Components 1 – 3 and 5) involve the notion of "major." Paragraphs 22 - 27 of Chapter 5 discuss the Board's views of what constitutes "major" for the various components. While Components 1-3 have a clearly defined threshold, we are concerned that the threshold for Component 5 is simply a matter of professional judgment. If these components are reported as RSI, the auditor has a responsibility under professional standards to inquire of management about whether the methods of preparing the RSI are in accordance with prescribed guidelines and to communicate when some or all of the RSI has not been presented in accordance with

guidelines established. Given that the criteria provided for Component 5 is professional judgment, we are concerned that it will be difficult for an auditor to determine whether the government has included the interdependencies that it should have. Our preference would be for the Board to include a more objective criterion for “major” service interdependencies.

Additionally, Component 5 would require a narrative discussion of the major intergovernmental “service” interdependencies. We are concerned that this description may not be reflective of the Board’s intent for this Component. Many intergovernmental revenues do not represent an exchange for providing a service. However, Component 5 refers to “service” interdependencies. An example of this confusion appears in Illustration 6 in the Appendix to the PV which provides an example relating to the city’s dependence on the state to provide various cash inflows, including state aid to education, state revenue sharing, property tax homestead exemptions, and other various grants. These items do not appear to represent “service” interdependencies, but rather reliance on grant funds. We recommend that the Board clarify its intent for Component 5 by more clearly addressing how nonexchange transactions should be treated. The Board should also consider eliminating the term “service” from the title of Component 5 if the intent is broader.

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

We believe that basing financial projections on current policy, historical information, and known events eliminates a certain level of subjectivity from these projections and provides a hypothetical base from which to project the required components. Therefore, in light of the Board’s preliminary view to categorize the projections as RSI, we would support the “current policy, historical information, and known events” approach over an alternative that, while perhaps more realistic (e.g., forecast or prediction), could prove to be even more subjective.

However, even with such an approach, there will still be some level of subjectivity involved. We continue to have some concerns about this remaining subjectivity leading to inconsistencies in reporting both within the same government and between government entities. For example, we assert that if two knowledgeable and well-meaning preparers were given the same exact fact pattern, they would likely prepare the required financial projections and end up with significantly different results.

Finally, we also have some concerns about the “current policy, historical information, and known events” approach resulting in projections that could be misleading overall. We know that governments change current policies on an ongoing basis. For example, when budgets are passed, governing bodies revise spending and revenue policies in reaction to

current financial events. If a projection indicates spending well in excess of revenue, it is likely that a governing body will change its spending policies. However, the proposed financial projections would not allow those revised policies to be reflected in the financial projections since the governing body has not yet approved the budget for that future year.

With all of this said, if the Board continues its tentative conclusion to consider this information as RSI, our preference would be for the Board to continue its “current policy, historical information, and known events” approach in that it is less subjective than other alternatives.

Question 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?

While we acknowledge that many governments budget on a cash basis, we disagree with the Board on projecting inflows and outflows on a cash basis of accounting. In our view, this approach would provide users of governmental financial reports with limited information regarding a government’s economic condition. Further, projections of cash inflows and outflows on a cash basis would be confusing for users because it would be inconsistent with the basis of accounting used to prepare the basic financial statements. It would also add to the existing complexity of governmental financial reports.

We believe that preparing these inflow and outflow measures on the same basis of accounting used to prepare the financial statements would provide users with better information upon which to assess fiscal sustainability and a government’s financial position. We are also concerned that cash basis outflows could be more easily manipulated to “manage” results. For example, a governmental unit expecting to experience fiscal stress could assert that delaying the payment of invoices would be consistent with current policy. Such delayed payments would be excluded from a cash basis projection and would fail to show the deteriorating situation in a transparent manner. If the Board accepts our recommendation, consideration should be given to revising the terminology ‘inflows’ and ‘outflows’ as both terms imply a cash basis.

Finally, from a practical standpoint, having these measures prepared on a cash basis may add additional steps for auditees and auditors in light of the fact that the basis of accounting used to prepare the financial statements would be different.

Question 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?

Similar to our response to Question 2, the principles based approach suggested to identify and develop assumptions for making financial projections will still involve enough judgment and subjectivity such that different preparers using the same set of facts and circumstances are likely to achieve different projection results. We are troubled by this potential for inconsistency, particularly in light of the Board's classification of the information as RSI.

As further discussed in our response to Question 2, given the Board has concluded that "current policy, historical information, and known events" approach is appropriate, we take exception that the assumptions will be comprehensive because they limit the consideration of the most likely outcome. We believe that by eliminating potential events and conditions that may be likely but not in current policy contradicts the Board's view that the assumptions are comprehensive.

Question 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?

We believe that a five-year projection period is the longest period the Board should consider. A longer projection period would only increase the volatility of the assumptions and decrease the related reliability of the information. If the Board maintains the scope of the project as proposed in the PV (see our response to Question 7), it may be beneficial to explore a projection period of three years for smaller governments to alleviate the cost burden of preparing the projections for those governments. Many governments already budget and forecast on a three-year period and permitting smaller governments to align their projections to that timeframe could provide some relief.

Question 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?

While the projections included in the PV may be useful information for financial statement users, we strongly disagree with the Board's position that all of the components of fiscal sustainability are essential for placing the basic financial statements and notes in an appropriate operational, historical, or economic context. We are also not aware of an existing pervasive problem by users in assessing fiscal sustainability based on the current model of reporting and believe that for some governments, the cost of preparing and reporting this information may outweigh the benefits. Instead, we agree with the

Alternative View that the proposed projections do not meet the definition of RSI in Concepts Statement No. 3. However, unlike the Alternative View, we recommend that the Board encourage the use of these projections as SI and remove the requirement for it to be presented at RSI. This would be similar to the approach taken by the Board in GASB Statement No. 44, *Economic Condition Reporting: The Statistical Section—an amendment of NCGA Statement 1*. Such an approach would also allow individual governments the ability to assess the cost versus benefit of preparing the information based on their specific circumstances.

We also believe there is a direct conflict with the Board's conclusion to present the projections as RSI with paragraph 44 of Concepts Statement No. 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. . . ." As discussed in our response to Questions 2 and 4, we believe there will still be a level of subjectivity relating to the "current policy, historical information, and known events" approach and the assumptions that underlie the projections. Further, the projections proposed by the Board provide information on future financial position. All of these issues appear to be in direct conflict with Concepts Statement No. 3. This adds further support to our recommendation that the Board simply encourage this information to be presented as SI.

Finally, we are concerned that users of this information will not be able to put the projections into proper context despite the cautionary language proposed by the Board and the disclosures required to accompany the projections. In our view, for users to truly understand the projections, they would need to have the knowledge management had in developing the projections. Given that the proposed projections could be subject to inconsistent application between various governmental entities and could be misunderstood by users, we do not support their inclusion as RSI.

Question 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 believe that the requirements for financial projections and related discussions should only apply to general-purpose governments. While other governments may benefit from performing an internal analysis of fiscal sustainability, if the Board proceeds with categorizing the projections as RSI we recommend that certain governmental entities be carved out due to cost-benefit considerations and differing needs of user communities.

We identified a number of governments for which the cost to report such information would far exceed any benefit. For example, we believe there would be little benefit for smaller entities that take on limited debt and have relatively simplistic operational and funding characteristics. We also question how the projections would help users of the financial statements of governmental university foundations. The major inflows to such foundations generally relate to contributions which are largely unpredictable and

investment income which is primarily affected by the inherent volatility of investment markets. We also question the usefulness of this information for certain stand-alone fiduciary activities such as pension plans, other postemployment benefit plans and public entity risk pools whose inflows are also affected by investments and are already providing certain forward-looking information. It appears to us that for these entities, some of what is being proposed in the PV would be duplicative.

Finally, the purpose of some governmental entities, such as tribal enterprises and certain business-type component units of tribal governments, is to generate profit not to provide governmental services. Such entities are not directly involved with maintaining and improving the delivery of public services or with achieving intergenerational equity (i.e., two of the user needs identified in paragraph 7 of Chapter 1 of the PV). Accordingly, we believe the PV's required presentation of financial projections and other information for these entities should not be required. Further, since the projections would reflect future business initiatives that have been approved, but are not yet public information, presentation of such information as RSI would result in the potential to report information that is confidential and competitively sensitive.

Question 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)?

In light of our recommendation in Question 7 to limit the reporting to general-purpose governments, we believe a phase-in period would not be necessary. However, if the Board does not accept our recommendation in Question 7, we would not oppose consideration of a phase-in for smaller governments.

OTHER COMMENTS AND RECOMMENDATIONS

Alternative View Position on the Statistical Section

As noted in our response to Question 6, we agree with the Alternative View that financial projections and related narrative discussions should not be included as RSI. However, unlike the Alternative View, we recommend that the Board encourage the projections outlined in the PV to be presented as SI. Further, we take exception to the portion of the Alternative View which concludes that certain aspects of the Statistical Section of a comprehensive annual financial report should be reclassified from SI to RSI. While certain of the historical financial information in the Statistical Section may be useful to the needs of certain financial statement users, we disagree that it is essential for placing the basic financial statements and notes to the basic financial statements in a historical, operational, or economic context. We also believe the current requirements for the Statistical Section provide an appropriate level of flexibility in reporting such information, based on the characteristics of the reporting entity and the needs of the users of the financial statements.

Potential Issues for Entities Issuing Municipal Securities

The projections the Board is considering are proposed as RSI, thus they may be included as part of an official statement relating to a bond offering. Some of our members expressed concerns about the potential for confusion to investors as to what the projection information purports to present as it relates to the municipal offering, and that the projections could ultimately be misinterpreted by investors. Concerns were also raised as to whether governments that include these projections in offering documents could be at risk if the forward-looking information ultimately does not reflect what actually happens in terms of the antifraud provisions in the Securities and Exchange Commission rules. We recommend that as the Board further deliberates this project that it consider potential implications for issuers of municipal securities regarding the inclusion of forward looking financial information in offering documents.

AICPA Professional Standards Assessment

The AICPA's professional standards and a related AICPA Guide covering financial forecasts and projections discuss certain restrictions on the presentation and distribution of certain forward-looking financial information. Therefore, in evaluating the proposals in this PV, we discussed with the AICPA's auditing standards team the interplay of existing guidance and the auditor's role with regard to reporting on RSI when projections are involved. In light of the GASB's PV, as well as existing requirements in Federal Accounting Standards Advisory Board standards for forward-looking information, the AICPA Auditing Standards Board is in the process of establishing a task force to look more closely at the auditor's responsibilities when projections are included as RSI and/or in the basic financial statements. For example, one matter that may be considered by the task force is whether, even with the disclaimer of opinion currently provided by auditors on RSI, users may misunderstand the auditor's association with the projections. The task force may consider whether additional verbiage would be appropriate in the auditor's reporting when RSI includes projections or may make future recommendations to the Board regarding revisions to the cautionary notice that is described in paragraph 28 of Chapter 5. We will keep the Board informed on the progress of this task force and any further issues or concerns regarding auditor association with forward-looking financial information.

Projection Versus Forecast

The GASB PV refers to the information that is to be presented as a projection. It also uses a dictionary definition of a projection which is an estimate of what something will be in the future, based on the present trend or rate of change. As we recently discussed with GASB staff, this definition may be confusing to the auditor community as the professional attestation literature defines a financial projection as "prospective financial statements that present, to the best of the responsible party's knowledge and belief, *given one or more hypothetical assumptions*, an entity's expected financial position, results of operations, and cash flows." After first reviewing the definition of a projection provided in the PV, we thought it seemed closer to the definition of a forecast, which in the professional attestation literature is, "prospective financial statements that present, to the best of the responsible party's knowledge and belief, an entity's expected financial position, results of operations, and cash flows." However in discussing this further with the GASB staff, we determined

that the “current policy, historical information, and known events” approach taken by the Board would likely serve as the hypothetical assumption in the profession’s definition of a projection. Therefore, we are comfortable with the Board’s use of this term “projection.” However, going forward, we believe that there will need to be educational activity with the auditor community regarding this definitional nuance which we are prepared to undertake as the Board moves forward with this project. The Board could assist with this endeavor by considering mention of the issue in future due process documents, perhaps in the basis for conclusions.

Treatment of Investing Activities Needs Clarification

We encourage the Board to more specifically address the treatment of investing activities in Components 1 and 2. The various illustrations in the PV are unclear as to what should be considered cash for purposes of the projections. Specifically, Illustrations 1, 2, 6, 7, and 11 in the Appendix to the PV appear to exclude cash inflows or outflows resulting from investing activities. Yet the descriptions of Components 1 and 2 in Chapter 3 specify comprehensive reporting of all cash inflows and outflows. Without further clarification, complications and inconsistencies may arise, especially for permanent funds, pension funds and some enterprise activities, which likely have significant portfolios of financial assets comprised of both cash and investments.

Outreach and Education of User Community

If the conclusions reached in the PV are continued by the Board as this project progresses, we recommend the Board develop an outreach and education plan to better inform the user community. As previously discussed, we are concerned with the potential misinterpretation of the proposed projections by users despite the cautionary notice that the Board has developed. In order for the projections to have utility to the general public, efforts to educate the public regarding the nature of the information and the limited procedures performed on the information by the auditor need to be undertaken.

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The AICPA appreciates the opportunity to comment on the PV. 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,



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Chair
AICPA State and Local Government
Expert Panel



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