NATIONAL FEDERATION *of* MUNICIPAL ANALYSTS

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Via email to drbean@gasb.org

RE: NFMA's Comments on Project No. 3-251, Financial Reporting Model Improvements – Governmental Funds

Dear David:

The National Federation of Municipal Analysts (NFMA) is pleased to respond to the Invitation to Comment (ITC) on the subject project.

The NFMA was chartered in 1983 as a not-for-profit association with the goals of promoting professionalism in municipal credit analysis and furthering the skills of our members. The NFMA now comprises approximately 1,400 members who evaluate credit and other risks of municipal securities. Our members represent institutional investors, including mutual funds and insurance companies, bond insurers, broker/dealers, and rating agencies. Credit analysts are present at all stages of the municipal securities market, from the inception, structuring, rating, insurance and primary market offering of each transaction through to the sale and purchase of securities in the secondary market. The comments that follow are made in recognition of the clear alignment of interests that exists between the GASB's mission and our professional needs as analysts of municipal credit risk.

A review of the existing financial reporting model is timely, particularly given the fiscal distress experienced by state and local governments due to the "Great Recession", compounded by the effects of burgeoning pension and OPEB obligations. Current day fiscal and economic "extremis" were not the norm when GASB 34 was implemented from 2002 to 2005. That said, the financial reporting model, that uses both economic resources measurement and current financial resources measurement, has provided valuable information for assessment of governmental entities' management of fund activities and the financial position of those funds. Simultaneously, the government-wide statements have enabled evaluation of a government's financial position overall. Regardless of which financial reporting model improvements is ultimately chosen for presentation in a future Preliminary Views document, governmental fund and the government-wide accounting statements should both remain in place.

The NFMA strongly supports the GASB's efforts to improve the transparency and quality of information available to help the reader, both subject-matter and non-subject-matter experts alike, more accurately evaluate the credit attributes of governmental entities. The current financial reporting model does not adequately provide for recognition of certain non-current assets and liabilities at the governmental fund level which the NFMA hopes will be addressed with this re-examination of the Financial Reporting Model – Governmental Funds.

As we understand the ITC, the GASB is first and foremost seeking input on which of the three proposed government funds recognition models (Near-Term, Short-Term and Long-Term) would provide the most valuable information to NFMA membership. Choosing a preferred government fund recognition/reporting model for governmental funds is somewhat challenging due to the diverse membership of the NFMA – many of whom have differing financial reporting informational needs. [*] For example, traders may favor the Short-Term approach (STM) that speaks more directly to the government's' liquidity, even if liabilities are potentially understated. Rating agencies or institutional buyers with interest in holding an investment for *less than one* year may favor the Near-Term approach (NTM), which aligns more closely with a government's operating cycle. An institutional purchase, made under a "*buy and hold*" investment strategy, may rely on the Long-Term approach (LTM), despite potential overstatement of non-current liabilities in governmental funds and the inability to capture non-current capital assets at the governmental funds level.

Given the diversity of our membership, the NFMA labored to develop a clear consensus regarding the preference for one model over the others. That being said, the committee tasked with this effort has expressed a preference for the STM, but recommends further exploration of the ramifications of using each of the models. A discussion of our thoughts related to each model is discussed below:

The following is a list of the material advantages of the STM over the other recognition models discussed in the ITC:

- The STM appears to be closest to existing government budgetary accounting and more "relevant" to government officials' actual operation of fiscal resources over a yearly operating cycle.

- The STM appears to be a better basis to generate interim financials for government officials/users, and should help the GASB to establish interim financial reporting standards for governments.

- The STM appears to provide a better reconciliation to the existing government-wide

[*] See results of a survey of NFMA members entitled "Assessing the Impact of GASB Statement No.34: The Perceptions of Municipal Bond Analysts" authored by Rebecca Bloch and published in the Municipal Finance Journal, Volume 37, Number 02, Summer 2016. http://www.civicresearchinstitute.com/online/PDF/MFJ-3702-03-GASB34.pdf

financial statements.

- The STM appears to be more consistent with the existing current financial resources recognition/reporting model for government funds, thereby causing less "strain" and dislocation to accommodate new standards on both governments staff and their auditors/AICPA.

- Regarding specific recognition improvements, it appears that improvements are found, at least, in the following areas:
    - better recognition and inter-period allocation of receivable transactions (deferred inflows and net position changes) such as taxes, special assessments, and notes receivable;
    - better recognition and inter-period allocation of payable transactions (deferred outflows and net position changes) such as interest on long-term debt, claims payable, pension expense, short-term notes, and long-term bond payable changes;
    - better identification and allocation of inflows/outflows for "current activities"; and
    - better detail on net flows for "long-term activities".

In addition to the above advantages, the STM approach may somewhat mitigate the manipulation of balance sheets, wherein payment of a current year's liabilities in succeeding fiscal year(s) could distort debt and liquidity ratios, which would then mask the nature of a governmental entity's fiscal stress in such year. The STM would also provide insight into inter-period equity, with its focus on a one year operating cycle. (See response to question 2.3, below.)

We view the STM reporting model approach as potentially the best compromise to the NTM and LTM. That said, it appears that the STM would show only debt principal due the following year on the income statement, not the amount of principal actually paid during the current year. It is unclear whether it would be possible to identify how much principal the issuer actually paid versus the amount that was scheduled to be paid and "expensed" on the prior's year's income statement. This raises the question of whether the cash flow statement would provide insight into principal repayment. Further, if the issuer refinances the debt in the following year, rather than repaying the principal that has already been expensed, how would the STM presentation be impacted?

We believe the NTM can overstate fund balances when a government issues short-term notes such as tax anticipation or revenue anticipation notes that are repaid outside the near-term operating cycle of 90 days. Also, the NTM would not result in the creation of a statement of cash flow, which if absent would omit key information relevant to understanding a government's short-term liquidity and short-term financing needs. Finally, the NTM would have inconsistent treatment of the principal versus the interest on debt obligations in terms of their outflow recognition. On the other hand, the LTM, which recognizes governmental funds liabilities in their entirety, would no longer present the shorter time perspective of financial position and resource flows for governmental funds. This approach would result in a significant distortion, since it would load up governmental funds with long-term liabilities, while failing to reflect the financial resources that would be used to pay such liabilities over the long-term.

NFMA Responses to ITC Questions:

Chapter 2:

2.1) Governmental funds financial statements should continue to reflect a shorter time perspective than the information presented in the government-wide financial statements.

The NFMA agrees with this government accounting perspective. Governments generally operate on a shorter time perspective and prepare budgets typically on a 12-14-month basis. Budgets are based on a 12-month period, but clearly anticipate some use of revenues not collected within that 12-month budget period—essentially a working capital approach. The STM appears to recognize this budgetary expectation. Governments must manage their financial resources over the operating cycle to continue to provide services in subsequent periods while meeting their legal obligations. How governments manage the short-term financial resource utilization while planning for the long-term use of financial resources, may be best captured by the proposed STM recognition model. The delicate balancing of short-term and long-term financial resources are analyzed and evaluated/rated by not only the NFMA membership, but by taxpayers, governmental officials and legislatures as well.

2.2) Governmental fund financial statements should continue to present information that facilitates comparisons with a government's budgetary information.

The NFMA agrees with this governmental accounting perspective. The STM recognition model will facilitate the assessment of a governmental entity's management of its financial resources as budgeted and as required by legal constraints. Budgets provide one material basis for evaluating the quality of a government's fiscal management and accountability. The STM recognition model seems to be the best of the three proposed methods to foster easy reconciliation and comparison of a government's budgets and accounting conventions to its governmental fund activity. One would not be able to readily assess fiscal accountability absent this shorter time perspective and focus on financial versus economic resources.

2.3) As currently presented in the ITC, the NFMA would prefer the STM reporting model subject to the comments and questions noted by the NFMA below.

The NFMA finds value in the STM's more detailed and comprehensive approach to inflows and outflows. Its break-out of current assets and liabilities (i.e., current activities) from longer-term inflows and outflows of financial resources, helps to isolate these types of items for NFMA analysis. By including both short-term and longer term inflows/outflows of financial resources in one government fund statement – assets due to convert to cash and debt due in the next operating cycle – the STM provides analysts and investors with a broader view of the assets and financial resources available to support the government's operating obligations at the fund level.
Regarding the current financial reporting model, it does not provide adequately for recognition of

certain non-current assets and liabilities at the governmental fund level. It has led to potentially misleading assessments of credit quality attributes for some governmental entities by investors, rating agencies, and the public, and may have contributed to some poor fiscal choices on the part of governmental management.

Moreover, the current model does not distinguish between a reporting entity that has, for example, paid its debt, pension and other post-employment benefits (OPEB) obligations in full, versus one that has achieved its "balance" by underfunding its pension, OPEB and/or other liabilities, thus "kicking the can down the road". This creates a lack of comparability across governmental reporting entities. The current unfunded obligations become long-term liabilities, ultimately to be paid out of the General Fund in subsequent fiscal periods. Yet, as proposed, the current portion of these obligations are not reflected as government fund flows/liabilities in either the current financial reporting model or the NTM. The NFMA believes that the STM reporting model would help to rectify these current government fund reporting shortcomings.

Regarding the proposed NTM, the NFMA believes that, in practice, it would most resemble the current model and would not provide sufficiently enhanced information to justify a change from the current financial reporting model. An additional area of concern with this model would revolve around treatment of tax anticipation notes (TANs) and revenue anticipation notes (RANs) on the Statement of Near-Term Financial Resources Flows.

As to the treatment of TANs that are not near-term liabilities under the proposed NTM reconciliation, it is likely that a more sophisticated reader would be able to recognize that a note liability exists under the reconciliation statement at the bottom of Illustration 3, but not by others less familiar with the reporting model. A simpler communication of what is and is not reflected in financial reporting models would assist readers of *all* levels – beyond those with deep subject matter expertise – in assessing the quality of governmental entity management and financial performance. A lack of clarity is noted within the existing near-term financial resource flows presentations, since note payments are not reflected; a net increase from note proceeds would be recognized as shown in Illustration 4A. While Illustration 4B is an improvement over 4A, the message that two short-term notes had existed and that an increased $4.4 million note would remain to be paid at the end of the reporting period, is not clear to the more casual reader of financial statements.

Ultimately, should the NTM be pursued, the NFMA recommends a 90-day accrual of liabilities after the close of the fiscal year.

The LTM would reflect all assets and liabilities that are not capital-related on a modified accrual basis, but would appear to have the same types of information on a full accrual basis that can already be found in the government-wide financial statements. The only advantage to the LTM is that the various financial resources and liabilities would be allocated to specific government funds. Improved allocation of all assets and liabilities (excluding capital related items) to governmental funds could provide a more accurate understanding of the size and availability of ending governmental fund balances. However, the LTM model would result in a significant distortion to governmental fund balances since it would load-up governmental funds with long-term liabilities without reflection of the financial resources that would be available to pay for such liabilities in the fullness of time.

2.4) Repayment of notes should be presented as a reduction to an outstanding liability and as a reduction to cash. Outstanding balances on TANs and RANs at the end of a fiscal year should be reported on the balance sheet as a liability as is consistent with the STM reporting model approach.

2.5) The NFMA believes that prepaid items and inventories have been and should continue to be considered as financial resources. Financial resources, defined as "items that can be converted to cash or are consumable in lieu of financial resources", provide the most valuable information.

2.6) Looking at the suggested formats for the Statement of Short-Term Financial Resource Flows, the NFMA believes Illustration 6B to be more informative than Illustration 6A. The current and long-term activity format is more focused in its identification and measurement of both current inflows/outflows and net flows of allocable long-term liabilities/government activities which facilitates both fiscal operating strength and liquidity assessments of government credits. The STM's break-out of current activities from long term activities aids in the analysis of near term and longer term stress.

2.7) Providing language to clearly communicate to the reader that the information in governmental fund financial statements is of a shorter time perspective than information found in the government-wide financial statements, and focuses on financial, rather than economic resources, would be an effective approach.

The NFMA agrees that a reconciliation at the bottom of the government fund statement would provide value, but the NFMA prefers a detailed reconciliation with appropriate note references. The government-wide statement reconciliation in the proposed government fund statements should be accompanied by good note and required supplementary information (RSI) references to improve the ability of the user to reconcile and analyze information between the two sets of statements. Additionally, for many municipal entities, it is unlikely that any such reconciliation would fit on the same page as a detailed balance sheet.

<u>Chapter 3:</u>

3.1) The ITC examples of governmental funds resource flows statement provides an existing format to the proposed funds flows statement (4A, 6A and 8A for the respective approaches) and the alternative format, depicting a breakout between current and long-term activity (Illustrations 4B, 6B and 8B). The NFMA believes that the alternative format (6B) is an improvement over the existing format (6A). (See 2.6 above.)

3.2 and 3.3) Based on our understanding of the GASB proposals, the proposed Statement of Cash Flows for Governmental Funds (Government Fund Cash Flow Statement) provided in Illustration 9 would be needed for both the STM and LTM, since neither are as closely aligned with the fiscal year budget period as is the NTM.

The NFMA is in favor of the GASB's proposed Government Fund Cash Flow Statement in the formats already in use for governments' enterprise/proprietary funds. The cash flow information as proposed by the GASB is reasonably detailed, and the NFMA finds that the information presented by fiscal activities is informative and not typically found on other financial statements. This Government Fund Cash Flow Statement presentation allows NFMA members to better evaluate the cash flow strength/weaknesses in each government fund, the need for external liquidity facilities, and obtain information not otherwise readily available in other government financial statements. The NFMA also believes this Government Cash Flow Statement would be valuable both to the government fiscal team itself plus become the basis for interim financial reporting. The NFMA would recommend that the Government Cash Flow Statement have some basic reconciliation notes to the government's approved budget to help users judge the year-to-date budgetary tracking and stress. However, the NFMA is cognizant of the extra costs associated with audits of this information, and might be amenable to excluding the Government Cash Flow Statement from the audit requirement-similar to the treatment of the government budget.

3.4) The NFMA believes that the four classifications for the statement of government cash flows under Illustration 9, are appropriate classifications for governmental funds (see 3.2-3.3 above). The NFMA would like to see as much granularity in the Cash Flows from non-capital financing activities (as this reflects areas of cash flow stress/bad cash management concerns). The NFMA would like to see the "transfers in/out" sections have express note support/details, as "inter-fund" transfers during the year can identify bad cash management practices, cash flow stress, improper use of restricted funds, etc.

The NFMA Additional Comments & Questions Regarding the ITC & GASB-Proposed Government Funds Recognition Models:

In addition to the required responses above, the NFMA has additional comments and questions about the ITC and proposed government fund recognition models as listed below:

- Which note adjustments are needed to accommodate the proposed STM? Overall, the NFMA hopes the proposed STM promotes less reliance on/need for extensive "note" and RSI disclosures to get an adequate understanding of the fiscal health of the government's operating cycles.
- What type of changes in RSI will be needed to accommodate the STM?
- Is the GASB still proposing a Statement of Government Cash Flows?
- Can the GASB provide a STM reconciliation to the government's final approved budget as an additional reconciliation statement? This reconciliation statement can be in the Notes or RSI as it would not need to be audited.
- What changes are needed to the government-wide reconciliations to accommodate the proposed STM?
- The NFMA would like to see greater specificity in the classifications of "current" and

"long-term" activities. Will the GASB publish parameters or will it be determined by each government on a case-by-case basis? For example, can a government use different definitions of "current" and "long-term" for different financial transactions?
- Does the GASB anticipate any new audit/AICPA problems in auditing the STM?
- The NFMA recommends the proposed STM revenue and expense entries have as much "granularity" as possible—e.g., specifying the different types of tax inflow transactions (sales, property, gas, etc.) versus just a lump sum "taxes" accounting entry.

We thank you for the opportunity to provide our thoughts on the topic of "Financial Reporting Model Improvements – Governmental Funds." and would be happy to elaborate further on our views in follow-up communication as needed. Potential improvements to the financial reporting model are an important consideration to the NFMA membership and we look forward to working with the GASB in the future towards the objective of identifying best practices for reporting requirements in this area.

Sincerely,

/s/

Anne G. Ross
NFMA Board Member