ILLINOIS

GOVERNMENT FINANCE OFFICERS ASSOCIATION

May 7, 1997



Mr. David R. Bean Director of Research Project No. 3-4E Governmental Accounting Standards Board 401 Merritt 7, P.O. Box 5116 Norwalk, Connecticut 06856-5116

Dear Mr. Bean:

The Illinois Government Finance Officers Association (IGFOA) is an organization in excess of 750 members comprised of public finance officers, auditors, accountants, bankers, and others interested in public finance in the state of Illinois. Our organization is dedicated to the common goal of promoting and improving methods of public finance so as to enhance the quality and efficiency of government.

To assist in achieving its goal, the IGFOA has organized several committees. The Technical Accounting Review Committee (TARC) was created for the purpose of reviewing accounting, auditing, and financial reporting requirements for governmental entities. Therefore, the TARC has consistently responded to due process documents issued by the GASB. The following is our response to the Exposure Draft (ED), <u>Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments</u>.

At the outset, we want to emphasize that we do not support the new financial reporting model which is contemplated by the GASB. We appreciate the fact that a great deal of effort has been devoted to this project. However, we believe that the proposed reporting model is an attempt to be all things to all users. We feel it will create more problems than it will solve.

We have several significant objections to the proposed reporting model. We know that the GASB has heard most, if not all, of these objections earlier in its consideration of the model. Obviously, the objections have not dissuaded the GASB from pursuing its present course. Nevertheless, we will voice our objections in the hope that changes will be made to the model before financial reporting by governments becomes totally unwieldy and too complex to be effectual.

OBJECTIONS TO THE PROPOSED REPORTING MODEL

Dual-Perspective Reporting

The first and most important of our objections concerns the very concept of dual-perspective reporting. Dual-perspective reporting is at the heart of the proposed reporting model. Financial reporting using the dual-perspective would be extremely confusing as it would present much of the same financial information in two different ways. Any discussion of the varying objectives of the two perspectives in a Management's Discussion and Analysis notwithstanding, all but the most sophisticated users would find it difficult to understand why financial statements using different bases of accounting and measurement focuses are necessary. Indeed, from legislative bodies and citizens, we expect that we would often be asked the question, "Which are the *real* financial statements?"

Not only would dual-perspective financial statements be difficult to understand, they would be difficult and costly to prepare. Even under the current reporting model, the preparation of financial statements is a very time consuming, labor intensive task. For most governments, it is a task which takes several months to accomplish. Dual-perspective reporting certainly would require increased resources because it is more complex. If the proposed reporting model is adopted and a government simply does not have enough professional staff to prepare its financial statements in-house, the government would have to rely on its auditors to prepare them. All four of the auditing firms represented on our committee have stated that they would have no choice but to significantly increase their fees if dual-perspective reporting is adopted. If already preparing the financial statements for a given client, the auditors on our committee have indicated they would charge more for preparing statements using the dual perspectives because doing so would require more staff time. In fact, one of the audit firms on our committee stated that it has been placing a fee qualification in the proposals it has made recently on multi-year engagements. That firm is reserving the right to increase its fees if dual-perspective reporting is adopted.

Given the confusion which dual-perspective reporting would create and the burden it would place upon governments, we believe that it is possible that some governments may elect to abandon financial reporting based upon generally accepted accounting principles (GAAP). These governments may decide to prepare their financial statements in accordance with the current model and accept any less-than-unqualified audit opinion that may be issued. We do not believe that the need to secure or maintain a bond rating would deter a government from following this path. If a government which does not prepare its financial statements in accordance with GAAP needs to obtain a bond rating or update a bond rating firm on its financial condition, it could simply work with the bond rating firm to provide any supplementary information which the rating firm may request. Understanding the problems with dual-perspective reporting, bond rating firms may become accustomed to less-than-unqualified opinions and adjust their operations to deal with financial statements which carry such opinions. With bond rating firms already accustomed to analyzing financial statements with qualified opinions related to fixed assets, further adjustments in their analytical procedures may not be difficult to make. Illinois GFOA Response to ED on Basic Financial Statements for State and Local Governments

Infrastructure Reporting

Our objection to dual-perspective reporting aside, we find the provision in the proposed reporting model which would require the reporting of infrastructure assets acquired during the 25 years preceding the effective date of the statement at the entity-wide level to be fraught with problems. First, accumulating actual cost data for a past 25-year period would be very burdensome. Data extending so far into the past may not be available. These points are conceded in the ED and two methods are offered for estimating the cost of a government's infrastructure. However, infrastructure could comprise a large proportion of the reportable assets of many governments. Governmental financial reporting has always required the use of judgment and estimates. Yet never have the preparers of financial statements been asked to make an estimate which could potentially have such a large financial statement impact. Conceivably, under the proposed reporting model, one half or more of the amount of a government's total assets could be arrived at through an estimate. We believe this goes too far. If, over our vehement objections, the GASB adopts the proposed reporting model, the historical cost of infrastructure assets should not be estimated to any significant degree. Thus, we find that only the prospective reporting of infrastructure assets is justifiable.

We are compelled to add that a requirement to report infrastructure at the entity-wide perspective reporting will have a marked impact upon audit costs. Under the current reporting model, auditors need not spend much time examining general fixed assets even if a government opts to report infrastructure in its financial statements. General fixed assets have no effect on the operating statements and present little risk to an auditor. However, if general fixed assets, especially high-cost infrastructure, affect a government's operating statements, auditors will need to devote significant time to testing the related transactions. As a result, audit costs will increase. This further supports the point we made above that the proposed reporting model would make GAAP-basis financial statements much more costly to prepare.

Statement of Activities at the Entity-Wide Perspective

We believe that the combining of governmental and business-type activities at the entity-wide perspective in a Statement of Activities is ill-advised. The format of the Statement of Activities would only prompt inappropriate comparisons between governmental and business-type activities. Some financial statement readers will surely come to the conclusion that business-type activities pay for themselves but governmental activities do not. This will cast governmental activities in a poor light. We do not believe that it is meaningful to compare the public safety function (which would likely report a net expense before general revenues) with the water function (which probably would have net revenue before general revenues). The current reporting model, which reports governmental and proprietary activities separately in the general purpose financial statements, properly does not elicit such comparisons. It recognizes that governmental and proprietary activities are fundamentally different. Consequently, the combined operating statements in the current model are preferred over the Statement of Activities.

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Budgetary Comparison Statement at the Fund Perspective

We object to required presentation of both original and final budget amounts in the Budgetary Comparison Statement at the fund perspective. Traditionally, the purpose of presenting budget amounts in governmental financial statements has been to demonstrate compliance with legal spending restrictions. Only final, amended budget amounts are relevant to this end. Although governments may adopt budget amendments near the end of a fiscal year or even afterwards, legal compliance has been achieved in these cases and that is all that needs to be reported.

In addition, having two columns related to the budget in the Budgetary Comparison Statement injects unnecessary complexity. The financial statements of governments have been criticized in the past for their complexity. Much of this criticism has arisen from the fact that governmental financial statements typically have numerous columns. Similar to other features of the proposed reporting model, the presentation of two budget-related columns would make governmental financial statements more difficult to understand.

RECOMMENDATIONS

We believe that the current reporting model should be retained. It has served financial statement users well for many years. In the governmental funds, the flow of current financial resources measurement focus and modified accrual basis of accounting have yielded the information needed to make important financial management decisions and enable meaningful financial analysis. In addition, the current financial reporting model produces financial statements that a citizen, who makes a modest effort to inform himself or herself, can understand. The same cannot be said for financial statements which would be prepared under the proposed reporting model.

Having definitively endorsed retention of the current reporting model, we see certain features of the proposed model which are attractive. Those features are identified below. We believe that all of these features can be incorporated into the current reporting model.

1) Requiring a Management's Discussion and Analysis (MD&A). We believe that an MD&A could be very helpful to a reader in understanding and interpreting the financial statements of a government. We maintain, however, that *only* currently known facts, decisions, and conditions should be covered. The MD&A included in the proposed reporting model appears to go somewhat further than that. For example, the illustrative MD&A in the ED includes a section entitled "Outlook for the Future" (page E-9). This section discusses projections and budget estimates. Such matters are better addressed in a transmittal letter. This would make the MD&A more auditable. Also, the MD&A should not include "a discussion of whether the government's financial position has improved or deteriorated as a result of the year's activities" (paragraph 26e of the ED). Such a highly subjective assessment is also better presented in a transmittal letter.

2) Eliminating Expendable Trust Funds. Eliminating the reporting of expendable trust funds would serve to simplify reporting to a degree.

3) Revising the Definition and Reporting of Fiduciary Funds. We applaud the proposed redefinition of fiduciary funds as activities for which a government acts as a trustee or agent for individuals or organizations outside of the government. We also see great merit in limiting the reporting of the fiduciary funds because they have little bearing on the financial condition or position of a government. Incorporating this concept in the current reporting model, fiduciary funds should not be reported above the combining level.

CONCLUSION

It appears to us that with the dual-perspective approach, the GASB has indeed attempted to be all things to all people. By presenting governmental activities on both an accrual and modified accrual basis of accounting, the GASB is trying to meet the needs of multiple user groups. However, if the proposed financial reporting model is adopted, we will be left with financial statements that are actually less useful and much more costly than those which the current reporting model provides us.

We believe financial statements should not attempt to present all possible information about a government. For example, if an individual wishes to know how well a government is diversifying its work force, he or she should not expect to find that information in the government's financial statements even though the government may suffer financial loss for failing to exercise fairness in its hiring practices. As another example, if a citizen wants to know how well his or her government is maintaining its infrastructure, he or she may need to request an engineering report from the government.

In Concepts Statement No. 1, the GASB recognized that financial reporting cannot do it all:

Financial reporting is only one source of information needed by users to make decisions about state and local governments. Governmental entities - and those who have an interest in them - are affected by numerous factors that interact with each other in complex ways. To make decisions, users need to combine the information provided by financial reporting with other pertinent information... (Paragraph 71 of Concepts Statement No. 1)

Also in Concepts Statement No. 1, the GASB concurred with the FASB's approach to the adoption of accounting standards:

Before a decision is made to develop a standard, the Board needs to satisfy itself that the matter to be ruled on represents a significant problem and that a standard that is promulgated will not impose costs on the many for the benefit of a few. If the proposal passes the first test, a second test may be subsequently useful. There are usually alternative ways of handling an issue. Is the one of them less costly and only slightly less effective? Even if absolute magnitudes cannot be attached to costs and benefits, a comparison between alternatives may yet be possible and useful. (Paragraph 94 of Concepts Statement No. 1)

We implore the GASB to reevaluate the direction of this project, both in terms of the complexity and costs of the proposed reporting model. The current reporting model is not so seriously deficient that drastic corrective action is necessary. Some of the concepts included in the proposed reporting model, those endorsed above, would enhance governmental financial reporting. Let's incorporate those into the model we now have and really make some progress.

We appreciate the opportunity to respond to the ED. If the Board has any questions or needs clarification on any matter we have discussed, please let me know. I may be reached at (847) 392-6000.

Sincerely,

C:

Brian W. Caputo

Brian W. Caputo, C.P.A. Chair Technical Accounting Review Committee

Richard A. Schnuer, President, IGFOA Marianne Shank, Executive Director, IGFOA Each IGFOA TARC Member Stephen J. Gauthier, Director of Technical Services, GFOA Irwin A. Lyons, Miller Cooper & Co. Dr. John H. Engstrom, Northern Illinois University