ILLINOIS
GOVERNMENT FINANCE
OFFICERS ASSOCIATION
Incorporated 1958

November 28, 1995

Mr. David R. Bean
Director of Research
Project No. 18-1i
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 700 members comprised of public finance officers, auditors, accountants, bankers, and others interested in public finance in the state of Illinois. The organization is dedicated to the common objective of promoting and improving methods of public finance so as to enhance the quality and efficiency of government.

To assist in achieving its objective, 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. In fulfilling this purpose, we have consistently responded to due process documents issued by the Governmental Accounting Standards Board. The following is our response to the Exposure Draft (ED), Accounting and Financial Reporting for Capitalization Contributions to Public Entity Risk Pools, An Interpretation of GASB Statements No. 10 and 14.

In the ED, comments are requested on three specific issues. I will address those issues in turn.

Issue 1 - *Reporting a Capitalization Contribution as a Deposit or Prepaid Insurance*

a. We believe that reporting a capitalization contribution as a deposit or as prepaid insurance, depending on the likelihood of the return of the contribution, is appropriate. However, we recommend that the interpretation state that financial statement preparers should consult the by-laws of the risk pools in which they participate to determine the circumstances under which their capitalization contributions will be returned. Reviewing the by-laws will

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provide a sound basis for assessing the likelihood of the return of a capitalization contribution. A capitalization contribution should only be recorded as a deposit if the risk pool by-laws suggest that the return of a capitalization contribution is probable.

b. We believe that the periods for which coverage is expected to be provided are an appropriate basis for allocating prepaid insurance over future periods.

Issue 2 - *Reporting a Capitalization Contribution as an Equity Interest*

We do not believe that an entity should be allowed or required to report its participation in, or capitalization contribution to, a public entity risk pool as an equity interest. We subscribe to the theory expressed in paragraph 19 of the ED; that is, the truest measures of a pool participant's share in a pool's experience are premiums, required contributions, refunds, and dividends. Furthermore, use of the equity method would effectively permit the recording of a gain contingency if a pool has net income in a fiscal period. The recording of gain contingencies is a direct contravention of FASB Statement No. 5, paragraph 17.

Issue 3 - *Reporting a Capitalization Contribution Received as a Liability or Unearned Premiums*

a. We believe that reporting a capitalization contribution as a liability or as unearned premiums, depending on the likelihood of the return of contribution, is appropriate.

b. We believe that the periods for which coverage is expected to be provided are an appropriate basis for allocating unearned premiums over future periods.

We appreciate the opportunity to respond to the ED. If the board has any questions or needs clarification on any issue, please let me know. I may be reached at (708) 882-9100.

Sincerely,

Brian W. Caputo

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

cc: Leonard J. Flood, President, IGFOA
Marianne Shank, Executive Director, IGFOA
Each IGFOA TARC member

Replaces No. 78

TESTIMONY OF

Brian W. Caputo, C.P.A.
Illinois Government Finance Officers Association

Before the
Governmental Accounting Standards Board
November 10, 1995
Elmhurst, Illinois

Concerning
The Governmental Financial Reporting Model:
Core Financial Statements

Good morning. I am Brian Caputo, the Assistant Director of Finance of the Village of Hoffman Estates, Illinois. Today, I am representing the Illinois Government Finance Officers Association (IGFOA). At present, I serve as the Chairman of the IGFOA's Technical Accounting Review Committee. I very much appreciate the opportunity to speak to you today concerning the Preliminary Views (PV) document which you have released, Governmental Financial Reporting Model: Core Financial Statements.

First, permit me to briefly tell you about the organization I represent. The IGFOA is an organization in excess of 700 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 developing better understanding and cooperation among those concerned with public jurisdictions and other objectives of mutual interest to public finance officers.

The IGFOA has several committees actively involved in the achievement of greater success in efficiency and service of government. The Technical Accounting Review Committee was created for the purpose of reviewing accounting, auditing, and financial reporting requirements as they effect the membership of the IGFOA. In fulfilling this purpose, we have consistently responded to due process documents issued by the GASB.

We believe we have become well acquainted with your work on the financial reporting model. In October of 1994, we responded to your Invitation to Comment (ITC), Government Financial Reporting Model. In our response, we expressed our serious concerns about both models under consideration at that time. Many of the concerns we expressed then continue to apply to the model addressed in the PV. I would now like to discuss those concerns. My testimony is organized by major issue areas.

Measurement Focus and Basis of Accounting

In the PV you introduce the concept of dual-perspective reporting. We recognize the dual-perspective approach is an attempt to meet the needs of a diverse group of financial statement users. However, we believe that presenting essentially the same financial information on two different bases will not be more informative to financial statement users. Any brief explanation which might be provided in a Management Discussion and Analysis notwithstanding, the use of two different bases of accounting would be far more likely to confuse financial statement users, particularly those who are not highly sophisticated.

Several practical problems are evident to us with the dual-perspective approach. First, the question will be asked by some users, "Which financial statements are the 'real' ones?" Although as public finance professionals we can answer this question, it should not need to be asked. Having two sets of financial statements gives the impression that governmental accounting and reporting are imprecise. Second, the fact that numbers appearing in fund perspective statements could not be traced to the entity-wide perspective statements would suggest to some financial statement readers that something has been lost. Requiring that a reconciliation be included in the financial report to detail the differences between the two sets of financial statements would remedy this problem to a degree. However, such a reconciliation would be complicated and difficult to prepare for anything other than the most simple financial statements.

Third, the dual-perspective approach would undoubtedly increase the amount of time necessary to prepare financial reports and would increase audit costs. The preparation of financial reports is already an onerous task, especially for small governments. Dual-perspective reporting will be more than many governments can handle with the staff resources available. Because auditing firms would be asked to opine on financial statements prepared on two different bases of accounting, additional testing would be required. This additional testing would certainly lead to higher audit costs.

In our response to the ITC, we presented an alternative model which simplified the current top-of-pyramid reports but retained the measurement focus and basis of accounting of the underlying fund statements. A few moments ago we provided you with that revised model. The revised IGFOA model incorporates the points which I will be making. The primary difference between the revised IGFOA model and our previous model is that the revised model includes a "capital asset fund," which I will also discuss. You may recall that our top-of-pyramid statements included two columns, one for "tax-financed funds" and another for "fee-financed funds," with no total column. Our revised model again uses the flow of total financial resources measurement focus and accrual basis of accounting in the "tax-financed funds" (which we have renamed "governmental activities" in the revised model) and the flow of economic resources measurement focus and accrual basis of accounting in the "fee-financed funds" (which we have renamed "business-type activities" in the revised model).

We ask that you reconsider our model. We assert that the measurement focus and basis of accounting which is appropriate at the fund level is also appropriate at the top of the pyramid. We believe that having columnar totals carry forward from one level of the pyramid to the next is an important feature which should be retained. At the same time, reports can be simplified by preparing top-of-pyramid statements with only two columns as we did in our model. Three columns would be shown if discretely presented component units are involved as I will describe later.

Fixed Assets and Infrastructure Reporting

Consistent with our discussion concerning measurement focus and basis of accounting, we do not believe that fixed assets and infrastructure belong in the financial statements of governmental type funds. Our experience has been that the users of these financial statements rely on them to provide information concerning the flow of financial resources. However, we do acknowledge that it would be helpful for financial statements to communicate how much of a government's fixed assets (motor vehicles, computer hardware, etc.) have been consumed in providing services. We maintain that the best way to do this, without degrading the usefulness of the financial statements of the governmental type funds, is to require that governmental fund fixed assets, but not infrastructure, be recorded in a "capital asset fund." This fund would be an internal service fund.

The revised IGFOA model which we have presented to you includes a capital asset fund. In that fund, we have recorded all of governmental fund fixed assets through debits and their funding sources through credits. When the capital asset fund is created, the entry to record fixed assets previously purchased with operating revenues should include a credit to fund equity.

We propose that depreciation or a capital use charge be recorded for the fixed assets in the capital asset fund. The revenue of the fund would be operating charges or transfers from the appropriate governmental funds. Of course, governments would have the option of actually assessing the charges or making the transfers. However, a government's funding practices will give financial statement readers some insight into how well future fixed asset replacements are being funded.

We believe that infrastructure, as defined by NCGA Statement No. 1, should be recorded in the capital asset fund at the option of the reporting entity. We take this position because it can be argued that infrastructure is not directly related to a government's provision of services. In addition, recording infrastructure in the capital asset fund would likely cause the fund's operating statement to show deficits in most years. This would be the case because large depreciation charges might not be offset by operating charges (i.e., revenues) or transfers-in as the vast majority of governmental units fund their infrastructure expenditures with long-term debt. In short, recording infrastructure in the capital asset fund could obscure the fund's financial statements. The same would be true for the entity-wide financial statements contemplated in the PV.

The Statement of Activities

For three reasons, we take strong exception to the attempt made in the PV to match the expenditures of a government's programs with any corresponding revenues. First, most governments do not intend for their general governmental programs to be self-supporting. Showing many programs running a deficit, including probably public safety and highway and streets programs, draws attention to a matter which is of little importance. Second, for those governments which decide to allocate as much of their revenue as possible to specific programs, revenue allocation could become a totally arbitrary exercise. Thus, a financial statement reader could actually be misled concerning the self-sufficiency of a given program.

Our third concern pertains to the program approach itself. The PV appears to be promoting or perhaps even compelling the use of program accounting and budgeting, as well as the costing of government services. For example, you state in paragraph 11a on page x of the PV that "The Statement of Activities should be reported using a 'net *program* cost' format." (I emphasize the word "program" here.) Although the program approach certainly possesses distinct advantages, many governments prefer accounting and budgeting by line item. They believe that the line item approach is better suited to their organizations. We feel that the decision to adopt a program approach should be left to the management of the individual government. Additionally, to the extent that the reporting model would influence the budgeting practices of governments, we must point out that budgeting issues are beyond the scope of the GASB's authority.

In essence, we suggest that an operating statement be adopted which is generally similar in format to the present combined statement of revenues, expenditures, and changes in fund balances. Furthermore, governments should have far more flexibility in the detailed formatting of their operating statements than appears to be contemplated in the PV.

Budgetary Reporting

We feel that it is ill-advised to include originally budgeted amounts in fund operating reports when amended budgets have been adopted. With respect to expenditures and expenses, the reason for including budgeted amounts in financial statements is to demonstrate compliance with the legal authority to spend. That authority is represented by the final amended budget. Presenting the originally budgeted amounts obviously invites questions. These questions cannot be adequately answered in the financial statements without greatly adding to their volume. We assert that questions about why a budget revision is or was necessary are much more appropriately and effectively addressed through budget hearings, legislative meetings, and other contacts with the public which permit dialog.

Statement of Cash Flows

As you are in the process of developing a new reporting model, this would be the opportune time to discontinue the requirement for the statement of cash flows. Our experience has been that few of those who read the financial statements of governments understand the cash flows statement; an even smaller number actually use it. The cash flows statement is important for commercial business entities whose investors and potential investors need to measure a firm's ability to weather seasonal business cycles. But for a governmental entity, this need is far less significant, even for its proprietary activities.

If you decide to retain the statement of cash flows, we would strongly encourage you to permit its presentation using either the direct or indirect method. While the direct method is more theoretically pure, we have found that statements prepared under the indirect method are more useful to financial statement readers. Beginning the cash flows statement with operating income, as is done under the indirect method, and reconciling it ultimately to the change in cash provides a practical orientation to financial statement readers concerning the difference between accrual and cash-basis accounting. If the cash flows statement has any redeeming value for governments, this feature provides it.

Definition of an Enterprise Fund

We applaud your attempt to better define what constitutes an enterprise fund. We believe the guidelines included in the PV would be very helpful. Yet, we recommend you go one step further. It appears to us that your guidelines attempt to ensure that activities such as water and sewer systems, transit systems, and other activities operated with the intent to recover costs through fees be accounted for as enterprise funds. If this is your intent, it would be best if you were explicit. That is, the new model should require that water and sewer systems, transit systems, and other activities operated with the intent to recover costs through fees be accounted for as enterprise funds.

Extraordinary Items

We take exception to what you would report as extraordinary items in the governmental funds. Liberal application of the "one-time" criteria presented in the PV might suggest that many items which are not truly extraordinary would be classified as "extraordinary items." Capital projects offer an excellent example of this. Many capital projects are one-time in nature but to report them as extraordinary items would be a dramatic, undesirable departure from current reporting practices. At a minimum, the definition of an extraordinary item should be refined.

Trust and Agency Funds

Currently, a workable definition of trust and agency funds does not exist. As a result, some governments report agency funds in cases where other types of funds actually should be reported. A revised definition, which establishes clear criteria for what is and is not a trust or agency fund, is needed.

We do not believe that reporting trust and agency funds in the body of the financial statements is necessary because governments do not have genuine control over them. Disclosure in the notes to the financial statements would be sufficient. Pension trust fund disclosures should be in accordance with GASB Statement Nos. 25, 26, and 27.

Discretely Presented Component Units

We disagree with the proposal to limit the reporting of discretely presented component units to the fund perspective. We find no persuasive argument for this. If a component unit is deemed to be enough a part of the government to be included at the fund perspective, its financial activity should be carried forward to the entity-wide perspective/top of the pyramid. As alluded to above, the financial information related to discretely presented component units should be shown in a third column in the top-of-pyramid statements.

Should you decide to retain pension trust funds in the body of the financial statements, reporting of their financial information should not be limited to the fund perspective. As with other discretely presented component units, pension trust fund information should be brought forward to the entity-wide perspective/top of the pyramid. To do otherwise would obfuscate the top-of-pyramid statements.

Management Discussion and Analysis, Transmittal Letter, and Notes to the Financial Statements

One of the primary purposes of the proposed introduction of a Management Discussion and Analysis (MD&A) is to explain the objectives of dual-perspective reporting. If dual-perspective reporting is abandoned as we suggest, the need for an MD&A is reduced.

Another purpose for the MD&A would be to discuss matters which could have an impact on a government's financial position, results of operations, or financial condition. This essentially asks that a government's management look into the future. Although a government certainly should examine its future, the annual financial report, which is subject to audit, is not the place to present its analysis in this regard. Auditing such a discussion would be virtually impossible and would most likely result in qualified audit opinions. A government's view of its future would more appropriately be presented in an optional transmittal letter. In fact, the other items you would have discussed in an MD&A (Chapter 5, paragraph 8b-d of the PV) should be addressed in an optional transmittal letter not subject to audit.

It is disconcerting to us that the GASB is seeking to make the matters proposed for an MD&A an integral part of the financial statements. In reality, these matters are not true financial information. Here again, the GASB appears to be moving into an area which is not within its jurisdiction.

Finally, in the exposure draft on the reporting model, we recommend that you include proposed note disclosures. Doing so will provide a better picture of what financial statements using the new model will really look like. The proposed note disclosures should be scaled down as much as possible. The purposes should be to 1) explain important points directly related to the financial statements which cannot be conveyed with numbers and 2) to present important financial information which would obscure the financial statements if included in them, such as trust and agency fund information. No attempt should be made to teach accounting or financial statement interpretation.

In closing, I once again thank you for the opportunity to testify this morning. I and certain other members of our Technical Accounting Review Committee who are here today would be happy to answer any question you may have.