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September 9, 2022

Governmental Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856

RE: Comments on GASB Project No. 3-41, Exposure Draft – *Certain Risk Disclosures*

The Financial Management Standards Board (FMSB) of the AGA appreciates the opportunity to provide comments on the Governmental Accounting Standards Board's proposed standards.

G.1 Which of the proposals in the Exposure Draft do you agree with?

We agree with disclosure of meaningful concentrations and constraints that exist as of the financial statement date or that arose as a subsequent event.

G.2 Which of the proposals in the Exposure Draft do you disagree with?

In general, we disagree with the objective of creating an "early warning" disclosure, since this would be prospective analysis rather than general purpose historical financial reporting. We are accordingly unclear how this approach would meet the GASB Concept Statement No. 7 paragraph 7 guidance that disclosures support items recognized in the financial statements, since an "early warning" is a disclosure of the potential for future recognition rather than recognition of a financial effect that has already occurred, even as a subsequent event. Specifically, we note that GASB Concept Statement 7, paragraph 10 reads "The following types of information are not appropriate for notes to financial statements: ... Predications about the effects of future events on future financial position."

We can currently observe that there is a high degree of variability in judgments about government finances with regard to likelihood of events, relevance of events, implications of events, nature of impacts, likelihood of impacts, magnitude of impacts, timeframes for impacts, and especially about the potential effectiveness of mitigating actions. We can also observe that the high variability in these judgments can often be included in political rhetoric and justification for political decision-making by governing officials, rather than being confined to more academic differences of opinion among financial managers or analysts. We see this as evidence that a high-leverage disclosure requiring this degree of layered subjective judgments will not have a sufficient degree of consistency or reliability for financial reporting.

For example, in Illustration 2 management of the school district determined that it is more likely than not that the State Legislature will approve the proposed reduction in funding. However, some members are confident based on their experiences with legislative sessions that in such a situation, there will likely be

many other school districts that would determine the opposite, resulting in inconsistent disclosure of the same event by different school districts across the state. During a legislative session, there are often varied expert opinions on what will happen and drastic changes to predictions, even up to the last minute. Moreover, individual local governments and their auditors would not be in a position to have evidence that amounts to anything more than “hearsay” regarding the matter. Based on actual experience, guesses made by local government officials – and the degree of confidence in their guesses – will vary widely. To expect school districts to all arrive at the same determination would be unreasonable. And to expect that a high-leverage disclosure is based on what is essentially a guess is inappropriate. In the case of districts that disclose the matter, there is a significant probability that the disclosure will be proved incorrect (either wholly or to a significant degree) within two months. For other districts that determined the opposite, the situation would be undisclosed.

G.3 Do you believe that the information resulting from the proposed disclosure requirements in the exposure draft would be utilized by users in their analyses for decision making?

As proposed, the disclosure seems to be intended to apply only in a narrow set of situations where the preparer is giving an “early warning” as an alert about the likelihood of future financial difficulty – either for users who are not currently performing their own analysis, or as a supplement or replacement for those who are performing their own analysis or relying on a third-party rating or analysis.

In contrast, simply providing information about the existence of concentrations and constraints without the prospective disclosure criteria would provide information for users in making their own forecasts or risk analysis. By conditioning disclosure on predictions of unmitigated future effects, governments would not disclose concentrations or constraints that are relevant but are either considered by the government to be mitigated or unlikely to have a substantial effect. Full disclosure of such concentrations and constraints that the government would be relevant to user analysis, as evidenced by the fact that certain types of concentrations and constraints are already required by bond documents and in the ACFR statistical section, regardless of any forecasted events or impacts.

G.3.a What types of users would utilize the information and how would they utilize it?

We expect that when present, such a disclosure would be used as a negative factor by bond analysts. Such a disclosure may also lead to negative media attention.

Some members felt that investors or analysts may use the disclosure requirement to transfer risk to the preparer and auditor and thus increase exposure for litigation in situations where a default or ratings decline occurs that was not sufficiently preceded by an “early warning” disclosure. This concern is more acute given the highly subjective nature of the criteria, which could be easily questioned in hindsight.

G.4 Do you believe that the proposed provisions in the exposure draft would be operable and auditable?

No. As we discuss further in our response to question S.6, it is possible to interpret the disclosure criteria in such a way that virtually every government would be subject to disclosure for regular business conditions and budgeting priorities that are normal to both public and private entities. But assuming an interpretation in line with the Board's stated purpose of an "early warning," we felt that most governments would not report anything and thus the true burden of evaluating whether there is such a situation would fall to auditors, who are not in a position to do this effectively.

Preparers and auditors felt comfortable with identifying and disclosing relevant constraints and concentrations, and with reporting subsequent events and substantial doubt about the ability of the government to continue as a going concern. However, neither preparers nor auditors were comfortable with the idea of estimating the likelihood of an event occurring, which had an estimated effect - offset by estimated effects of mitigating actions - occurring at an even more distant estimated time. For audit purposes, there would need to be sufficient appropriate evidence supporting the underlying assumptions and judgments made by management, which in most cases would not be readily auditable.

Reasons for this concern were as follows:

- Some members felt this type of forecasting or analysis was a different skill-set from financial accounting.
- Other members speculated that governments that might be subject to such disclosures would be highly disincentivized to disclose and would likely be in that spot because management and the governing body do not believe it will result in negative outcomes - or are otherwise personally invested in political positions or rhetoric to the contrary.
- Still other members drew on personal experiences to point out that governments that do not wish to disclose a particular risk could almost always assert that mitigating actions have taken place that would appear plausible when considering a three or four year future timeframe.
- Finally, other members suggested that preparer and auditor evidence would sufficiently support the presence or absence of such risks would be challenging at best.

S.1 Do you agree or disagree with the scope and applicability (par 3)?

We agree with disclosure of concentrations and constraints, since these are applicable and meaningful in the government environment.

S.2 Do you agree or disagree with the proposal to include risks related to certain concentrations and the description of that risk (par 4)?



We agreed with inclusion of concentrations and the examples provided in the exposure draft.

S.3 Do you agree or disagree with the proposal to include risks related to certain constraints common in the governmental environment and the description of that risk (par 5)?

We agreed with inclusion of constraints and the examples provided in the exposure draft.

However, we are somewhat concerned with the criteria that constraints may be imposed by formal action of a government's highest level of decision-making authority. This criteria is aligned with GASB 54 criteria for committed fund balance. However, in the experience of our members, this criteria is too easy for local governments to change to be considered a true constraint, since there is not typically a balance of powers. In contrast, state governments have a balance of powers and a large, diverse legislative body. We would therefore encourage the Board to consider limiting the criteria for constraints to only those imposed by external parties, constitution or state law. We see this as a current problem with GASB 54 that is being repeated in the proposed standard.

S.4 Do you agree or disagree with the proposed disclosure criterion that an event associated with the concentration or constraint has occurred or is more likely than not to begin to occur within 12 months of the financial statement date or shortly thereafter (par 6b)?

We disagree on two points. First, we find the criteria of "within 12 months of the financial statement date or shortly thereafter" as too noncommittal. If this is intended to be 15 months, then the standard should clearly state that the period is 15 months. We would further suggest that the FASB definition of 12 months from the date of financial statement issuance would be an even more appropriate to use as a criterion.

Secondly, we disagree with the notion of disclosure based on an estimate of the possibility of an event occurring. Such an approach would directly contradict guidance of GASB Concept Statement 7, paragraph 10. Accordingly, we believe that if disclosures will be conditioned on an estimate of the net effects of events, that the events in question should have already occurred as of the financial statement date or as a subsequent event.

S.5 Do you agree or disagree with the proposed disclosure criterion that it is at least reasonably possible that the effect of the event will be felt within three years of the financial statement date (par 6c)?

As discussed above, we disagree with the notion of conditioning disclosures on these types of estimates.

S.6 Do you agree or disagree with the proposed disclosure criterion that the event will have a substantial effect on the government's ability (1) to continue to provide services at the level provided in the current reporting period or (2) to meet its obligations as they come due (par 6c)?

If disclosure is to be conditioned on the estimated future effects of events, we would agree with criteria (2) as this aligns with conditions for substantial doubt about the ability of the government to continue as a going concern and is more converged with the concept of "severe effect" used by the FASB.

However, we disagree with criteria (1) regarding continuing to provide services at the level provided in the current reporting period. We find this criteria far too ambiguous, such that it could possibly be viewed as applying to virtually every challenge or risk faced by governments. It is unclear how granular "services provided" are to be evaluated, whether to measure the change in the level of services provided based on dollars, non-financial inputs, non-financial outputs, or outcomes, what level of change triggers the criteria, and how to differentiate a changes in service that is an "effect" of an event as opposed to an effect of the government's mitigating action, policy decision, or strategic prioritization.

For example, Illustration 4 describes a situation where a government experiences a need for large capital expenditures and – like all organizations public and private – is constrained by a lack of infinite resources. The government therefore has to use normal business strategies such as (a) capital financing, (b) pursuing grants or taxes to increase revenues, or (c) making prioritization or cost-cutting decisions to decrease other non-capital expenditures. While the situation will take many years to work through, during which the government has ample opportunity to employ different strategies if their vote does not work out, there remains a reasonable possibility during those years that cost-cutting in other areas besides capital spending will be a solution. However, the illustration demonstrates the ambiguity of the "level of service" criterion. Namely:

- Is capital construction not considered to be "services provided"?
- Is "services provided" considered on a granular level such that the disclosure would apply any time a government decreases any previously offered category of service by making a budget priority decision to shift spending to other categories of service?
- If total spending increases, is it considered a decrease in services if amounts are less on an inflation-adjusted basis, or if inputs, outputs or outcomes decreased?
- If government officials believed that costs to be cut would come from low performing programs or low priority areas or would be temporary and not result in a long-term decrease in service, then would the disclosure criterion be met? What if there were strong differences of opinion among government officials on this point?

S.7 Do you agree or disagree with the proposed disclosure requirement to provide a description of the concentration or constraint and associated event (par 7a and 7b)?

We agree with the proposed disclosure requirements.

S.8 Do you agree or disagree with the proposed disclosure requirement to provide a description of mitigation action taken (par 7c)?

We would agree that the government's mitigating actions would be relevant to the disclosure and should be included.

However, if the estimated effect of mitigating actions are considered as an offset to disclosure criteria, then it would be helpful if this was more clearly described as part of the disclosure criteria in paragraph 6 rather than as an aside in paragraph 7.

With regard to mitigating actions, illustration 5 describes a situation where a utility encounters a large expected cost increase. However, to the extent the cost increase is realized, the utility will simply increase rates to cover the new cost (assuming no cost reduction policies or actions are taken). This happens commonly and in fact it is so commonplace that the GASB has allowed for utilities to use regulatory accounting. If for some unthinkable reason the utility refused to act and defaulted on their debt, bondholders could actually compel the utility to raise rates. However, the illustrated disclosure unfairly presents the situation as an impending doubt to going concern for the utility when in fact there is no real risk at all. While perhaps this could be addressed with more sophisticated criterion for incorporating mitigating actions, we see this as an inherent issue with "early warning" disclosures of potential effects so far in the future that the government simply hasn't had time to employ normal business strategies or reasonably certain mitigations.

S.9 Do you agree or disagree with the proposal that disclosures generally should be provided for the primary government, unless the risk is specific to a reporting unit, in which case the information be provided for that reporting unit (par 8)?

Our group was confused by the way that paragraph 8 was written, and interpreted it as meaning that if a concentration or constraint is specific to a component unit, then it should be reported in the component unit's separately issued financial statements. If the Board intends for disclosure to be at the reporting unit level, then the standard should be phrased clearly.

However, we would point out that disclosure at the reporting unit level would create a conflict with the disclosure criteria in paragraph 6. Disclosure criteria of paragraph 6c is "on the government's ability" which we would take as meaning the primary government. Moreover, the risk that is ostensibly being addressed is going concern, which applies only at the primary government level.

In other words, either the disclosure criteria would appear to preempt any situation that exists only at a reporting unit level (but not at a primary government level), or the requirement of paragraph 8 could be



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viewed as ambiguously expanding the criteria of paragraph 6c to somehow apply at a reporting unit level. In any case, the proposed language is not effective.

S.10 Do you agree or disagree with the proposed effective date of fiscal years beginning after Jun 14, 2023 (par 9)?

We had no concerns about the proposed effective date.

O.1 What other feedback would you like to provide about the exposure draft?

We note that the recent *Financial Reporting Model Improvements* exposure draft proposes new content for Management's Discussion & Analysis on "currently known facts, decisions or conditions." It is unclear to us how this content might overlap with this disclosure, since concentrations and constraints are not specifically mentioned although some of the examples appear to be the same or similar. In any case, we see MD&A as a more appropriate placement for management's prognostications about which concentrations or constraints may have significant impacts in the future, if not mitigated.

Sincerely,

A handwritten signature in black ink, appearing to read 'Scott DeViney', with a large, sweeping flourish at the end.

Scott DeViney, CPA
Chair, Financial Management Standards Board



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AGA
Financial Management Standards Board

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