



## ACCOUNTING

## Theory in Practice?

GASB's New Concepts Statement on Note Disclosures and ... a Proposal for More Notes!

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In June 2022, the Governmental Accounting Standards Board (GASB) issued its latest expansion of the conceptual framework for governmental generally accepted accounting principles (GAAP), Concepts Statement No. 7, *Communication Methods in General Purpose External Financial Reports That Contain Basic Financial Statements: Notes to Financial Statements* (CS7). Concepts statements are not themselves GAAP standards, of course; instead, they provide current and future board members with a framework that should help to set standards that are consistent with each other and logically function together. Also in June, GASB

issued an exposure draft of a statement, *Certain Risk Disclosures* (ED), that, if adopted in final form, would require new note disclosures. Let's look at both and then consider how closely the ED seems to follow CS7.

### What's in the Concepts Statement?

Much of CS7 carries forward the preexisting concepts on note disclosures from GASB Concepts Statement No. 3, *Communication Methods in General Purpose External Financial Reports That Contain Basic Financial Statements* (CS3), with few substantial changes. As part of basic financial statements, note disclosures remain limited to

information that explains, describes, or supplements the financial statements, including:

1. Descriptions of accounting and finance-related policies underlying the amounts in the financial statements.
2. Details and explanations of those amounts.
3. Information about the financial position or results of operations that do not meet the criteria for recognition (e.g., because they are not reasonably estimable).<sup>1</sup>

CS7 added "other finance-related information associated with the

accountability of the government” to this list.<sup>2</sup> While this is a change from CS3, it is drawn from existing language in GASB Concepts Statement No. 1, *Objectives of Financial Reporting*, so it is not a substantive addition to the objectives of note disclosures so much as a way of tying them more explicitly to the overall objectives of financial reporting.

To the prohibitions against including “Subjective assessments of the effects of reported information on the government’s future financial position” and “predictions about the effects of future events on future financial position” (more on this shortly), CS7 added a carve-out explicitly permitting disclosure of “expectations and assumptions about the future that are inputs to current measures in the financial statements or notes to financial statements.” This simply acknowledges the extensive use of estimates throughout financial statements and the information about those estimates required under current GAAP. Additionally, CS7 specifies that “general or educational information that is not specific to the government” is not appropriate for notes.<sup>3</sup>

CS7 states that users “are responsible for (a) obtaining a reasonable understanding of government and public finance activities and of the fundamentals of governmental financial reporting, (b) studying the information with reasonable diligence, and (c) applying relevant analytical skill.”<sup>4</sup> The same level of user sophistication was referenced in CS3, in a slightly different context.

What is new and notable in CS7 is that characteristics of essential information are included. Like beauty, GASB’s initial research demonstrated that essentiality is in the eye of the beholder. While there is much general agreement across constituencies that note disclosures are too voluminous, seemingly every existing disclosure has its own cadre of supporters. CS7 tells us that the determination of essentiality should be based on the degree to which information [1] has, or

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is expected to have if it were available, a meaningful effect on users’ analyses for making decisions or assessing accountability, and (2) the breadth or depth of users expected to use the information for such analyses.<sup>5</sup>

#### What’s in the Exposure Draft?

The premise of the ED is that governments should be required to disclose situations where certain *concentrations or constraints* limit financial flexibility such that the occurrence of an event may have a substantial negative effect on the government’s ability to continue to provide services and meet its obligations as they come due.<sup>6</sup> The ED specifies that the level of services that were provided in the financial reporting period is the benchmark that should be used when determining if a reduction will be substantial; it provided no guidance for situations where the types or levels of services in the period were unusual (e.g., nonrecurring pandemic services and dedicated funding for them).

**Concentrations.** Governments are exposed to risks based on a lack of diversity in significant revenue sources or expenses, which may limit their ability to acquire resources or control spending. The listed examples include concentrations of principal employers, industries, and other resource providers (taxpayers, grantors, suppliers), and a workforce covered by a collective bargaining

agreement.<sup>7</sup> This is analogous to investment concentration risk in that the financial health of a government is highly dependent on a single provider of funds, labor, or materials.

**Constraints.** Similarly, governments are exposed to risks based on limitations on raising revenue (property tax caps), spending, and incurring debt, as well as mandated spending. As with concentrations, the ED points out that such constraints may limit a government’s ability to acquire resources or control spending and ultimately its ability to continue to provide services or meet obligations as they come due.

Presumably, requiring disclosure of all such concentrations and constraints would become “boilerplate,” increasing the volume of note disclosures without having “a meaningful effect on users’ analyses.”<sup>8</sup> So the ED proposes to require disclosure only in situations in which some specific event that is related to the concentration or constraint may have a substantial effect on the government’s ability to provide services or meet its financial obligations.

**Criteria for disclosure.** The ED proposes to mandate disclosure (discussed below) when:

- A concentration or constraint is known to a government prior to the issuance of the financial statements;
- 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 (for which the ED gives the example of three months);<sup>10</sup> and
- It is at least reasonably possible (the chance is greater than remote) that within three years of the financial statement date, the event will cause there to be a substantial effect on the government’s ability to either:
  - Continue to provide services at the level provided in the current reporting period, or
  - Meet obligations as they come due.<sup>11</sup>





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**Disclosure requirements.** When the above criteria are met, the ED proposes to require:

- A description of the concentration or constraint;
- A description of each associated event, including:
  - That the event has occurred or is more likely than not to begin to occur within 12 months of the financial statement date or shortly thereafter;
  - That it is at least reasonably possible that within three years of the financial statement date there will be a substantial effect on the government's ability to either
    - Continue to provide services at the level provided in the current reporting period, or
    - Meet its obligations as they come due; and
    - A description of actions taken by the government *prior to the issuance of the financial statements* to mitigate the substantial effect.

Of course, if mitigation actions taken result in the criteria for disclosure no longer be met, none of the disclosures are required.<sup>12</sup> The ED would not require governments to repeat a prior period's disclosure in comparative financial statements; however, if the criteria are still met for an event associated with a concentration or constraint, that should be included in the current year disclosures.<sup>13</sup>

### Use CS7 concepts in developing ED proposal

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#### Characteristics of essentiality.

Preliminary to issuing any exposure drafts, GASB staff members conduct research on the issue, often including discussions with relevant parties. As part of the project that led to the ED, staff members interviewed representatives of various user groups. In addition to the concentration and constraint disclosures in the ED, GASB staff had sought feedback on additional categories of risk disclosures, risks, and uncertainties pertaining to significant estimates and those unique to the government environment. Feedback showed that neither a broad range of users across all user groups ("a breadth of users") nor a large proportion of users in a specific group ("a depth of users") said that they expected to use, and could articulate how they would use, the information if it were available, so GASB removed those from further consideration.<sup>14</sup> Therefore, regarding the only significant change made by CS7, the ED proposal can be seen as an appropriate application of the new concepts statement.

**Predictions.** As mentioned above, CS7 retained and reiterated the

conceptual framework's warning *against* including "predictions about the effects of future events on future financial position" in note disclosures. Nonetheless, that the ED proposes to require governments to predict both the likelihood and the magnitude of future events,<sup>15</sup> which GFOA and others observe seems like GASB is not putting their theory into practice. ❏

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<sup>1</sup> GASB Concepts Statement No. 7, *Communication Methods in General Purpose External Financial Reports That Contain Basic Financial Statements: Notes to Financial Statements* (CS7), paragraph 9.

<sup>2</sup> CS7, paragraph 9.

<sup>3</sup> CS7, paragraph 10.

<sup>4</sup> CS7, paragraph 8.

<sup>5</sup> CS7, paragraph 11. The meaning of *depth and breadth of users* may be clearer when the terms are used in context, below.

<sup>6</sup> Substantial is not defined in the ED or elsewhere, but is used in other GASB standards and is intended to refer to amounts quantitatively greater than the minimums that would be considered material or significant; which are themselves equivalent terms (CS7 nonauthoritative basis for conclusion, paragraph B31).

<sup>7</sup> GASB Exposure Draft *Certain Risk Disclosures* (ED), paragraph 4.

<sup>8</sup> ED, paragraph 5.

<sup>9</sup> See note 5, above.

<sup>10</sup> "Event" is not defined (or even explained) in the ED, although it includes a nonauthoritative appendix with illustrations where examples of events include (1) a government's awareness that a primary taxpayer (the concentration) was "experiencing significant financial difficulties" and subsequently filed for bankruptcy (the event) and (2) the expiration of a labor agreement covering nearly all firefighters (the concentration) that could lead to labor disruption (the event).

<sup>11</sup> ED, paragraph 6.

<sup>12</sup> ED, paragraph 7.

<sup>13</sup> ED, nonauthoritative basis for conclusion, paragraph B11.

<sup>14</sup> Based on the writer's observation, review of discussion papers, and review of minutes of GASB's deliberations at its June-July 2021 meetings.

<sup>15</sup> [GFOA's comment letter has been drafted based on a AAFRC taskforce discussion of the ED. As soon as it is approved by the full committee it will be sent to GASB and posted on our website. A link to that letter should be included in this note.]