

The GASB's Preliminary Views on  
Economic Condition Reporting Financial Projections: Securities Law  
Concerns with Bond Disclosure Documents



BY WILLIAM L. HIRATA  
AND JOSEPH (JODIE) E. SMITH

The Preliminary Views issued by the Governmental Accounting Standards Board (GASB) in November 2011 on reporting financial projections and helping users assess a governmental entity's economic condition generated a number of comments — 171, as of May 1, 2012. Most of these comments discussed the feasibility or usefulness of implementing the accounting and financial reporting standards described in the Preliminary Views (PV). Rather than focusing on the practicality of these standards, the comments submitted by the National Association of Bond Lawyers (NABL) discussed the possible ramifications, under federal securities law, if governmental entities include projections in their primary and secondary market disclosure documents.

### CHANGES TO CURRENT REPORTING

Debt issued by state and local governments is generally exempt from the registration and reporting provisions of the state and federal securities laws. This exemption does not mean, however, that the securities laws do not affect offerings of municipal securities. These offerings, and other statements made in connection with purchasing and selling the securities (such as continuing disclosure filings made with the Municipal Securities Rulemaking Board, or MSRB), are governed by the antifraud provisions of the securities laws, which prohibit issuers and other municipal market participants from making material misrepresentations and omitting material facts in any statement regarding the offer, purchase, or sale of securities.<sup>1</sup>

The PV (Project No. 13-3) reflects the GASB's belief that the bond investors, taxpayers, and other constituent groups that use financial statements need information that will allow them to assess a government's fiscal sustainability (defined in the PV as "a government's ability and willingness to generate inflows of resources necessary to honor current service commitments and to meet financial obligations as they come due, without transferring financial obligations to future periods that do not result in commensurate benefits"). The PV provides an initial proposal that would require governmental

Rather than focusing on the practicality of the standards, the comments submitted by the National Association of Bond Lawyers discussed the possible ramifications, under federal securities law.

entities to provide the following information to help users assess the fiscal sustainability of issuers:

- Projections of total cash inflows and major individual cash inflows, with explanations of the known causes of fluctuations.
- Projections of total cash outflows and major individual cash outflows, with explanations of the known causes of fluctuations.
- Projections of the total financial obligations and major individual financial obligations, including bonds, pensions, other postemployment benefits, and long-term contracts, with explanations of the known causes for fluctuations.
- Projections of annual debt service payments.
- A written explanation of the major intergovernmental service interdependencies that exist and the nature of these interdependencies.

These financial projections would be included in the required supplementary information (RSI) to the financial statements for each of the next five fiscal years, at a minimum. The projections would be based on current policy, including historical information, and adjusted to account for any known events and conditions that affect the projection period. Issuers

would also include underlying assumptions, based on relevant historical information, and events and conditions that affected the projection periods.

### IMPLEMENTING THE PV

Most governments include their comprehensive annual financial reports (CAFRs) from the prior fiscal year in their bond offering documents and continuing disclosure reports. These documents and reports are submitted to the MSRB's Electronic Municipal Market Access (EMMA) system, where investors and the public can view them free of charge. The GASB's proposal would have governments include the financial projection information discussed in the PV within the CAFR, which is then provided to investors.

Offering documents generally include the CAFR, which in turn includes: the independent auditor's report; management's discussion and analysis; the basic financial statements, comprising government-wide financial statements, fund financial statements, and notes to the financial statements; and RSI. If the PV is implemented in its current form, these audited financial statements, which include the financial projections the PV requires in the RSI, will be subject to scrutiny under the antifraud provisions of federal securities law.

Financial statements included in the governmental entity's bond offering documents might not reflect the issuer's current financial position. For example, consider the typical auditing process for a governmental entity with a fiscal year ending June 30 — the auditing process would not typically be completed until December. If that governmental entity were to issue bonds in November, its offering document

Offerings of municipal securities and other statements made in connection with purchasing and selling the securities are governed by the antifraud provisions of the securities laws.

would include audited financial statements that are 17 months old. If the jurisdiction included GASB-mandated financial projections, its RSI would also include projections based on 17-month old assumptions.

In a series of enforcement actions, the Securities and Exchange Commission (SEC) has emphasized that if a governmental entity's financial condition changes materially, the

governmental entity's bond offering document or continuing disclosure report must explain why the historical financial information in the audited financial statements no longer reflects the issuer's current financial position. Under this standard, the SEC could take the position that outdated projections in financial statements should also be reviewed and commented on in a bond offering document or continuing disclosure report, in order to provide context for an issuer's current financial position.

Under the antifraud provisions of federal securities law, the assumptions used in financial projections that are communicated to investors have to be reasonable, and the issuer must believe they are reasonable statements of expected future performance. Accordingly, if the Preliminary Views are implemented in the current form, whenever an issuer



GFOA's comments (submitted jointly with the International City/County Management Association, National Association of Counties, National League of Cities, and United States Conference of Mayors) and NABL's comments, along with the other comments submitted, are available on the GASB website at <http://www.gasb.org>. Select the "Projects" tab, then "Comment Letters" and the "Economic Condition Reporting" project.

Want to read more about the GASB's Preliminary Views on *Economic Condition Reporting: Financial Projections*? See "New GASB Guidance on Deferred Items and Risk Financing," by Stephen Gauthier, in the April 2012 issue of *Government Finance Review*.



prepares a bond offering document or continuing disclosure report that includes financial statements (which would thus include financial projections), it would need to consider whether the assumptions underlying the projections remain reasonable, as of the date the offering document or continuing disclosure report is released to the market. In the likely case that the assumptions have become outdated, that fact must be disclosed, and the assumptions and projections might need to be updated.

### **GASB'S PROPOSED CAUTIONARY NOTICE**

The PV proposes a cautionary notice that could be included in a government's financial statements. A governmental entity that includes financial statements with forward-looking information as part of an offering document would need to add meaningful cautionary statements that specifically identify the factors that could cause actual results to differ materially from the forward-looking statements. The proposed cautionary notice, however, might not be sufficient to enable government entities or underwriters to avail themselves of the "bespeaks caution" doctrine under the federal securities laws for forward-looking statements made in offering documents.

Additionally, issuers frequently ask their auditors for consent to include audit reports in their offering documents. Allowing this will cause the accountants to become "associated" with the official statement, and they will therefore be expected to perform "keeping current" and consistency procedures. If an offering document includes financial statements, RSI, and an accountant's report, investors might reasonably think the financial projections had been reviewed, post-audit. However, unless specifically requested, auditors will not review projections.<sup>2</sup>

To avoid potential confusion on the part of investors, the GASB's proposed cautionary language should be expanded. NABL suggested the following changes: align the language with the accepted "forward-looking statement" principles used in corporate and municipal offering documents;<sup>3</sup> emphasize that, unless otherwise specified, RSI has not been audited; and add explicit disclaimers emphasizing

As the GASB indicates, publishing a PV is "a step toward an Exposure Draft of a Statement of Governmental Accounting Standards but is *not* an Exposure Draft."



that the financial projections have not been subject to post-audit review.

### **NEXT STEPS**

As the GASB indicates, publishing a PV is "a step toward an Exposure Draft of a Statement of Governmental Accounting Standards but is not an Exposure Draft." Preliminary views documents are generally issued when the GASB expects respondents to be sharply divided on the issues, or when the board itself is sharply divided. Based on the comments received in response to the PV, as well as the alternative views expressed by two GASB board members, an Exposure Draft that includes the concepts in the PV will generate a similarly healthy exchange of comments. As NABL has pointed out in its comments, the GASB's work needs to consider the important securities law implications as the PV moves forward. ■

all the  
PORTFOLIO ACCOUNTING  
AND REPORTING  
you'll ever need!



# Tracker

**195.00**  
PER MONTH

**Tracker** is an easy to use, web-based portfolio accounting and reporting investment tool for institutional investors.

We simplify the labor intensive and time consuming task of investment management.

**60** day  
free trial  
COMPLIMENTARY PORTFOLIO SET UP

**tracker.us.com**

**WE MAKE IT EASY!**

Toll Free 888.327.1422

Corporate Headquarters: Charlotte, North Carolina Since 1997

## Notes

1. Although state and local government securities are exempt from the registration and reporting provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934, any offering of municipal securities (as well as other statements made in connection with the purchase and sale of those securities, such as continuing disclosure reports filed with the MSRB) are nevertheless governed by the antifraud provisions of Section 17(a) of the 1933 Act (which applies to the "offer or sale of any securities") and/or Section 10(b) of the 1934 Act and Rule 10b-5 (which apply to the "purchase or sale of any security") promulgated thereunder.
2. The American Institute of Certified Public Accountants Statement on Auditing Standards No. 120, *Required Supplementary Information*, indicates that although the auditor's report on the financial statements will include a discussion of the responsibility the auditor takes for that information, an auditor's opinion on how fairly financial statements are presented, in accordance with generally accepted accounting principles, would not be affected by the presentation of RSI or the failure to present some or all of the RSI.
3. Under federal securities law, forward-looking statements are not misleading so long as a prospectus includes meaningful cautionary language that warns investors.

WILLIAM L. HIRATA is a partner at Parker Poe Adams & Bernstein LLP, and a former Chair of the National Association of Bond Lawyers Securities Law and Disclosure Committee. JOSEPH (JODIE) E. SMITH is a partner at Maynard, Cooper & Gale, P.C., and is the current Chair of NABL's Securities Law and Disclosure Committee.

