



U.S. GOVERNMENT ACCOUNTABILITY OFFICE

441 G St. N.W.

Washington, DC 20548

January 12, 2015

Federal Accounting Standards Advisory Board

Wendy M. Payne, Executive Director

441 G Street, NW, Suite 6814

Washington, D.C. 20548

Dear Ms. Payne,

This letter provides the U.S. Government Accountability Office's (GAO) comments on the Federal Accounting Standards Advisory Board's (FASAB) *Public-Private Partnerships Disclosure Requirements* Exposure Draft. We fully support the Board's efforts to improve federal financial reporting by proposing a standard on disclosure requirements for public-private partnerships (P3s) and believe that appropriate disclosures could add value to users of the financial statements. We also believe that it is especially important to establish clear and appropriate principles for P3 disclosures so that as the Board develops other accounting standards for disclosing risks across many areas (e.g., insurance risks), there is consistency in the nature and magnitude of such disclosures.

We concur with the Alternative View provided in the Exposure Draft. We believe that certain aspects of the proposed standard would likely result in preparers and auditors encountering implementation challenges and incurring costs that may not be commensurate with the value of the disclosures to users of the financial statements, and the proposed disclosures may detract from rather than enhance the user's ability to assess the entity's finances. We provide suggestions to the proposed standard that:

- Narrow the proposed P3 definition to more closely align with P3 arrangements and transactions by (1) excluding items that likely have limited risk of contingent losses or (2) building upon more restrictive definitions used by other standard-setters. Also, ensure that all terms in the definition are clearly defined.
- Limit the disclosure requirements for remote contingencies to contractual terms specified in contractual agreements and more clearly incorporate the existing requirements in FASAB's Statement of Federal Financial Accounting Standards 5 (SFFAS 5.)¹ Also, exclude business risks² from the scope of required disclosures.
- Provide a clear disclosure threshold for remote risks that is higher than materiality as currently applied.

Narrow The Definition Of P3s And Ensure Clarity In The Definition

The P3 definition proposed at paragraph 17 captures many of the most widely identified features of federal P3s; however, it is our view that the breadth of the definition does not confine the scope of arrangements and transactions solely to P3's. In addition, we believe that the definition does not provide sufficient clarity to facilitate consistent application of the standard

¹SFFAS 5: *Accounting for Liabilities of the Federal Government*

² As discussed in the Alternative View, business risks relate to entity operations or performance.

among preparers or between the preparer and the auditor. In operation, we anticipate that preparers and their auditors would need to demonstrate that:

- all contracts and agreements that meet the broad definition have been identified;
- each contract and agreement has been compared with the conclusive and suggestive characteristics; and
- the significant exposure criteria (paragraph 8) have been applied.

In addition to challenges encountered in applying the P3 definition consistently, a substantial number of contracts and agreements may be identified that ultimately have little or no material financial statement effect or risk. Consequently, we have concerns that the proposed standard would require significantly more preparer and auditor resources to implement than if the definition was narrower and clearer. The proposed definition states that P3s are contractual arrangements or transactions between public and private sector entities to provide a service or an asset for either government or general public use where in addition to the sharing of resources, each party shares in the risks and rewards of said arrangements or transactions. Sharing of risks and rewards is evidenced by conditions such as (1) agreements covering a significant portion of the economic life of a project or asset, and/or lasting more than five years, (2) financing provided in whole or shared in part by the private partner, (3) conveyance or transfer of real property, personal property, or multi-sector skills and expertise, or (4) formation of special purpose vehicles.

The breadth of the definition appears to encompass (1) contracts that are not traditionally considered P3s and (2) arrangements and transactions that do not necessarily result in potential contingent losses to the entity. This could include:

- contracts that relate to standard procurements of capital assets under the Federal Acquisition Regulation;
- long-term contracts in which some financing is incurred by the private sector entity;
- leases that include any other services related to the lease; and
- arrangements or transactions where government skills are transferred to the private party.

These examples would likely meet the P3 conclusive or suggestive criteria as stated in paragraph 19. Consequently, federal entities may expend resources developing and implementing processes to identify contracts and agreements that meet the proposed definition but are not true P3s and have limited risk of contingent losses.

An alternative approach for narrowing the P3 definition is to build upon the more restrictive definitions of P3s that are currently used by other standard setters. The Financial Accounting Standards Board, Governmental Accounting Standards Board and the International Accounting Standards Board have issued standards related to a narrower, but significant subset of P3s, service concession arrangements. Generally, a service concession arrangement includes a private sector entity operating infrastructure (such as roads, bridges, etc.) or another public asset to provide public services in exchange for compensation, which may include user fees. As part of the service concession arrangement, the private sector entity may be required to construct, upgrade, or maintain such infrastructure or public asset.

Limit The Disclosure Of Remote Contingencies To Contractual Terms Specified In Contractual Agreements And Exclude Disclosures Of Business Risks

The proposed standard would significantly expand the disclosure requirements for contingent liabilities that are provided under SFFAS 5 by requiring disclosures of (1) certain *remote contingencies*³ (paragraph 8) and (2) *business risks* such as comparative costs and skill transfers to the private sector.

It is our view that the standard should limit the disclosure requirements for remote contingencies to contractual terms that are specified in contractual P3 arrangements and exclude business risks from the disclosure requirements. To that end, disclosures of contingencies where the chance of the future event occurring is slight and business risks that do not necessarily affect the financial statements could overwhelm users with extensive information and could be misleading and/or confusing to users. While general purpose federal financial reports support decision-making and accountability over taxpayer provided and other resources, federal entities have a number of existing reporting vehicles where the reporting and disclosures of such types of risks may be more appropriate and relevant.

We believe that the treatment for recognition and disclosure of contingencies relating to contractual terms such as termination clauses, minimum payment guarantees, and other types of non-performance or other external events applicable to P3 arrangements and transactions are currently covered under SFFAS 5. With regard to contingent liabilities, currently SFFAS 5 requires the recognition of a contingent liability when the contingency is deemed *probable* and measureable (SFFAS 5 paragraphs 38-39) and disclosure of a *reasonably possible* contingency or a *probable* contingency that is not measureable (SFFAS 5 paragraphs 40-42.) We believe that the proposed standard should more clearly incorporate the existing requirements of SFFAS 5 so that entities and their auditors understand how the proposed standard and SFFAS 5 inter-relate.

In addition, SFFAS 5 provides that contingencies that are classified as *remote* need not be reported in general purpose federal financial reports. The proposed standard would require disclosure of P3 arrangements and transactions that are remote contingencies. This could include transactions and arrangements that result from:

- contractual terms (e.g. the contract may contain early termination clauses and minimum payment guarantees) that specify the amount or the basis for determining the amount of any contingent loss or
- circumstances not addressed in the contract and relate to other types of non-performance or other external events.

To determine whether a remote contingency represents a *significant fiscal exposure* and meets the disclosure requirements of paragraph 23 d (2), the entity would need to develop an inventory and complete an assessment of remote contingencies. This would include estimating the maximum loss to the federal entity assuming that all potential adverse events with respect to the federal government were to occur, whether or not such events were contemplated in the contract. Such disclosures would represent the maximum loss to the federal government, even though there is only a remote chance of occurrence. It is envisioned that such disclosures could be numerous and we question the meaningfulness of this information to users for the reasons

³ Refer to SFFAS 5 paragraph 36

stated in the Alternative View. Also, as noted in the Alternative View, proposals by the Financial Accounting Standards Board for disclosing remote risks were not widely supported in public comments on the proposal. We support narrowly defining the instances in which remote risks would be disclosed to only those contractual terms as specified in P3 contractual arrangements to minimize the possibility of excessive disclosures and preparer and auditor implementation challenges.

It is also our view that business risks should be excluded from disclosure in the financial statements. As noted above, including information related to business risks in the financial statements could overwhelm users with extensive information, and could be misleading and/or confusing to users. While information about business risks is relevant to management and possibly to performance reporting, requiring disclosure of business risks:

- extends significantly beyond current financial reporting requirements;
- would not necessarily reflect potential future losses to the entity;
- may be highly subjective;
- would also present difficulties in determining whether the exposures meet the “*significant exposure*” disclosure threshold; and
- may cause confusion to users about the entity’s finances.

Also, the preparer and auditor would likely experience significant challenges in preparing and auditing such business risk disclosures, particularly in determining whether all such business risks were considered and properly evaluated. Risks not affecting the financial statements are generally outside the scope of a financial statement audit. Further, if the underlying principle of disclosure of business risks were to be applied by the Board to other types of contracts or other areas, it could substantially increase the volume of disclosures in the financial statements. It is unclear whether such additional information would add value to the financial statements and may detract from the readers’ ability to properly assess the entity’s financial condition.

Provide A Clear Disclosure Threshold For Remote Risks That Is Higher Than Materiality

The disclosure threshold of *significant exposure* (paragraph 8) does not provide a clearly defined conceptual threshold to facilitate appropriate and consistent disclosures of risk related to P3 contractual arrangements and transactions. The proposed standard states that disclosures of remote contingencies should be provided if they would result in *significant exposure* to the entity, but does not define the term. In addition, the term is not clearly linked to the discussion of materiality in paragraph 11 or included in the disclosure requirements or other authoritative sections of the proposed standard. In fact, we believe that the term “significant” is often perceived as an amount less than “material.” Also, we believe that the standard should develop and clearly define a disclosure threshold that is higher than materiality as it is applied to other areas, consistent with earlier Board discussions. Such a threshold would appropriately limit the extent of disclosures while providing disclosure of remote contingencies that could, for example, fundamentally affect the entity’s ability to operate. Also, clear definitions would facilitate appropriate and consistent disclosures related to P3s. Further, we noted that the proposed standard also inconsistently uses terms related to risk (e.g., significant risk, significant remote risk, significant contractual risk) and exposure (e.g., significant fiscal exposure, fiscal exposure, significant exposure), which also may be confusing to entities and their auditors.

The proposed standard indicates that certain remote risks may have a reasonably *high materiality threshold*, but does not indicate how that would be applied or whether certain remote

risks could likewise have a low materiality threshold. We believe that use of the term *significant exposure* without a definition is not sufficiently clear for consistent implementation and consequently would also cause challenges between the preparer and auditor. Also, it is unclear how the concept of *significant exposure* would be applied to commitments (e.g. future payments under paragraph 23 c ii.) Further, the term *fiscal exposure* has been used in GAO reports and in the International Organization of Supreme Audit Institutions' international auditing standards, and possibly by others to refer to concepts different from that used in the proposed standard--which may cause confusion.

Another difficulty is that the proposed standard provides disclosure requirements for risks related to P3 contracts and arrangements while the FASAB has not first established a standard that provides recognition and reporting requirements specifically for P3s and related disclosure requirements. Such recognition and reporting requirements would provide better context in which to define incremental risk disclosures related to P3s.

Overall, we commend the Board for its work to develop a standard on P3 disclosures and have made suggestions to reduce challenges related to implementation and consistent application of the standard. We thank you for considering our comments on these important issues. Please contact me at (202) 512 – 2600, or sebastians@gao.gov if you have questions on GAO's perspectives.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Steven J. Sebastian". The signature is fluid and cursive, with a long horizontal line extending from the end.

Steven J. Sebastian
Managing Director,
Financial Management and Assurance