

DEMYSTIFYING DEFERRALS: WHAT THEY ARE, WHAT THEY MEAN, AND WHY THEY ARE IMPORTANT



Introduction

State and local governments have their own body of accounting and financial reporting standards – established by the [Governmental Accounting Standards Board \(GASB\)](#) – separate from the standards established by the [Financial Accounting Standards Board \(FASB\)](#) for companies and nongovernmental not-for-profits (NFPs). Nevertheless, many provisions of those two sets of standards are identical. For instance, when an employee works and earns a salary, it results in the reporting of salaries payable and salaries expense no matter what type of entity the employer is.

When the generally accepted accounting principles (GAAP) established by the GASB and the FASB differ, the disparity is sometimes considerable. There may be no better example of this than the GASB requirement to report *deferred outflows of resources* and *deferred inflows of resources* (together, deferrals), which are unique to governments.¹ To people familiar only with corporate or NFP financial statements, the appearance of deferrals in government financial statements is a strange new concept, one that they often have difficulty understanding and that even experienced governmental accountants have trouble explaining.

Deferrals do not have to be confusing. Though unfamiliar to some, deferrals are an essential aspect of governmental accounting and communicate important information about a government's financial health. This article, adapted from a [webinar of the same name](#), is intended to help clear the fog that surrounds deferrals by explaining:

- What deferrals are and how they differ from other items in financial statements like assets and expenses
- How deferrals arrived in governmental financial statements in the first place
- Why deferrals are important
- What types of deferrals the GASB requires and how they are reported, and
- What deferral information says about a government's financial health.

What Are Deferrals?

Like any other type of entity, governments prepare two types of financial statements – statements of financial position and statements of resource flows. The latter may be called income statements or statements of revenue and expense; they report inflows of resources related to the current period covered by the statement – primarily revenues – and outflows of resources related to the current period – primarily expenses.²

¹ That is, state and local governments, which this article refers to corporately as governments. Deferrals are not an aspect, however, of the standards established for the federal government by the Federal Accounting Standards Advisory Board (FASAB).

² For ease of reading, this document refers to all current-period outflows as expenses and all current-period inflows as revenue. In practice, current-period outflows in the governmental funds are reported as expenditures. In the fiduciary funds, the current-period inflows are reported as additions and the current-period outflows as deductions.

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The former financial statements – called statements of net position, statements of net assets, or balance sheets – report assets, liabilities, and the difference between them (called net assets, net equity, net position, or fund balance, depending on where you look). But this is where governments are distinct – they also report deferrals in their statements of net position and balance sheets.

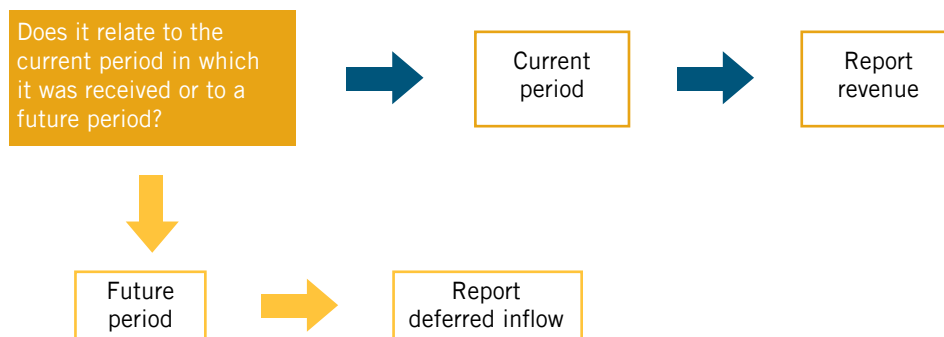
A **deferred outflow of resources** is an outflow of resources that has occurred but is related to a future period, rather than the current period; therefore, a government postpones reporting it as an expense until that future period (i.e., the government defers it).

A **deferred inflow of resources** is an inflow of resources that has occurred but is related to a future period, rather than the current period; therefore, a government postpones reporting it as revenue until that future period.

One source of the confusion surrounding deferrals is their names, which suggest that the outflows and inflows of resources will occur later. But, as the preceding definitions say, *the flows have already happened – it is the reporting of them as expense and revenue, respectively, that will occur later.*

The vast majority of a government’s inflows or outflows of resources in any given year are related to that year and, therefore, the government reports them in the statements of resource flows³ as revenues and expenses. However, suppose a government receives an inflow of resources from a local business (such as cash or an account receivable) during the year, but those resources are related to a future year. In that case, the government reports a deferred inflow of resources in its statements of financial position⁴ until that future year arrives, at which time it reports the inflow as revenue.

Government *receives* cash or a promise to pay

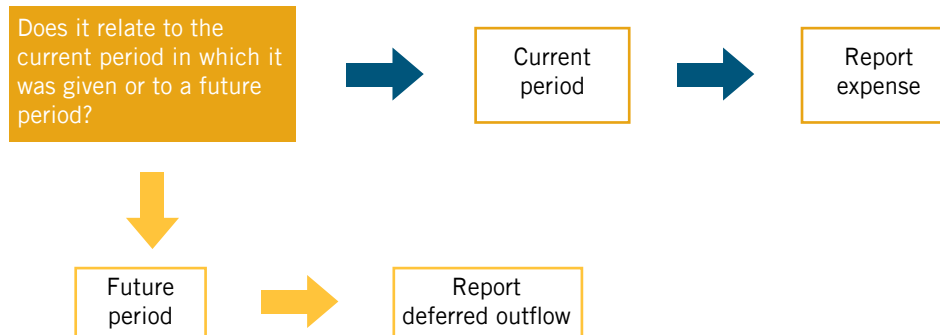


Similarly, if a government provides an outflow of resources to a business (such as cash or an account payable) during the year, but those resources are related to a future year, then the government reports a deferred outflow of resources in its statements of financial position until that future year arrives, at which time it reports the outflow as expense.

³ For governments, those are the government-wide statement of activities; governmental funds statement of revenues, expenditures, and changes in fund balances; proprietary funds statement of revenues, expenses, and changes in fund net position; and fiduciary funds statement of changes in fiduciary net position.

⁴ For governments, those are the government-wide statement of net position; governmental funds balance sheet; proprietary funds statement of fund net position; and fiduciary funds statement of fiduciary net position.

Government *gives* cash or a promise to pay



Where Did Deferrals Come From?

In the early 2000s, the GASB was working on definitions for the items reported in statements of financial position. As expected, it found assets and liabilities:

An **asset** is a resource that (1) a government controls at present and (2) has *service capacity*; in other words, the government can use the asset to provide service (like a school building) or to support the provision of service (such as an office building that houses executive staff), or invest or sell the asset to produce income that pays for services.

A **liability** is an amount a government owes at present to another entity or individual, and it is certain or close to certain that the government must pay that amount or satisfy the other party in some other way.

The GASB also found items in those financial statements that didn't meet the definition of an asset or a liability. Those items didn't have service capacity – they couldn't be used to provide service or to support the provision of service, and they couldn't be invested or sold. They also did not represent an amount that a government must pay to another party or satisfy by other means. Most of those items being reported as assets and liabilities were the things we now call deferrals.⁵ To paraphrase a character from a schlock horror film, "They have always lived among us."

As explained in the preceding section, deferrals look a lot like the items that are reported in the statements of resource flows:

An **outflow of resources** is a using up of a government's net assets (assets minus liabilities) that relates to the current period. These generally are reported as expenses or losses in the financial statements.

⁵ Some of those items reported as assets and liabilities met the definition of a current-period inflow or outflow, such as the costs related to issuing debt, and are now reported as revenue or expense.

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An **inflow of resources** is an acquisition of net assets that relates to the current period. These generally are reported as revenues or gains in the financial statements.

The key difference between an outflow that is reported as an expense and one reported as a deferral is that the former relates to the current period, and the latter refers to a future period (at which time it will become an expense). Likewise, the key difference between an inflow reported as a revenue and one that is reported as a deferral is that the former relates to the current period, and the latter refers to a future period (at which time it will become a revenue).

The GASB published its definitions in Concepts Statement No. 4, [Elements of Financial Statements](#), in 2007. The next year, it issued Statement No. 53, [Accounting and Financial Reporting for Derivative Instruments](#), the first pronouncement that required the reporting of deferrals. In 2010, the GASB issued Statement No. 60, [Accounting and Financial Reporting for Service Concession Arrangements \(SCAs\)](#), which also required deferrals. Governments preparing to implement those Statements faced a dilemma: The GASB's standards did not address how deferrals should be displayed on the face of the financial statements or disclosed in notes to financial statements. Furthermore, the items that the GASB identified as deferrals when developing Concepts Statement 4 were still being reported as assets and liabilities.

How Should Deferrals Be Reported?

The GASB dealt with how to display and disclose deferrals in Statement No. 63, [Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position](#):

- Governments are required to present deferred outflows in their own section of the financial statements, following but separate from assets. Governments have the option to show a subtotal for assets plus deferred outflows, but must include separate totals for assets and deferred outflows.
- Governments are required to present deferred inflows in their own section of the financial statements, following but separate from liabilities. Governments have the option to show a subtotal for liabilities plus deferred inflows, but must include separate totals for liabilities and deferred inflows.

Prior to Statement 63, governments reported the difference between assets and liabilities as net assets. However, when deferrals are added to the equation, the remaining amount reported is called *net position* (comparable to equity in corporate financial statements, but a government is not *owned* in the way that a company is). A government's statement of net position is arranged like that equation:



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Figure 1

GOVERNMENT-WIDE STATEMENT OF NET POSITION

	Primary Government			Component Units
	Governmental Activities	Business-Type Activities	Total	
ASSETS				
Cash and cash equivalents	\$ 2,934,874	\$ 1,877,643	\$ 4,812,517	\$ 2,110,099
Investments	1,989,343	1,101,259	3,090,602	1,123,876
Receivables, net of allowances for uncollectibles				
Taxes receivable	3,909,221	-	3,909,221	-
Fees and charges receivable	283,420	2,098,745	2,382,165	3,189,230
Due from federal government	1,903,487	33,009	1,936,496	2,874,543
Due from state government	1,224,911	214,598	1,439,509	990,877
Other	454,333	11,002	465,335	101,822
Internal balances	(90,322)	90,322	-	-
Other assets	307,356	33,111	340,467	32,099
Restricted assets				
Restricted cash	1,128,001	787,832	1,915,833	773,214
Restricted investments	1,330,777	1,100,223	2,431,000	1,923,456
Capital assets				
Land and construction in progress	3,905,123	2,763,293	6,668,416	3,298,734
Buildings, equipment, and infrastructure, net of depreciation	13,893,202	8,900,356	22,793,558	7,324,564
Intangible right-to-use assets, net of amortization	334,556	450,008	784,564	112,344
Total capital assets	18,132,881	12,113,657	30,246,538	10,735,642
Total assets	\$ 33,508,282	\$ 19,461,401	\$ 52,969,683	\$ 23,854,858
DEFERRED OUTFLOWS OF RESOURCES	\$ 328,654	\$ 364,302	\$ 692,956	\$ 312,072
LIABILITIES				
Payables:				
Salaries payable	\$ 1,452,098	\$ 173,928	\$ 1,626,026	\$ 803,452
Accounts payable	1,139,283	982,343	2,121,626	1,330,293
Accrued interest payable	203,912	383,920	587,832	230,192
Due to other governments	93,451	-	93,451	78,324
Deposits and retainage payable	-	829,672	829,672	254,121
Liabilities payable from restricted assets	2,112,003	923,099	3,035,102	2,308,745
Noncurrent liabilities				
Due within one year	1,004,923	335,846	1,340,769	449,702
Due after one year				
Claims and judgments	209,444	90,332	299,776	138,030
Compensated absences	987,345	111,000	1,098,345	490,322
Leases payable	317,828	427,508	745,336	106,727
Net pension liability	4,987,453	809,342	5,796,795	1,109,342
Net other postemployment benefits liability	2,333,023	500,245	2,833,268	789,324
Bonds and notes	6,238,749	3,099,261	9,338,010	4,111,783
Total liabilities	\$ 21,079,512	\$ 8,666,495	\$ 29,746,007	\$ 12,200,357
DEFERRED INFLOWS OF RESOURCES	\$ 416,174	\$ 79,074	\$ 495,248	\$ 203,127
NET POSITION				
Net investment in capital assets	\$ 11,894,132	\$ 9,014,396	\$ 20,908,528	\$ 6,623,859
Restricted for:				
Debt service	107,320	33,090	140,410	77,319
Capital projects	134,099	45,122	179,221	32,335
Perpetual cemetery care	34,102	-	34,102	-
Other purposes	22,943	18,733	41,676	32,222
Unrestricted	148,654	1,968,792	2,117,446	4,997,712
Total net position	\$ 12,341,250	\$ 11,080,133	\$ 23,421,383	\$ 11,763,447

In the governmental funds balance sheet, which employs modified accrual accounting, the arrangement is:

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Governments are required to report their deferrals by type. Governments either (1) show deferrals by type on face of the financial statements or (2) show a total for deferred outflows and a total for deferred inflows on the face and then disaggregate them by type in a note to the financial statements. Figure 1 illustrates a government-wide statement of net position that shows totals for deferrals, with the required detail disclosed in a note illustrated in Figure 2.

Figure 2

NOTE 10. DEFERRED OUTFLOWS OF RESOURCES AND DEFERRED INFLOWS OF RESOURCES

	Primary Government		
	Governmental Activities	Business-Type Activities	Total
Deferred Outflows of Resources			
Leases	\$ 158,914	\$ 213,754	\$ 372,668
Hedging derivative instruments	-	87,345	87,345
Loss on refundings	-	32,009	32,009
Related to pensions	99,749	16,187	115,936
Related to other postemployment benefits	69,991	15,007	84,998
Total deferred outflows of resources	\$ 328,654	\$ 364,302	\$ 692,956
Deferred Inflows of Resources			
Property taxes levied in advance	\$ 232,944	\$ -	\$ 232,944
Grants with time restrictions	23,007	-	23,007
Hedging derivative instruments	-	31,744	31,744
Gain on refundings	24,110	22,566	46,676
Related to pensions	84,787	13,759	98,546
Related to other postemployment benefits	51,327	11,005	62,332
Total deferred outflows of resources	\$ 416,174	\$ 79,074	\$ 495,248

Why Are Deferrals Important?

Some reasons why governments prepare audited financial statements for public consumption are similar to why corporations and NFPs do. There are a couple of objectives of financial reporting that are unique to governments, however. First, for a variety of reasons, it is important to governments to accurately measure the cost of providing services; for instance:

- Many grants received from the federal and state governments are based on the amount of allowable costs that a grant recipient incurs when providing specific services, such as free or reduced-price meals in schools or health care provided to persons living in poverty. At present, accurate cost reporting is central to governments justifying how they have used the hundreds of billions of dollars of federal pandemic-relief funds.
- Obtaining disaster relief funding from the federal government is based on documenting the cost of recovery.
- Because governments are largely funded by taxes (which are not provided willingly) and grants (which the providing government also pays for with taxes), there is a need to be accountable to taxpayers and grantors for the efficiency with which tax and grant dollars are used to provide services. Efficiency typically is evaluated as the cost per unit of service, such as cost-per-student or cost-per-lane-mile of highways paved.

- Measuring service costs accurately using the same approach across governments and over time enables comparisons that inform the degree of efficiency (“Is the government more or less efficient than other governments, and is efficiency improving or deteriorating?”) and program choices (“Which alternative method of providing service produces the best quantity and quality for the money available?”).

Expenses are the measure of the cost of services. Thus, it is important to ensure that expenses are accurately stated. Deferrals result in certain costs being recognized as expenses in the proper periods, which helps to keep expenses from being overstated or understated in any given year.

Second – again, because of the sources of most government revenue – governments are expected to be accountable for making ends meet, year in and year out. In other words, governments need to demonstrate that they have raised sufficient revenue each year to cover expenses instead of draining a government’s savings or pushing costs off to future taxpayers. The GASB refers to that concept as *interperiod equity*. A unique objective of governmental accounting and financial reporting is to provide financial statement readers with information that allows them to assess interperiod equity. Deferrals assist with that assessment by ensuring that revenues and expenses are reported in the proper periods and not overstated or understated.

In summary, deferrals contribute to the information value of government financial statements by either postponing the reporting of revenues and expenses until the appropriate period or ensuring that certain inflows and outflows of resources are never reported as revenues and expenses.

What Types of Deferrals Do Governments Report?

Among the deferrals that postpone the reporting of revenues and expenses until the proper year arrives, governments report the following if they engage in the related transaction:

1. Debt refundings
2. Property taxes levied in advance
3. Advances on grants with time restrictions
4. Leases
5. Public-private and public-public partnerships (P3s), including SCAs
6. Revenue recognition in governmental funds
7. Increases and decreases in a pension or other postemployment benefit (OPEB) liability due to:
 - a. Changes in assumptions
 - b. Differences between expected and actual economic and demographic factors
 - c. Differences between expected and actual proportionate share of contributions
 - d. Changes in contribution proportion
8. Pension and OPEB contributions after the measurement date
9. Sales of future revenues
10. Transfers of revenue from one part of a government to another part
11. Sale-leasebacks
12. Payments from borrowers for points
13. Fees paid related to loans held for sale
14. Rate-regulated entities
15. Irrevocable split-interest agreements
16. Asset retirement obligations.

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The deferrals that may result in inflows and outflows never being reported as revenue and expense, include:

17. Changes in a pension or OPEB liability due to differences between expected and actual investment income
18. Hedging derivative instruments.

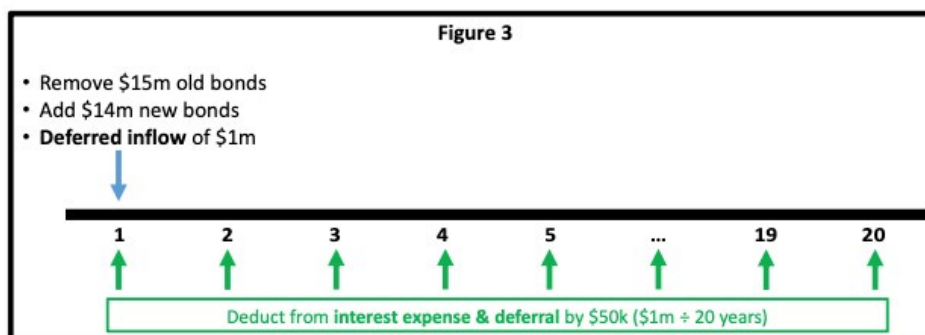
This section discusses the most commonly reported deferrals: 1–4, 6–8, and 17. All 21 (#7 is four related types) are covered in the slide deck, [Demystifying Deferrals: Technical Requirements & Resources](#).

Debt Refundings

To reduce their costs for repaying outstanding bonds, governments may engage in a *refunding* – they issue new bonds at a lower interest rate and use the proceeds to retire the old bonds. If the amount a government needs to issue in new refunding bonds is *less* than the amount of old bonds being retired, it results in an economic *gain*. Governments initially report the economic gain as a *deferred inflow* and then gradually report a *reduction* in interest expense and the deferred inflow over the shorter of the remaining years on the old or new bonds, typically in equal annual installments. This transaction stretches over multiple years, and the gain is related to the entire period, not just the year of the refunding. Therefore, reporting all of the gain at the time of the refunding would overstate the effect on interest expense in the initial year and understate it in all of the remaining years that the debt is outstanding.

Imagine that a government issues \$14 million of new refunding bonds to refund \$15 million of outstanding bonds, and both the new and old bonds have 20 years remaining. The government would:

- ✓ Initially report a deferred inflow of \$1 million
- ✓ Reduce both debt service expense and the deferred inflow by \$50,000 ($\$1 \text{ million} \div 20 \text{ years}$ annually⁶ (see Figure 3)



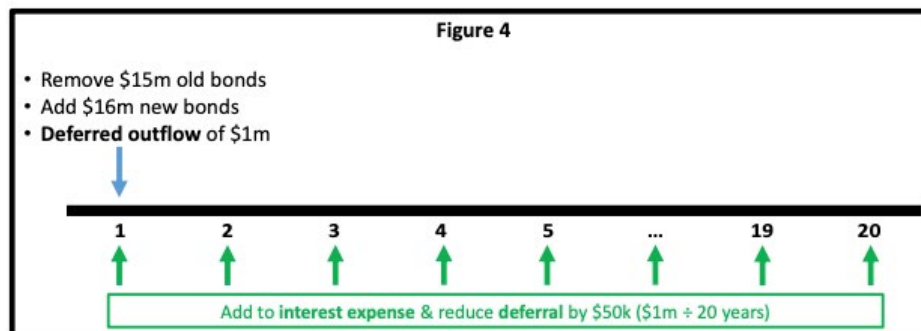
If the entire \$1 million were reflected in the resource flows statements immediately, interest expense would be substantially understated (by \$950,000) in the first year and overstated in each of the next 19 years (by \$50,000 a year).

⁶ The GASB typically requires that the spreading of revenue and expense reporting over time be done “in a systematic and rational manner.” Most of the time, governments interpret that requirement as equal annual installments. For the sake of simplicity, the relevant examples in this document follow that practice.

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On the other hand, if the amount a government needs to issue in new bonds is *greater* than the amount of old bonds being retired, it results in an economic *loss*. Governments initially report the economic loss as a *deferred outflow* and then gradually report an *increase* in debt service expense and a *reduction* in the deferred outflow over the shorter of the remaining years on the old or new bonds, typically in equal annual installments. Imagine that a government issues \$16 million of new refunding bonds to refund \$15 million of outstanding bonds, and both the new and old bonds have 20 years remaining. The government would:

- ✓ Initially report a deferred outflow of \$1 million
- ✓ Increase debt service expense and reduce the deferred outflow by \$50,000 ($\$1 \text{ million} \div 20 \text{ years}$) annually (see Figure 4)

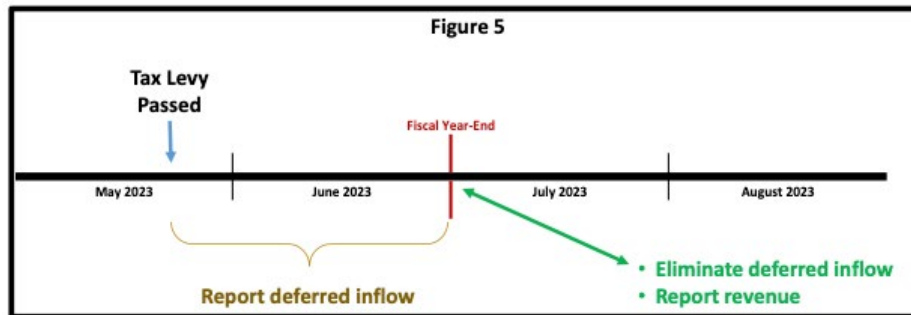


If the entire \$1 million were reflected in the resource flows statements immediately, interest expense would be substantially overstated (by \$950,000) in the first year and understated in each of the next 19 years (by \$50,000 a year).

Property Taxes Levied in Advance

Governments report property taxes receivable and property tax revenue when they are legally entitled to payment. Some governments levy property taxes toward the end of each fiscal year for the following fiscal year, say, in May for a fiscal year that begins July 1. If a government does so and has a *legally enforceable claim* to payment before the start of the fiscal year, it would report property taxes receivable – but it would not be appropriate to report next year’s revenue in the current year. Therefore, governments report a deferred inflow until the start of the fiscal year for which the property taxes were levied. (See Figure 5.)

- ✓ When the government has a legally enforceable claim: report property taxes receivable and a deferred inflow
- ✓ When the fiscal year begins: eliminate the deferred inflow and report property tax revenue



Advances on Grants with Time Restrictions

The way many intergovernmental grants work is that a government must first spend on a particular service to be eligible to receive a grant – so-called expenditure-driven grants. At the time the government incurs allowable expenditures, it can report a grant receivable and grant revenue. If a government receives a grant prior to spending on the service or meeting some other eligibility requirement, it reports a liability back to the grantor until the eligibility requirements are met. That is proper because, if the government never meets the eligibility requirement, the grant must be returned to the grantor.

Consider, however, a government that receives a grant with no eligibility requirements, or for which the government already has met the requirements – but the grantor says that the government cannot use the grant money *until next year*. The government does not need to do anything but wait, so there is no liability to the grantor. Instead, the government would report a deferred inflow until the date on or after which it is allowed to spend the money, at which point it is appropriate to treat the grant as revenue.

- ✓ When the grant with time restrictions is received: increase cash and report a deferred inflow
- ✓ On the date the grant can first be used: eliminate the deferred inflow and report grant revenue

If the grantor in this transaction is a government, it reports the mirror image of the grantee:

- ✓ When the grant with time restrictions is paid: reduce cash and report a deferred outflow
- ✓ On the date the grant can first be used: eliminate the deferred outflow and report grant expense

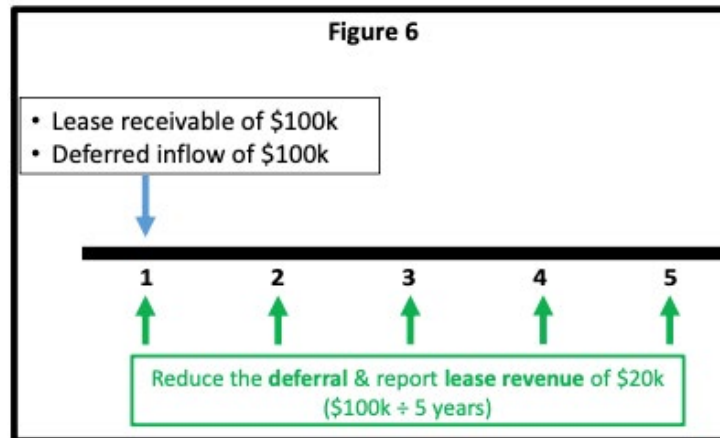
Leases

If a government leases an asset such as office space to a business for a period greater than a year, it reports a lease receivable equal to the present value of the future payments it will receive – in other words, the value of those payments if received today. Because the lease contract lasts for more than a year, it would not be appropriate to report the entire amount of the receivable as revenue immediately; rather, revenue should be reported over the course of the lease contract. Therefore, a government reports a deferred inflow, then reports revenue and reduces the deferral over time.

For example, if the lease lasts five years with five annual payments, the present value of which the government measures at \$100,000, the government would:

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- ✓ Report a lease receivable and a deferred inflow at the start of the lease of \$100,000 each
- ✓ Reduce the deferred inflow by \$20,000 and report lease revenue of \$20,000 in each year of the lease (see Figure 6)



Revenue Recognition in Governmental Funds

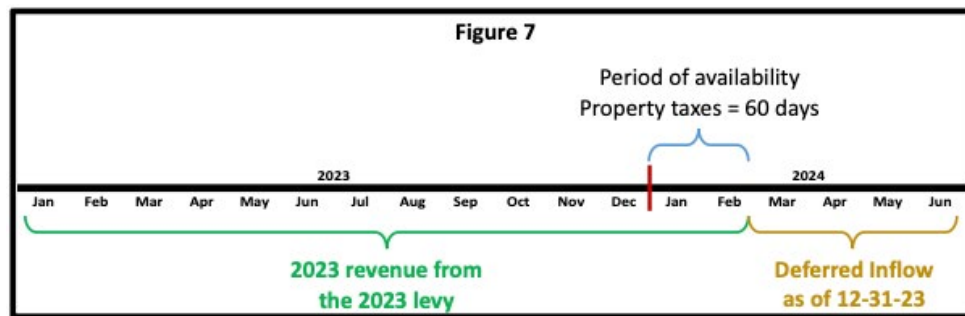
Generally, governments report revenue when the applicable criteria in the accounting standards have been met – recall, for instance, that property tax revenue is reported when a government is legally entitled to payment from taxpayers – *presuming that the amount is measurable and collectible*. Stated differently, to avoid recording money that a government will never receive, revenue can be reported only if a government knows or can reasonably estimate how much it will actually receive. That is why a government may levy a property tax of \$1 million but report revenue of \$980,000 based on historical experience that it is unable to collect 2 percent on average.

That is how revenue reporting works under *accrual* accounting, which is used in all financial statements except those for the governmental funds, which employ *modified accrual* accounting. All of the revenue reporting rules of accrual accounting apply in the governmental funds, with an additional requirement that the revenue be *available*. Available means that payment will be received during this year or soon enough after the end of the year to pay for this year's expenditures. The GASB requires a *period of availability* of 60 days beyond fiscal year-end for property taxes but does not specify what the period should be for other types of revenue; governments are allowed to select their own.

Using the example of the \$1 million property tax levy, of which \$980,000 is collectable, let's say that \$950,000 is received during fiscal year 2023 or within 60 days after year-end. The government would:

- ✓ Report property tax revenue of \$950,000 in the governmental funds
- ✓ Report a deferred inflow of \$30,000, usually called *unavailable revenue*
- ✓ Eliminate the deferral and report the revenue when the payments are received later in fiscal year 2024 (see Figure 7)

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Pension and OPEB Liabilities

The GASB's standards for liabilities to current and retired employees for defined benefit pensions and OPEB (most commonly, health insurance) are based in part on a view that this form of compensation is a multiyear transaction that unfolds over the years that an employee works for a government, rather than a series of separate annual transactions between governments and employees. That point of view affects how certain aspects of pension and OPEB expense are reported.

Pension and OPEB Expense

A variety of factors cause a government's pension and OPEB liabilities to increase and decrease each year. The *amount* of pension and OPEB expense reported by a government and *when* it is reported depend on the cause of the increase or decrease. The three factors that tend to cause the largest changes in pension and OPEB liabilities are *reported as expense immediately* because they relate specifically to each year:

- *Normal or service cost*, which is the value of pension and OPEB benefits earned during the year, adds to pension and OPEB expense.
- *Interest* on the balance of the liability at the start of the year also adds to pension and OPEB expense.
- *Changes in benefit terms* – If a government changes the provisions that determine how much benefit an employee will get when they retire, such as how many years they have to work or the percentage of their salary that is paid as pension, it may increase the liability (and therefore add to pension and OPEB expense) or decrease it (and therefore reduce pension and OPEB expense).

The increases or decreases in pension and OPEB liabilities as a result of four other factors are reflected in pension and OPEB expense over multiple years, rather than being included immediately. The amount of the change in the liability resulting from those four factors is initially reported as a deferral and introduced into expense over a period equal to the average remaining years of employment of all members of the pension or OPEB plan, both active and retired. This approach is intended to mirror how those four factors affect the liabilities over multiple years as employees continue to work and earn benefits. Those factors are (1) changes in assumptions, (2) differences between expected and actual economic and demographic factors (also called experience gains and losses), (3) differences between expected and actual proportionate share of contributions, and (4) changes in contribution proportion.

Changes in assumptions

The measurement of a pension or OPEB liability is the result of complex calculations based on a variety of assumptions that are relevant to determining how much a government owes to its employees, such as how much

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employees will be earning when they retire and life expectancy (how long they will live and collect benefits after retirement). If a government changes an assumption, the measurement of the liability will change as well.

For instance, if evidence shows that plan members are living longer on average, a government may increase the life expectancy assumption, which would have the effect of increasing the amount owed to those members. In other words, the liability would increase.

Experience gains and losses

In any given year, the actual experience with the assumptions that go into the liability measurement is likely to be different from what was assumed. Those assumptions are expectations over a very long period (often 60 or 70 years) – in other words, they are a long-run annual average – but in any given year the actual experience will be higher or lower than the assumption. The differences between expected and actual experience can increase or decrease the pension and OPEB liabilities.

For example, if the liability calculation assumed annual inflation of 3 percent, but inflation in the most recent year was 4 percent, that additional percentage point will increase the liability more than expected – that is an experience loss. On the other hand, if actual inflation was 2 percent, the liability will not increase as much as expected due to that factor – that is an experience gain.

Differences between expected and actual proportionate share of contributions

Many governments participate in what are called *cost-sharing multiple-employer plans*, particularly for pensions. As the name suggests, two or more governments – even thousands of governments in state government-run plans – combine their contributions, invest them together, and share the cost of providing benefits to their employees. For other types of pension and OPEB plans, the liability is measured for each individual government; for cost-sharing plans, though, because their benefits are paid from a common pool of assets, the liability is measured for all participating governments combined. In order for each of those governments to report their own part of the liability, they need to calculate their percentage or *proportion* of the total. For example, if the collective liability for the plan is \$10 million and a government made contributions equal to 5 percent of all employer⁷ contributions to the plan, that government's *proportionate share* of the liability would be \$500,000 ($\$10 \text{ million} \times 0.05$).

As with other aspects of measuring the liability, the proportionate share is based on assumptions about how much a government will contribute to the plan relative to the total contributions of all participating governments. In any particular year, therefore, the actual proportionate share may be higher or lower than the expected proportion, which causes that government's liability to be higher or lower. Like the factors discussed in the preceding section, that change in the liability is reported as a deferral and introduced into pension or OPEB expense gradually.

For instance, if the total number of members in the plan increases during the year but one government's number remains the same, despite assuming the number and the related contributions would grow, that government's contributions likely will be less than expected and a smaller share of all contributions.

⁷ The total contributions to the plan may also include contributions from nonemployer contributing entities – primarily governments – that make contributions to the plan on behalf of the employees of other governments. For example, some state governments make contributions to the pension plans of teachers employed by local school districts.

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Consequently, that government's actual proportionate share of the liability would be less than expected, with the difference initially reported as a deferred inflow.

Changes in contribution proportion

Actual experience over time may lead to a government changing its assumption about its proportion of contributions to the plan. Like other changes in assumption, a change in contribution proportion directly affects the measurement of a government's liability; a larger proportion increases the liability, all other factors being equal, and a smaller proportion reduces the liability. That change in the liability is reported initially as a deferral and brought into pension and OPEB expense over multiple years.

An example of pension-related deferrals

An illustration should help to visualize how the preceding deferrals are determined and reported. A government reduces its assumption about annual salary growth from 3.0 to 2.5 percent to better reflect actual salary increases over the past decade. That change in assumption reduces the projected future benefit payments to retirees, which reduces the pension liability by \$5 million. The average remaining years of service for current employees and retirees in the plan is four years. The government would:

- ✓ Initially report a deferred inflow for changes in assumptions of \$5 million
- ✓ Starting in that same year, and for the next three years, reduce the deferred inflow and pension expense by \$1.25 million ($\$5 \text{ million} \div 4 \text{ years}$) annually

Pension and OPEB contributions after the measurement date

For practical reasons related to the need for coordination between governments and pension plans and the length of time it takes to perform the calculations necessary to measure a pension or OPEB liability, the accounting standards allow governments to measure those liabilities as of a date as early as one year prior to fiscal year-end. For instance, a government measuring its liability for the fiscal year ending June 30, 2023, could measure the liability as of June 30, 2022.

Consequently, the contributions the government makes to the pension plan during the year occur after the date on which the liability was measured and, therefore, are not reflected in the amount reported for the liability in the financial statements. For those contributions made after the measurement date, governments would:

- ✓ Initially report a deferred outflow for contributions after the measurement date
- ✓ Reduce the following year's pension liability and eliminate the deferred outflow

Differences between expected and actual investment income

Another of the assumptions that feeds into the measurement of the pension and OPEB liabilities is how much income the contributions to the plan will earn when invested. That assumption is called the *long-term expected rate of return*. As with the other long-term assumptions, the actual investment earnings in any year are likely to be higher or lower because the assumption is an *average*. When the actual investment earnings are higher than expected, the liability in excess of the plan's assets is smaller than expected; when the actual investment earnings are lower than expected, the liability in excess of the plan's assets is greater than expected.

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If a government has selected an appropriate investment return assumption, the greater returns in some years will offset the lower returns in other years and, thereby, achieve the expected returns over the long run. For that reason, whereas there can be *both* deferred inflows and deferred outflows related to changes in assumptions, experience gains and losses, differences between expected and actual proportionate shares, and changes in contribution proportion, there can only be *either* a deferred inflow or a deferred outflow related to investment returns.

Because assumed investment returns factor into the measurement of the pension and OPEB liabilities, those returns already are incorporated into pension and OPEB expense. By acknowledging that some or all of the annual ups and downs in investment earnings will offset, only the *net* amount by which actual earnings exceed or fall short of assumptions over time is reported as a deferral that adds to or reduces pension and OPEB expense. The accounting standards require all governments to bring that deferral into pension and OPEB expense over five years.

Another example should help to illustrate how governments report this deferral. The amounts in column A of Figure 8 are the differences between actual and expected investment earnings in 2023–2028.

- In 2023, actual earnings were \$20 million below expected returns, resulting in a *deferred outflow* of the same amount (column B) that *adds* \$4 million to pension expense (column C, \$20 million ÷ 5 years).
- In 2024, actual earnings were \$25 million *above* expected returns (column A). The remaining deferred outflow from 2023 was \$16 million after the \$4 million was added to pension expense. Subtracting the 2024 excess earnings of \$25 million results in a *deferred inflow* of \$9 million. That deferred inflow divided by 5 *reduces* pension expense in 2024 by \$1.8 million.
- In 2025, actual earnings were \$45 million *below* expected returns (column A). The remaining deferred inflow from 2024 was \$7.2 million after the \$1.8 million reduced pension expense. Adding the 2025 earnings shortfall of \$45 million results in a *deferred outflow* of \$37.8 million. That deferred inflow divided by 5 *adds* \$7.56 million to pension expense in 2025.

Figure 8
(dollars in millions)

	(A) Expected Minus Actual Earnings	(B)* Deferred Outflow (Inflow)	(C) Expenses (B ÷ 5)						
			2023	2024	2025	2026	2027	2028	
2023	\$20,000	\$20,000	\$ 4,000						
2024	(25,000)	(9,000)		\$ (1,800)					
2025	45,000	37,800			\$ 7,560				
2026	(35,000)	(4,760)				\$ (952)			
2027	15,000	11,192					\$ 2,238		
2028	(5,000)	3,954							\$ 791

* B = prior year's B – prior year's C + current year's A

The same pattern continues in 2026–2028. Comparing the amounts in column A with those in column B reveals how the earnings-related deferrals allow for annual earnings above and below assumptions to offset each other, rather than inflate or deflate pension and OPEB expense each year. The years that best exemplify that effect are 2024 – expenses are reduced by \$1.8 million rather than \$5 million (\$25 million ÷ 5) – and 2026 – expenses are reduced by \$952,000 rather than \$7 million (\$35 million ÷ 5).

What Does Deferral Information Communicate About a Government's Finances?

The reporting of deferrals in government financial statements essentially is a win-win scenario because they provide potentially valuable information and, at a minimum, do not in any way diminish the value of other information. The reader of the financial statements does not need to conduct a deferral hunt because governments are required to separate them in the financial statements. If one chose to ignore deferrals, one would still be able to use all of the other information for one's desired purpose.

Ignoring deferrals and the messages they communicate about a government's finances may, however, deprive one of valuable insights. There are at least five reasons why it is beneficial to pay attention to deferrals:

- Deferrals safeguard the reader from mistaking financial statement items for assets or liabilities.
- Deferrals improve the accuracy of financial ratios.
- Deferrals may offer clues as to a government's ability to collect its receivables.
- Deferrals provide a heads up as to trends in future pension and OPEB expenses.
- Deferrals assist with the evaluation of interperiod equity.

Misidentifying assets and liabilities

The items that are required to be reported in financial statements as deferrals are not assets or liabilities. They are not resources that can be used to provide service or sold or invested to generate income to finance services. Nor are they amounts that a government will need to pay off or otherwise satisfy. When they used to be reported among the assets and liabilities, the items that are now deferrals usually were not easy to identify. Consequently, the asset and liability amounts in the financial statements potentially were overstating the resources governments could call upon and the bills that would have to be paid in the future. Sometimes, the overstatement could be significant enough to alter the conclusions one would draw about a government.

A stark example of that is what used to be called *deferred revenue*. Deferred revenue was reported among the liabilities and often was a combination of (1) liabilities and (2) revenues waiting to be recognized. Unfortunately, there was no way for readers to distinguish them. Many readers would therefore remove or ignore deferred revenue when analyzing the financial statements, trading overstated liabilities for understated liabilities in the process.

Figure 9 shows a portion of a governmental funds balance sheet before and after the requirements for deferrals were introduced. In this example, almost all of the items reported as the deferred revenue liability were not actually liabilities; \$7.9 million of the \$9.3 million reported as liabilities (85 percent) would now be reported as "deferred inflows—unavailable revenue." Overall, the liabilities reported in the general fund were overstated by 121 percent and the liabilities for total governmental funds were overstated by 106 percent. It is not difficult to imagine that a reader might draw very different conclusions about this government after the hidden deferrals were revealed.

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Figure 9

	General	Federal & State Grants	Economic Development	Capital Projects	Total Governmental Funds
Before Deferrals					
LIABILITIES AND FUND BALANCES					
Liabilities:					
Accounts payable	\$ 3,408,680	\$ 129,975	\$ 190,548	\$ 2,179,463	\$ 5,908,666
Due to other funds	—	25,369	—	—	25,369
Payable to other governments	94,074	—	—	—	94,074
Deferred revenue	4,250,430	4,837,446	250,000	11,000	9,348,876
Total liabilities	7,753,184	4,992,790	440,548	2,190,463	15,376,985
After Deferrals					
LIABILITIES, DEFERRED INFLOWS OF RESOURCES, AND FUND BALANCES					
Liabilities:					
Accounts payable	\$ 3,408,680	\$ 129,975	\$ 190,548	\$ 2,179,463	\$ 5,908,666
Due to other funds	—	25,369	—	—	25,369
Payable to other governments	94,074	—	—	—	94,074
Advances on grants	—	1,435,599	—	—	1,435,599
Total liabilities	3,502,754	1,590,943	190,548	2,179,463	7,463,708
Deferred inflows of resources:					
Unavailable revenue—taxes	4,250,430	—	—	—	4,250,430
Unavailable revenue—grants	—	3,401,847	250,000	11,000	3,662,847
Total deferred inflows of resources	4,250,430	3,401,847	250,000	11,000	7,913,277
<i>Overstatement of liabilities before deferrals</i>	121%	214%	131%	1%	106%

Accuracy of Financial Ratios

Given that potential for overstating assets and liabilities, it follows that the removal of deferrals from the assets and liabilities also improved the accuracy of the financial ratios that readers calculate using asset and liability information. For example, a commonly used ratio is *total liabilities divided by total assets*. It is a *leverage* ratio that indicates the extent to which a government's assets are financed by incurring liabilities, such as by purchasing on account or borrowing. All other factors being equal, a government that is less leveraged (has a lower leverage ratio) is less burdened with the cost of repayment and is better able to afford more borrowing, if necessary.

Total assets for the general fund in Figure 9 were \$9,460,102. If one were to calculate the *total liabilities divided by total assets* ratio for the general fund, the results would be markedly different before and after the introduction of deferrals because of the significant overstatement of the deferred revenue liability. Prior to deferrals, the ratio would have been 82 percent ($\$7,753,184 \div 9,460,102$), whereas after deferrals the ratio would be 37 percent ($\$3,502,754 \div 9,460,102$). The latter result indicates a substantially less leveraged government.

Ability to Collect Receivables

Recall that unavailable revenue is a deferred inflow that represents resources a government is owed but did not receive during the fiscal year or within the period of availability beyond fiscal year-end. Tracking the size of deferred inflows for unavailable revenue relative to the amount of revenue reported may inform whether a government's ability to collect the money it is owed is improving or declining over time.

Figure 10 calculates a ratio by dividing the unavailable grant revenue deferral by total grant revenues for an eight-year period. At least two things immediately catch the eye. First, between 2014 and 2018, it appears to have taken this government a long time to collect on its grants. Between 40 and 50 percent of the grants that it was owed were not collected until beyond the period of availability. That may send up a red flag that bears

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further exploration. Is the government not processing its grant requests in a timely manner? Is the grantor not making its grant payments to the government in a timely manner? A combination of both?

Figure 10

	2014	2015	2016	2017	2018	2019	2020	2021
Deferred inflow: unavailable revenues - grants	\$ 44,405	\$ 35,513	\$ 33,433	\$ 36,642	\$ 38,480	\$ -	\$ 6,361	\$ 1,447
Grant revenues	\$ 88,251	\$ 83,348	\$ 76,448	\$ 79,726	\$ 81,431	\$ 86,005	\$ 102,592	\$ 104,933
Unavailable revenue ÷ revenue	50.32%	42.61%	43.73%	45.96%	47.25%	0.00%	6.20%	1.38%

Second, something significant occurred in 2019 that also may bear following up on: The government had no unavailable grant revenue in 2019, and the amounts in the following two years were considerably smaller relative to earlier years. What happened? Were the issues causing the delays in grant payments resolved? Alternatively, do those issues remain but are not as readily apparent because the government extended its period of availability to encompass grant payments received well after the end of the fiscal year? Either way, the answers to those question may be relevant to a reader’s interests in the government.

Trends in Future Pension and OPEB Expenses

Governments are required to disclose in notes to financial statements the balances for their pension- and OPEB-related deferrals, disaggregated by each of the factors discussed above. Additionally, governments disclose the aggregate amount by which pension and OPEB expense will increase or decrease due to those deferrals for each of the next five years and in five-year increments after that. Those notes can be used to assess future trends in pension and OPEB expense and how they are affected by changes from year to year in the deferral balances.

Figure 11 illustrates a government’s disclosure of pension deferrals for two consecutive years. One of the notable changes is a shift related to the difference between expected and actual investment earnings from a deferred outflow of \$16.1 million to a deferred inflow of \$37.5 million – a total change of \$53.1 million. A quick look at the government’s required supplementary information schedule of changes in the pension liability over the past 10 years likely will show substantial earnings above expectations in the most recent year.

Figure 11
(dollars in millions)

	2022		2021	
	Deferred Outflows of Resources	Deferred Inflows of Resources	Deferred Outflows of Resources	Deferred Inflows of Resources
Differences between expected and actual experience	\$ 25,638	\$ 8,075	\$ 26,744	\$ 5,291
Changes of assumptions	11,859	-	17,358	-
Net difference between projected and actual earnings on pension plan investments	-	37,508	16,095	-
City contributions subsequent to the measurement date	64,676	-	21,874	-
Total	\$ 102,173	\$ 45,583	\$ 82,071	\$ 5,291

What impact will that change in the earnings-related deferral have on the government’s pension expense in the near term? The note disclosures illustrated in Figure 12 show what would be expected based on the prior discussion of these types of deferrals: The change in the earnings-related deferral was so substantial that the

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expected impact on pension expense *for all deferrals combined* changed from increases in expense each year to either decreases or significantly smaller increases. For example, the 2021 disclosure shows an expected addition to pension expense for 2023 of \$13.3 million, but in the 2022 disclosure that addition is a mere \$306,000. The expected addition to expense of \$11.3 million in 2024 has become a reduction of pension expense of \$1.7 million.

Figure 12
(dollars in millions)

2022			2021	
Fiscal year ending June 30:			Fiscal year ending June 30:	
2023	\$ 306	←	2022	\$ 12,187
2024	(1,738)	←	2023	13,322
2025	(3,721)	←	2024	11,278
2026	(9,441)	←	2025	9,295
2027	925		2026	3,575
Thereafter	5,583		Thereafter	5,249

Interperiod Equity

As previously noted, deferrals are an essential part of enabling financial statement readers to evaluate whether a government is living within its means from year to year – interperiod equity. That evaluation is dependent on revenues and expenses being reported in the correct years. One major impact that deferrals have with regard to interperiod equity relates to property taxes levied in advance of the fiscal year they are levied for. As explained earlier, deferrals are reported to avoid reporting next year’s property tax revenues in the current year. If property tax revenues were reported whenever a government has a legal claim to payment, regardless of what year those taxes are levied for, it would undermine the reader’s ability to assess interperiod equity.

The effect of these types of deferrals is also apparent for agreements like leases and service concession arrangements (SCAs), which often last many years and may involve a government receiving an upfront payment. The accounting requirements ensure that a transaction that provides resources to a government for multiple years will be reported as revenue throughout the course of the agreement and not entirely at the start of the agreement when cash prepayments and receivables are reported. Recall that a government acting as a lessor reports a lease receivable when the lease term begins but does not immediately report the full amount as revenue; instead, it reports a deferred inflow and spreads the revenue reporting across the years of the agreement. If the government had received a prepayment from the lessee related to the years during the lease term, that too would be deferred and reported as revenue over the full lease term.

Governments engaging in such multi-year transactions that result in the reporting of deferrals will show those deferrals separately from other types of deferrals either on the face of the financial statements or in a note to financial statements. The amount of the deferred inflow that is disclosed for leases can be compared with information about how many years remain on the transaction (in the separate note about the transaction). That comparison can inform the reader about how much the transaction will contribute to a government’s ability to achieve interperiod equity going forward. For example, if a government’s deferral note shows a balance on an SCA deferred inflow of \$50 million and the SCA note indicates that 25 years are left on the agreement, one can ascertain that the transaction will contribute revenue of \$2 million annually for the remainder of the transaction term.