Federal Accounting Standards Advisory Board

July 31, 2003

TO: Members of FASAB

FROM: Robert Bramlett

THROUGH: Wendy Comes, Executive Director, FASAB

SUBJECT: 1996 draft GASB staff paper on elements of financial statements

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FASAB members have expressed interest in defining the elements of federal financial reporting. Because GASB has devoted considerable time and effort to such a project, it should be instructive to investigate what lessons might be learned about how to approach such a project as well as the implications of the definitions *per se*. Ms. Penny Wardlow, the principal GASB staff person who worked on this endeavor until recently, will be with us at our August meeting. A copy of her resume is enclosed.

The enclosed GASB staff paper was developed to support GASB's deliberations in 1996 in one of two projects GASB intended to lead to statements of accounting concepts. (The paper's opening reference is to GASB's November 1995 meeting.) The companion project dealt with communication methods (FASAB might say "reporting categories") such as basic financial statements, notes, and RSI. GASB has not yet published a final statement of concepts on either subject, but the ideas discussed in the projects have to some extent served as "tools" for GASB in its deliberations on various statements of standards. The drafts, though not published, have been widely available to people interested in following the GASB's deliberations. At the same time, GASB's deliberations in other projects have influenced its thinking about concepts.

For example, the enclosed 1996 paper proposed to change traditional definitions of "entity" and "fund" so that that a "fund" would be defined as an accounting "construct" rather than an "entity." The paper proposed that funds would account for "resources" and "obligations" rather than "assets" and "liabilities." GASB has not adopted those proposals in its subsequent standards such as GASBS 34. Presumably, therefore, a final statement on elements might differ

from the provisions of the 1996 draft. For example, a subsequent draft paper from GASB staff offered revised definitions for consideration:

> **Legal entity**: A governmental unit with separate legal standing.
>
> **Accounting Entity**: an economic unit for which accounts are maintained for the purpose of recording and reporting on the unit's financial activity.
>
> **Fund**: an accounting entity featuring an articulated set of accounts for recording fund resources, fund obligations, net fund resources, and the changes in them, which are segregated for specific activities or to meet certain legal or administrative objectives or restrictions.

A discussion of GASB's ideas and deliberations on elements should be relevant to FASAB. However, I do not mean to imply that either GASB's definitions or its approach are necessarily right for us. Indeed, my own perspective is rather different on some points. For example, the 1996 GASB staff draft said:

> . . . it is very important to the success of the elements statement and the conceptual framework as a whole that the definitions are not tied to any particular financial reporting model, such as the current model or the dual-perspective model proposed in the Board's 1995 *Preliminary Views* on the core financial statements . . . [page 2, emphasis in original]

This comment may seem reasonable, and appears consistent with the FASB's approach to its conceptual framework project, in which FASB early concluded that the definition of asset had "conceptual primacy."

On the other hand, my observations during 1986-89 of GASB's early deliberations on "measurement focus/basis of accounting" (leading to GASB Statement 11, which was deferred and superseded before its effective date) caused me to believe that it is probably not advisable--and perhaps not possible--to deliberate such matters entirely independently. Indeed, I would speculate that GASB might have been reluctant to finalize its conceptual statement on elements, at least in part, precisely because it was in the process of revising its reporting model.

Participants in those deliberations each had beliefs about the primary uses and users, or the primary decision makers and decision models, to be served. Put another way, they had beliefs about the objectives to be addressed. Ideas about objectives, reporting methods, elements, recognition, and display issues are interrelated. (Those interested in more detail about this history and interrelationship, at least as I perceive it, may read endnote 2 on page 4.)

It is possible, of course, to discuss different topics simultaneously, but in different papers. Over a period of years, as GASB discussed the draft "elements" paper, it also discussed the draft "communications methods" paper. The two projects have been separate, but proceeding on more-or-less parallel tracks while GASB deliberated recognition, measurement, and disclosure issues in various other projects. Likewise, FASAB initially adopted an approach that involved discussing the reporting model at the same time it discussed recognition and measurement.

FASB did define elements in a separate statement of concepts, but I would suggest that FASB, more than FASAB and perhaps more than GASB, began its work within the context of a relatively well-defined and widely accepted "reporting model." FASB also works within the context of considerable agreement about the primary users' information needs to be served. FASB has therefore been able to address its reporting model issues in a more evolutionary way.

The business of promulgating accounting standards involves both deductive and inductive elements. One might say that the approach exemplified in the draft GASB staff paper, like FASB's to some extent, emphasizes a deductive approach. And one might say that FASAB's initial approach relied somewhat more on an attempt to infer concepts and standards by induction from current practices and what was known or believed about users' information needs.

At least that is my impression; I don't claim more than that. No doubt the Board should employ both approaches to some extent to assure clear communication with users and clear deliberations.

Endnote 1: On the word "Proprietary"

The GASB staff draft uses the term "proprietary funds" as it was traditionally used in state and local governmental accounting, to refer to funds that use "business type" accounting, i.e., those that measure maintenance of financial capital. In federal terminology, "proprietary accounting" has traditionally been used to refer to accounting for those aspects of the financial transaction cycle that are not part of budgetary accounting. Thus, in particular, proprietary accounting implies accounting for assets and liabilities.

I recall seeing an old accounting text that referred to accounting as the "king" of management information systems. Probably that would not be asserted today, even in the private sector. In the federal government, most people would say that the budget process is king, with accounting, especially "proprietary accounting," historically relegated to a servant's role. Still, some servants can be important. The steward of the royal household, after all, was an important official. In that sense, perhaps it is natural for federal proprietary accountants to value "stewardship" as a function and objective.

Endnote 2: On the interrelationship among objectives, reporting model, elements and recognition in deliberations

Most of what follows recounts the history of some accounting issues in the state and local governmental arena. Accordingly, Board members should feel free to skip over this. I include it nevertheless, because it may illustrate some factors to consider in the federal context.

Traditional focus on funds control

Prior the creation of GASB's predecessor body, the National Council on Governmental Accounting (NCGA), the municipal governmental accounting model had evolved as a set of practices designed to meet the needs of municipal finance officers. Having served in that role, I can assert that those needs include (starting with the most pressing):

1. Making sure that checks don't bounce (which involves managing revenues, expenditures, and financing).

2. Telling elected officials how much spending they can authorize in the budget.

3. Making sure that the budget is executed in accordance with law, and avoiding headlines about operational problems, theft, fraud, waste, or abuse.

4. Answering questions from bond rating agencies about financial matters (e.g., compliance with debt covenants regarding revenue/debt service ratios, etc.).

5. Answering questions from elected officials about financial matters (e.g., "How much money has been collected and spent from the special assessment to pave sidewalks in my district?").

6. Answering questions from the news media about financial matters (e.g., "How much money has been collected and spent from the special assessment to pave sidewalks in a given neighborhood?").

7. Answering questions from citizens about financial matters (e.g., "How much money has been collected and spent from the special assessment to pave sidewalks in my neighborhood?").

8. Answering questions from the auditor.

I suspect that in the past most federal financial managers would relate to many of these objectives, except that:

(1) Most of them could rely on the Treasury Department to assure that checks don't bounce; instead they must assure compliance with the anti-deficiency act, and

(2) Most of them could rely on the Treasury Department to answer questions from capital market participants (not rating agencies) about anticipated sales of debt securities.

If left unanswered, questions in categories 7 and 8 can easily become category 5 or 6 questions. Questions in category 4 are (at least in my experience) less common than I would have expected—perhaps because standardized forms of special reporting (e.g., in bond offering statements) have evolved to assure that the answers are routinely provided. Questions in category 5 were less common that I would have expected as well—perhaps because elected officials are mainly interested in question number 2, unless an auditor, the news media, or citizens have elevated an issue.

As a result of these and similar operational demands from the environment, municipal accounting focused on funds control, legal compliance, and "spendable available resources." Information about current financial resources was displayed in columns arrayed by funds, supplemented with a column for long term debt and another for general fixed assets. Probably most elected officials did not focus on details of how "spendable available resources" differed from cash or from budgetary resources, but most had an intuitive understanding of the concept. Information about cost of services and about the financial position of the government as a whole were regarded as potentially useful supplementary information for special analyses, but outside the requirements of generally accepted municipal accounting requirements.

Attempts to add accruals

In 1983 the Council of State Governments published *Preferred Accounting Practices for State Governments*, which proposed moving toward a full accrual operating statement by reporting the accrual expense of pensions in the fund operating statement, with the unfunded/nonbudgeted portion of the annual accrual being shown as an increase in long term liabilities reported the long-term debt column, not as a fund liability. Thus the fund would continue to focus on current financial resources, yet an accrued (not bonded) long-term liability for any accumulated underfunding would be reported for the entity as a whole. The state proposal dealt simultaneously with recognition and display as a way to report more information about accrual-based expenses and liabilities while letting fund accounting continue to serve its customary role in its customary way.

Also in 1983, the National Council on Governmental Accounting (the predecessor to GASB) published a pension accounting standard (NCGA Statement 6) which some people interpreted as implying a similar result. This change proved to be unpopular with many people involved with state and local governmental accounting, and (after membership on NCGA changed when Marty Ives left to help found GASB), later in the same year NCGA published its Interpretation 8, *Certain Pension Matters*, which restored the *status quo ante*. This meant that there was no accrual based on an actuarial computation beyond the amount actually contributed to the pension fund.

When GASB subsequently took up its projects on "measurement focus/basis of accounting," (MFBA) and pension accounting, it did not simultaneously deal with display. For that reason, I believe, proposals to accrue new liabilities in the fund were confusing to some observers. The uses and objectives of the proposed approach were not clear to them. Others perceived the proposals as potentially obscuring or even destroying the traditional role, function, and message of fund accounting. For example, accruing a large pension liability, without some reporting mechanism such as had been proposed in 1983, would presumably imply reporting a fund deficit unless current financial resources were collected and held to match the accrual. Fund deficits were normally interpreted as major problems, and often were prohibited by law. Hence, some people saw proposals to accrue noncurrent liabilities in the funds, rather than reporting them in the long-term debt account group, as an attempt to set normative policies for budgeting and financial management.

In my opinion, GASB's attempt to deliberate MFBA without explicitly redefining the objectives of fund accounting, or explaining how the traditional functions would be met, or explaining the display or reporting model contemplated, led to unnecessarily protracted and obscure debates. In 1990 GASB published its new MFBA as Statement of Standards number 11, but it was deferred by GASB 17 before it became effective, and ultimately superseded by other GASB standards, including, in particular, Statement 34, which defines the "new model" for state and local governmental accounting.

GASB was able to deal with pension accounting before completing GASB 34, but when it did so it followed a "funding oriented" approach to defining the pension accrual. Because the pension recognition deliberations were not decoupled from the traditional reporting model, the resulting standards can be seen consistent with as an attempt to set normative policies for budgeting and financial management. Some observers, perhaps including Ms. Wardlow, who replaced me as the project manager on GASB's pension accounting project, would no doubt dispute this characterization.

I do not mean this characterization as a criticism. It can be seen as a decision by GASB to emphasize some unique aspects of the state and local governmental environment. If one understands governmental accounting as a social endeavor that plays various roles, and that coordinates the various actions and decisions by many people and groups in addition to capital market participants, then it may be wise to reflect those considerations when promulgating governmental accounting standards. Certainly some caution about imposing a conceptual construct designed for financial reporting to capital markets may be in order.

One might describe GASB's decision as emphasizing reporting to political markets over reporting to capital markets. GASB Statement 5 (since superseded) and its poorly-received *Preliminary Views* on pension accounting were efforts to compromise to meet the needs of both markets. Those efforts were handicapped, in my opinion, by the Board's decision not explicitly to discuss at the same time some related issues and options regarding the reporting model and the objectives of accounting.

With GASB 34, GASB retained much of the traditional fund accounting structure, in response to comments from many participants in due process. The objectives, uses and users for this information are well known. At the same time GASB added new reports on an entity-wide basis, which are intended to provide more information about cost of service and about the financial position of the reporting entity. I am not aware of any empirical evidence in the academic literature about who uses this information, for what purpose, and to what effect, but it is too early to expect that.

Implications for FASAB

I recount this history to explain why I believe that deliberations about objectives, elements, and reporting model are interdependent. It is impossible to consider everything at once, yet an effort to go too far with one without considering the others may also create problems. I think FASAB tried, with some degree of success, to deal with them simultaneously during its early years as it deliberated on recognition and reporting model issues.

In recent years FASAB has revised its original model, for example by eliminating reporting on "stewardship responsibilities" and "national defense PP&E" and adding a

new basic statement, the Statement of Social Insurance. In a sense, the "stewardship" categories functioned like elements of financial reporting, but were not defined as such because they were not recognized on the face of the basic financial statements. It now appears that the category will soon be entirely eliminated. Such changes are to be expected. It may continue to be useful, however, to consider reporting model or display options while we consider elements and recognition, as indeed the Board plans to do.

For example, proposals have been made in both academic and popular literature that imprecise accruals might be shown separately from "hard" numbers that can be verified, by using columnar presentations.[1] This might lead to a display superficially similar to the old state and local governmental accounting model, albeit quite different in other respects. I have been told that the IASB is investigating somewhat similar ideas, and that FASB may do so.

This idea may be relevant when the Board revisits recognition in its new project on accounting for social insurance. Alternatively, imprecise accruals could be shown in a horizontal "pancake" display. Or, in a manner similar to FAS 87, the Board might elect to require recognition of some "minimum" liability that it believes warrants recognition, with footnote disclosure of less precise projections of other amounts.

It likely will also be important to consider the definition of elements in conjunction with the new social insurance project. For example, the Board may want to consider, among other options:

- Modifying SFFAS 5's current definition of liability, recognizing a liability for social insurance, and eliminating the Statement of Social Insurance, or

- Retaining the Statement of Social Insurance and defining one or more new elements of federal financial reporting corresponding with the actuarial present values reported in the Statement of Social Insurance. This in turn might imply a need to consider whether to define "basic financial statements" and "recognition."

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[1] A. "CEO/CFO Certification and Emerging Needs to Separate Facts and Forecasts: Exploring 'Intertemporal Financial Statements' with Two Time-Phases," unpublished paper by Jonathan C. Glover, Yuji Ijiri, Carolyn B. Levine, and Pierre Jinghong Liang.
B. "True and fair is not hard and fast," *The Economist*, April 26th 2003.
C. See IASB project description regarding the reporting performance at:
http://www.iasc.org.uk/cmt/0001.asp?s=9521775&sc={8288A18C-DC60-4BC7-B8FC-68B3B3CAEEEF}&n=66